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Dear Joe and James,

PrePayPower, as Ireland's largest prepay electricity provider, welcomes the opportunity to contribute to the SEM Committee "Forwards and Liquidity" Discussion Paper (SEM-15-10).

PrePayPower is most interested in the incentives and potentially the obligations to participate in the forwards market, and the promotion of spot market liquidity for the day-ahead market and the intraday market.

The discussion paper covers:

- Existing failures, potential fixes and requirements for the new internal forwards market, along with the potential for regulatory intervention;
- The incentives around spot market participation (day-ahead and intraday). Here the paper is focussed on structural incentives, rather than regulatory intervention; and
- Cross-border design of the FTRs.

Forwards Market

Ireland and Northern Ireland has a strongly functioning retail market, despite having poor levels of available hedging, with the hedging that is available requiring high collateralisation. There are also restrictions in the retail market in Ireland on how quickly prices can be changed to end consumers. This has driven most utilities towards vertical integration.

This market scenario (restrictions on changing prices to end customers, combined with a lack of hedging for non-vertically integrated suppliers) can be allowed to continue on the basis that the existing SMP is highly correlated with international fuel prices, and input fuel price shocks have been rare[1]. The existing SEM is also structurally designed and regulated to minimise the impact of trading market behaviour on outcomes. As a result, both jurisdictions enjoy the competition arising from a large number (for the size of the retail market) of suppliers, both vertically integrated and non-vertically integrated, serving customers. The spot market outcomes have been sufficiently benign.

Vertical integration requires either investment in your own generation, or procuring power from a renewable generator[2] under an Intermediary arrangement. The renewable generation sector – which represents all independent generation entry – contracts using physical Intermediary Power Purchase Agreements (PPA) due to the requirements of renewable subsidies (REFIT sale to an Irish licensed supplier, the ROC relevant arrangement). The physical PPA sector remains non-regulated and is not – to PrePayPower's knowledge – actively monitored by the SEM Committee for signs of concentration or market power issues. This portion of the market is becoming more important with increased renewable penetration on the island.

It appears likely that within the ISEM there will be some relaxation of the Bidding Code of Practice BCOP), not least due to EUPHEMIA Order design and market coupling with neighbouring zones where no equivalent BCOP obligations exist. Participant discretion in behaviours will become a greater element of price discovery and formation. Therefore, in relation to the Spot Markets:

- Market power concerns increase – all other things being equal – due to the new behavioural element in price formation;
- With increased potential for behavioural market power, greater regulatory involvement is required to ensure the incentives to exercise such power are minimised;
- The EUPHEMIA outcomes are currently unproven for the ISEM, particularly with the influence of neighbouring zone's influences on those outcomes;
- The interaction of forward contracting terms with the Reliability Options hedging against ex ante pricing are not yet clear; and
- The liquidity and pricing of the intraday market also remains unclear.

Within the above context, PrePayPower views that regulatory involvement with the forwards market design and operation cannot be ruled out at this stage. It would place too much of a burden of faith on market participants that the market structural incentives will naturally create a vibrant forwards contracting market. The level to which regulatory intervention can ultimately fall will only become known once the above elements are resolved, which in PrePayPower's view will be several years into the new market operation. To that end, PrePayPower advises Regulatory involvement with:

- The formation of a forwards market for the ISEM;
- Interaction with the forwards contract design within that market so they can be traded between all parties, e.g. irrespective of whether they hold a Reliability Option or not;
- Cross-collateralisation of the forwards market with the subsequent markets in all timeframes, to reduce collateralisation costs; and
- Continued existence of market-maker obligations on larger players with conventional generation, tied into management of market power.

[1] The March 2013 price spike in gas is an example of one such price shock.
[2] No merchant conventional generation has occurred, although some are planned by developers.

Forwards Market – Interaction with Smart Metering

Particularly within the context of the Ireland retail market, the Smart Metering Programme has proposed mandatory Time-of-Use retail tariffs. It is vital that hedging consistent with this obligation is available to retail suppliers, or it could undermine the smart metering programme. It would be unfortunate if a regulator mandated a supplier to offer a retail tariff shape to end customers, oblige that supplier to observe notice periods before changing the rates of that tariff, while taking a hands-off role in the evolution of appropriate forwards markets at the SEM Committee level.

Spot Markets

The main drive for active participation in the spot markets appears to be focussing on suitable is participants' desire to have "appropriate" signals in the balancing market, and for participants not to be "sheltered" from those signals.

We note our response to the Building Blocks consultation (SEM-15-11) which potentially has raised structural market design features (around curtailment and non-firm access) that actually create incentives <u>not</u> to trade in ex ante spot markets. This interaction is not captured in this paper, and we don't believe these incentivise are consistent with this discussion paper's intent. We further suggest that items such as compensation for curtailment can rather be used as an incentive for trade in ex ante timeframes, rather than a potential incentive not to trade in ex ante timeframes.

We also look at the positive incentives of the Reliability Options for both generation and demand. We have suggested payment of a regulated Reliability Option fee for variable renewable generation to promote ex ante trading in previous consultation responses to the High Level Design. Further consideration of how the one-way CfD payments made by generators are recycled back to suppliers will also impact on trading decisions in ex ante markets.

Overall, PrePayPower would like to emphasise that over-reliance on the imbalance price to incentivise near-term spot market liquidity is a high risk strategy for a market that has a high proportion of renewable generation and non-vertically integrated suppliers. This risk is exacerbated with a short market trial, and little detail as yet available as to neighbouring zones' participation in that trial. Ideally incentives to trade ex-ante should be balanced between the extra value seen when trading ex ante, against the extra risk when cashing out ex post.

Interconnector Financial Transmission Rights

PrePayPower requests further information on the cross-border elements of the market plan for trading on Interconnectors, in particular engagement with Ofgem on the agreement on FTRs and initial discussions with CASC/CAO. We note, and agree with, the added complexity of the interaction of Reliability Options with the FTRs, and note that this is an equivalent concern for the internal forwards hedging arrangements, particularly if PrePayPower's preferred outcome of a liquid market in forward futures is to be realised.

Our response is not confidential and may be published in full. If you wish to have further communication in relation to our submission, please don't hesitate to contact me.

Yours faithfully,

Cathal Fay