



**Response by Energia to SEM Committee
Consultation Paper SEM-15-061**

I-SEM Detailed Design - Financial Transmission Rights

19 October 2015

1. Introduction

Energia welcomes the opportunity to respond to the SEM Committee consultation paper (SEM-15-061) on the introduction of Financial Transmission Rights (FTRs) on the I-SEM / GB border. This submission provides Energia's considered views on the questions raised in the consultation paper. Our views are informed by extensive experience trading GB power across the Moyle and EWIC interconnectors to service our customer needs and grow our customer base. We have made every effort to articulate our views clearly and comprehensively in this submission and have put forward considered responses to the questions consulted upon. We would welcome further constructive dialogue with the regulatory authorities (RAs) on these issues.

2. General Comments

2.1 Need for Continuity in Hedging Activities and Transitional Measures

It is vitally important that the RAs ensure there is continuity in hedging activities for generators and suppliers in the transition from SEM to I-SEM. This includes the continuing sale of interconnector capacity and CfDs during the transitional period to ensure participants are not faced with a cliff edge in relation to hedging their exposures in the lead up to I-SEM. There is also a pressing need for well thought through contingency arrangements in the event of a delay to the delivery of I-SEM.

As transitional arrangements are likely to become an issue during the next 6 months we recommend that finding effective solutions to transitional issues should be prioritised within the forwards and liquidity workstream. Energia would therefore welcome further urgent clarification on the approach to managing this area.

2.2 Market Power Concerns

Energia would stress that access to competitively priced, effective risk management instruments is of fundamental importance to the promotion of retail competition under the SEM and I-SEM. There is evidence to suggest that the "super dominant"¹ position of ESB has seriously undermined the development of a competitive, liquid SEM forward contracts market. As observed by Baringa:

*"Analysis of the current SEM forward market indicates exceptionally low levels of market led liquidity and exhibits dynamics that could be indicative of the exertion of market power."*² (P.26)

These dynamics are expected to persist and intensify under I-SEM with the market design further reinforcing ESB's position of dominance in the spot and forward contracts market³. Thus Energia is strongly of the view that a competitive forward

¹ NERA Report, 'Review of Market Power Principles for the I-SEM', 18 June 2015.

² See Baringa Report (April 2014), 'Promoting forward liquidity and mitigating market power in I-SEM'.

³ For example, Energia note the issue of scheduling risk in the day-ahead market, which Energia raised as a significant concern during the HLD consultation, which has now been independently confirmed by SEM-O on p. 63 of their recent report "I-SEM Trialling of EUPHEMIA: Initial Phase Report". Furthermore, we would again emphasise the information asymmetry that will exist in the I-SEM day-

market will not develop organically without regulatory direction and management. The effective management of ESB market power must be a central tenant of this regulatory strategy.

2.3 Role of Interconnectors

Given the chronic issues in the forward contract market outlined above, Energia reiterates the important role interconnector capacity currently plays in I-SEM participant's hedging strategies. We therefore welcome the RAs careful consideration of I-SEM capacity products and further recommend that capacity product offerings, including the lead times for, and duration of, interconnector capacity products are consulted upon as part of the forward and liquidity workstream. This would help to ensure that capacity offerings support participant hedging requirements.

In our response to the Forwards and Liquidity Discussion Paper SEM-15-010 we made the following suggestions:

- An increase in the volume of longer term import capacity products offered on I-SEM interconnectors, for example, quarterly, seasonal and annual products, with longer lead times of up to 6 months ahead of delivery. We note trading of short term products could be facilitated by means of a secondary market.
- The auctioning of monthly import capacity over a 6 month trading horizon to facilitate a lead time to delivery, for example, during each month M auctioning monthly capacity products for delivery months M+1 to M+6.

Adopting such an approach would better facilitate planning of hedging strategies by I-SEM suppliers, and could promote participation in the I-SEM forward contract market by GB participants which could inject some additional liquidity.

Energia, however, would strongly emphasise that access to interconnector capacity in no way removes the need for effective mitigation measures targeting the market power of ESB. This is because the volume of interconnector capacity relative to market demand (i.e. supplier's hedging requirements) is reasonably small and the fact that its effectiveness as a hedging instrument for I-SEM suppliers is contingent upon I-SEM / GB market price differentials.

2.4 Netting of Collateral

Energia would welcome proper consultation on collateral arrangements for the I-SEM and strongly support netting of collateral across I-SEM interconnectors, and with other I-SEM markets, where practical. As a general principle, optimising collateral requirements to the minimum necessary will help promote trade and generate liquidity, which in turn will support market access and therefore competition. We therefore request that this objective is considered as part of the development of capacity allocation platforms.

ahead market (i.e. the benefit accrued by ESB due to their large generation portfolio and also their large retail supply position, which, under the I-SEM design, will have the opportunity to be price making), and the consequent pressing need for this to be properly considered and addressed by the market power mitigation workstream.

3. Response to Consultation Questions

Question 1: Which offers the greater benefits to the I-SEM/GB market: FTR Options or FTR Obligations?

The ongoing chronic liquidity issues in the I-SEM forward market mean it is essential that FTRs provide participants with an effective risk management instrument to hedge price differentials between the I-SEM and GB markets. Furthermore, that the FTR product design does not raise barriers to efficient cross border trade due to the imposition of unmanageable risk, or onerous credit terms for FTR holders.

Given that valuation of FTR options requires participants to accurately forecast hourly market price spreads, Energia observe that obligations may be easier to value for participants, at least for baseload product offerings, and therefore may provide a more effective hedging instrument. FTR Obligations, however, are likely to confer upon their holders a larger credit burden. It is therefore difficult for participants to make an informed choice between FTR options and obligations without understanding the associated credit arrangements. Energia therefore recommend that the SEM Committee retain the option of implementing FTR obligations in I-SEM until more information on the credit terms for FTR obligations is made available. We discuss the potential system implications of this in our answers to questions 4 and 5 below.

Question 2: What arrangements would be preferred: one FTR between the I-SEM and GB or one FTR per interconnector?

Energia sees significant benefits in implementing one homogenous FTR product on the I-SEM / GB border. We recognise that this could significantly simplify the cross border hedging process, and in so doing, potentially help promote liquidity in the I-SEM forward contract market – i.e. trading of CfDs backed out by FTRs.⁴ However, we note the large difference in loss factors on Moyle and EWIC interconnectors, the potential complications around compensation for curtailment events and the fact that interconnectors are backed by consumers in different jurisdictions. We therefore acknowledge that there is some rationale for separate FTR products for each interconnector.

Energia, however, would stress that, if heterogeneous FTR products are introduced on the I-SEM / GB border, such products should only be differentiated by the treatment of transmission loss factors, and that this differentiation should only be introduced if loss factors are fixed and known by participants prior to the auctioning of capacity products. Energia further emphasise that the timelines for publication of loss factors should not act as a constraint to the offering of longer term FTR products by IC owners, an essential forward hedging instrument for I-SEM participants. Adopting such an approach will minimise any potential impediment to cross border trade. The rationale for this position is explained in more detail in our answer to question 3 below.

⁴ While this would be a welcome outcome Energia strongly emphasise that it would in no way reduce the requirement to properly address the “super dominant” position of ESB in the forward contract market.

Question 3: Should any of the following be discounted from the FTR product payouts?

- **Interconnector transmission losses**
- **Ramping constraints**
- **Curtailement risks**

Our answer to this question should be read in conjunction with our response to question 2 above. Energia recommends the following principles should be applied during the design of FTR products:

- FTR products should seek to minimise potential barriers to cross border trade; and
- FTR products should seek to ensure appropriate allocation of risk between FTR holders, IC owners and, where appropriate, the TSO.

Therefore, in line with these principles Energia recommends that:

- If FTR products model effects of transmission losses then loss factors should be fixed and known by participants prior to capacity auctions;
- Ramping constraints should not be modelled in FTR products; and
- Any transferal of commercial risks from IC owner to FTR holder associated with curtailment should be minimised to avoid distortion of incentives for IC owners.

The rationale for these recommendations is set out in detail below.

Transmission Losses

Modelling of the effects of transmission losses in FTR products could create barriers to cross border trade if transmission losses are not known by participants prior to capacity auctions. This is because auction participants will be unable to accurately forecast the effects of transmission losses on FTR pay outs, creating unmanageable commercial risks for FTR holders. The IC owner, who is afforded protection by consumers, is therefore better placed to manage the commercial exposure in this scenario.

Ramping Constraints

Energia emphasises that FTR payments should not be discounted for ramp rate restrictions. The rationale for this treatment is the same, in principle, to the reasoning presented in relation to transmission losses above.

The financial impact of ramping constraints is unknown by participants prior to capacity auctions and therefore cannot be accurately accounted for in the evaluation process for capacity auction bids, creating unmanageable commercial risk for auction participants, and raising barriers to cross border trade. Energia would therefore again emphasise that the IC owner is therefore better placed to absorb the financial exposure of not adjusting FTR pay outs for ramping constraints.

Energia would further observe that if the ramping constraint is not a physical limitation of the interconnector itself but a limit imposed by the TSO for system management reasons (i.e. a constraint) then the costs associated with ignoring such

ramping constraints in the FTR product design should be allocated to the TSO as a dispatch balancing cost. This could be accommodated by means of a recharge of the costs incurred by IC owners under FTR products to the TSO. Such an approach would ensure that the TSOs are correctly incentivised to optimise the use of interconnectors to support efficient cross border trade.

Curtailment Risks

Energia observe that the rules around treatment of curtailment in the FTR product design are defined by the Network Code on Forward Capacity Allocation but we would strongly emphasise the importance of appropriately defining the concept of “curtailment” for DC interconnectors. For example, the definition of “curtailment” should not include any procedures required to ensure the ongoing prudent operation of the interconnector asset (e.g. testing), or any conditions associated with the provision of ancillary service products (e.g. black start provision). This avoids the inappropriate transfer of costs from interconnector owners to capacity holders. If the definition of “curtailment” is inappropriately defined then it will increase the unmanageable commercial risk faced by FTR bidders, raising further barriers to cross border trade and distorting economic incentives for IC owners.

Question 4: What are the important issues to be considered in deciding on the development of an auction platform?

It is essential that the RAs ensure participants have sufficient access to robust hedging instruments during the transition to I-SEM, including access to FTRs. Therefore any Cost Benefit Analysis (CBA) carried out to determine the most appropriate approach to securing an auction platform needs to properly take into account the substantial loss of control, and consequent significant increase in delivery and implementation risk, of not developing a local I-SEM auction platform, including the potential negative effects delays in the delivery of I-SEM critical functionality in the FUIN or JAO platforms could have on the hedging activities of I-SEM participants. Any CBA should also properly take into account the heightened risk of I-SEM being fully reliant on European mechanisms (some of which are still under development) to deliver critical I-SEM market trading functionality.

Energia would furthermore stress the importance of ensuring that a suitable auction platform is in place a minimum of 3 months in advance of the first FTR auction, which is scheduled for April 2017, to allow robust market testing to take place. It is also important that the RAs ensure that there are robust arrangements in place to accommodate any potential delay to the delivery of I-SEM. It may be easier to achieve these objectives by developing the current AMP auction platform.

Question 5: What is the preferred approach in relation to the establishment of the I-SEM FTR auctioning platform?

Energia’s understanding is that the Network Code on Forward Capacity Allocation requires the Single Allocation Platform (SAP) to accommodate FTR Obligations but that they will not be accommodated under the early implementation HAR. It must be assumed that I-SEM will require a back-up allocation platform to the enduring SAP. And given the implementation risks associated with the FUIN and JAO platforms combined with the importance of maintaining robust access to hedging instruments for I-SEM participants during the transition to I-SEM (discussed in response to

question 4 above), we would recommend development of the current local allocation platform AMP. This reduces delivery / implementation risk and has the additional benefit of allowing the option of obligations to be maintained, or at least the decision to be deferred until sufficient information is available for participants to make an informed choice between FTR options and obligations.

Energia emphasises the importance that the allocation platform offers standardised contractual terms and netting of collateral, and provides a single point of contact for market participants for registrations, settlement and invoicing arrangements across I-SEM interconnectors. The auction platform should also provide central reporting solutions to European regulations such as MIFID II, EMIR, REMIT, etc. where possible. Simplifying contractual arrangements, optimising collateral requirements to the minimum required, and minimising operational, legal and administrative overheads on existing participants will help facilitate trade and promote liquidity, which in turn will support market access (particularly for smaller participants) and therefore competition.