ESB Generation & Wholesale Markets Response

I-SEM

Financial Transmission Rights Consultation

SEM-15-061

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1. INTRODUCTION AND SUMMARY

ESB Generation & Wholesale Markets (GWM) welcomes the opportunity to respond to this consultation. ESB GWM is an active user on both the Moyle and EWIC Interconnectors and participates regularly in the capacity auctions. An integral part of ESB GWM's hedging strategy involves Interconnector flows. How this area will work in I-SEM is therefore of critical importance to the business.

ESB GWM's main comments are summarised below. Section Two of the response outlines ESB GWM's position in relation to the specific questions raised in the consultation. Finally, Section Three includes comments on related issues that were not specifically raised in the consultation paper.

1.1 Summary of Main Comments

- The design of FTR products for I-SEM should be such so as to facilitate the wider integration of the I-SEM market with other European electricity markets, and not just GB. This will ensure the best outcome for I-SEM customers. Therefore there is a need for the FTR design process to deliver a simple financial product without any local issues and considerations complicating it.

- ESB GWM sees values and benefits to both FTR Options and Obligations and considers that both product types should be offered to the market. FTR Obligations should not be ruled out at this early stage, due to issues around implementation, or other perceived problems. As I-SEM evolves participants should have the full suite of products available to them in order to participate in integrated European markets in the most efficient way. Ultimately consumers will be the beneficiary.

- FTR products should be per border rather than per Interconnector. This will help with the promotion of market liquidity and also with wider market integration. Any issues in relation to revenue sharing agreements between the Interconnector Owners can be worked through and should not be viewed as insurmountable. Indeed both the CACM (Art 73) and the FCA (Art 57) both require the TSOs to propose a methodology to do this.

- ESB GWM strongly support a simple FTR product design without the inclusion of Interconnector transmission losses or ramping constraints. Participants have no control over such parameters. Inclusion of such factors increases the complexity of the FTR product, which then need to be factored into valuation by participants. The increased complexity introduced by the inclusion of local technical factors such as these also hinders integration of I-SEM with wider European markets. Adjusting FTR payouts for these factors diminishes the value of FTR product for participants and reduces auction income for the Interconnector Owners. Revenue adequacy considerations for the Interconnector Owners can be addressed through a range of mechanisms without being the key consideration in determining the FTR product design. The implications design features will have on market outcomes should be the main concern.

2. RESPONSE TO CONSULTATION QUESTIONS

2.1 FTR Type: Options and Obligations

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

- **Options v Obligations**

ESB GWM sees merit in both FTR Options and FTR Obligations and thinks both product types should be available to market participants in I-SEM.

Many of the advantages of both FTR product type have been discussed in the consultation paper. Options have the advantage of having minimal collateral requirements. They also offer potential "upside" to holders. Obligations offer a perfect hedge and also allow scope for increased liquidity through netting. Obligations should also require a more straightforward modelling activity to support valuation in comparison with Options.

A further advantage of Obligations, not discussed in the consultation, is the potential Obligations allow for the introduction of multinational products beyond GB. In its 2014 report[1] on bidding zones, ACER concludes that the liquidity of forward hedging products in smaller bidding zones tends to be unsatisfactory. To address these concerns and level the playing field for hedging opportunities across Europe, ACER suggests the implementation of a "multi-zone hub design" (as in the Nordic region with a common system price for forward trading) or "Transmission Rights also between non-neighbouring bidding zones". The latter implies consideration of products to hedge the basis risk between I-SEM and Germany, for example. An I-SEM-Germany Obligation can be decomposed into a chain of I-SEM-GB, GB-France, and France-Germany Obligations with equivalent payouts, but this does not hold for Options. This advantage of Obligations was noted in the report[2] ("Physical and Financial Capacity Rights for Cross-Border Trade") prepared by Booz & Company for the EC in 2011. The report states that Obligations present the advantage "that they can be chained to create rights connecting non-adjacent Zones" and that such a decomposition property should increase trading opportunities and liquidity. Such further integration with wider EU markets would offer I-SEM participants increased possibilities for hedging and ultimately put downward pressure on I-SEM prices to the benefit of consumers. Such integration with wider EU markets should be facilitated by the SEM Committee (SEMC) and market design wherever possible.

The Booz report also notes that "absolute priority should be toward issuing FTR Obligations", and TSOs should also aim to issue FTR Options to give market participants the widest range of choice. ESB GWM concur with this conclusion that both products should be made available.

- **Other Comments**

  - ESB GWM understands that FTR Obligations may not be available at the beginning of I-SEM timeframe if the JAO auction platform is implemented (see comments in Section 2.4). If this situation transpires, then it is important that the introduction of Obligations is implemented when the functionality becomes available in JAO, as is required under the FCA.

  - The consultation paper includes a worked example for valuing Options and Obligations. The result in the example is that a participant would need to purchase twice the amount of Obligations as Options to hedge their position. We note that the worked example assumes perfect foresight of I-SEM and GB spot prices. Analysis carried out by ESB GWM would question some of the conclusions reached on hedging efficiency, for example. Allowing for variations of outturn prices from the expected level, the hedge quantities for FTR Obligations in the worked example appear far from optimal.

  - ESB GWM believes that the possibility of some time-of-day FTR instruments for I-SEM should be investigated. The type of time-of-day products should be aligned with the type of forward products available in GB and I-SEM.

[1] *http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/ACER%20Market%20Report%20on%20Bidding%20Zones%202014.pdf*

[2] *https://**ec**.europa.**eu**/energy/sites/ener/files/.../2012_transmission.pdf*

- While ESB GWM understands from the Booz report mentioned above, that simultaneous auctions of both Options and Obligations are feasible, ESB GWM considers that the auctioning process, should both products be offered, would need to be given careful consideration.

In summary, ESB GWM sees values and benefits to both FTR Options and Obligations and considers that both product types should be offered to the market. FTR Obligations should not be ruled out at this early stage, due to issues around implementation, or other perceived problems. As I-SEM evolves participants should have the full suite of products available to them in order to participate in integrated European markets in the most efficient way. Ultimately consumers will be the beneficiary.

2.2 FTR per Interconnector or per Border

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

ESB GWM considers that a per border FTR product would result in the best outcome for I-SEM. A single product will increase liquidity rather than splitting it between Interconnectors. A single product will also facilitate easier integration with wider EU electricity markets, as the I-SEM product will be a more straightforward streamlined offering. A single product will also reduce complexity for participants in terms of the preparation and participation in auctions.

The consultation states that the additional complexity and cost involved in the collaboration of the Interconnector Owners providing a single FTR product would not be justified by the potential benefits that might accrue from a single product. It is not clear what analysis has been done to reach this conclusion. If a cost benefit analysis or similar has been carried out by the SEMC then the results of this should be published. The complexity and costs for participants should also be considered. While effort will be required by both Interconnector Owners in order to put in place an agreement, ESB GWM has confidence that this can be readily achieved.

The consultation also outlines how the SEMC are persuaded that there is greater flexibility and choice for FTR users if separate products are provided at each Interconnector and that this flexibility outweighs any potential loss of liquidity and increased complexity for FTR users. ESB GWM would challenge this assertion. Offering FTRs separately per Interconnector does not give users any more choice or flexibility as auctions are normally close together and offer the same products. In ESB GWM's view the impact on liquidity and increased complexity for users are more significant.

Finally, ESB GWM considers that having two Interconnector products will increase the FX complexity for participants.

2.3 FTR Payout Discounts

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

2.3.1 Interconnector Transmission Losses

Defining FTRs as a simple financial product has considerable advantages in terms of hedge effectiveness and liquidity. As outlined above, ESB GWM would prefer to see liquidity pooled in FTRs for the SEM-GB border rather than split across separate products per Interconnector. Consistent with this position, we consider that FTR payouts should not be discounted for transmission losses for the following reasons:

- Adjusting payouts for Interconnectors losses reduces the effectiveness of cross-border hedging strategies;
- Adjusting for losses introduces additional complexity to FTR valuation for the purposes of participation in auctions and secondary trading;
- With FTR products defined per border rather than per Interconnector, an average loss factor may be inappropriate to capture the impact of line-specific losses in the day-ahead scheduling process;
- Adjusting for losses is likely to hinder the development of multi-border products, since the pay-outs for a chain of FTR Obligations would no longer combine in a linear fashion.

Some of these points are expanded on below.

Adjusting FTRs payouts for Interconnector losses, as described in Section 5.1 of the consultation paper, implies there would be a deadband with no payments under FTR Options or Obligations when the market price spread is less than the loss factor. During such periods, the FTR would no longer provide a hedge, reducing the effectiveness of cross-border hedging strategies.

As noted in the consultation paper, FTRs should achieve higher prices at auction if FTRs holders are not exposed to reduced payouts due to technical characteristics such as Interconnector losses and ramping constraints. If loss adjustments are included in the FTR product definition, it is not simply an issue of discounting the expectation of FTR payouts by the prescribed loss factor (e.g. 5%) – participants will also need to estimate the frequency of deadband periods with market spreads below the loss factor, and discount their valuation accordingly. Adjusting FTR payouts for losses may ultimately lead to a lower net income for the Interconnector Owners, depending on the extent to which participants discount their auction bids to mitigate the loss of coverage during deadband periods. Furthermore, Interconnector Owners are likely to have a range of options for reducing revenue adequacy risks, without needing to adjust FTR payouts for losses. For example, the Interconnector Owners could choose not to sell forward rights equivalent to the volume of expected transmission losses.

Regarding multi-border products, one of the advantages we cited above for FTR Obligations is the potential to facilitate trade between non-neighbouring bidding zones via chains of financial products. This could widen the cross-border trading opportunities beyond the neighbouring GB market, enabling I-SEM participants to avail of greater forward liquidity in the German market, for example. With pure financial products, the payout for an FTR Obligation from A to C is equivalent to the payouts of Obligations from A to B and from B to C, However, this linear relationship breaks down if payouts are adjusted for losses (since there will be no payout on one leg of the chain during deadband periods).

While ESB GWM's preference is for losses to be excluded from the FTR product design, if losses are included this should be on the basis of pre-determined loss factors (rather than exposing FTR holders to changes in loss factors between the initial auction and delivery).

2.3.2 Ramping Constraints

ESB GWM supports the SEMC's minded to position that FTR product payouts should not be discounted for ramping constraints.

FTR purchasers have no control over ramping constraints and are not best placed to assess the impact of these constraints on Interconnector operations. Adjusting FTR payouts for ramping constraints would diminish the value of the FTR products, resulting in lower auction revenues for the Interconnector Owners.

2.3.3 Curtailment Risks

As implied in the consultation paper, the impact of curtailment on FTR products should be consistent with the EC Guideline on Forward Capacity Allocation (FCA). The general principle established in the FCA Guideline is that holders of long-term transmission rights should be compensated at the market spread in the event of curtailment.

While recognising that the FCA Guideline makes specific provisions in the case of DC Interconnectors, ESB GWM has a number of concerns with the proposed firmness arrangements for transmission rights on the SEM-GB border, as reflected in the harmonised allocation rules (HAR) issued by ENTSO-E in July-August2015. In particular, the SEM-GB regional annex (Annex 12) introduces an additional scenario of “Capacity Shortages” in which it is proposed curtailment caps would apply, in addition to specific events defined to be Force Majeure, an Emergency Situation or a System Security event. We consider that this additional curtailment category is far too broad and significantly undermines the FCA firmness principle, devaluing SEM-GB FTRs as an effective hedging tool to the detriment of cross-border trading, forward market liquidity and competition. These and other concerns were highlighted in the EAI’s response to ENTSO-E’s consultation on the draft HAR.

The CER and Utility Regulator have each, very recently, respectively published, their approval decisions on the Access Rules and Charging Methodology for EWIC Interconnector Limited and Moyle Interconnector Limited. While the letters issued by each of the RAs do reference the above concerns in relation to Annex 12, ESB GWM is disappointed that the RAs have not addressed these concerns. ESB GWM is also disappointed in relation to the timing of these recent publications, since the subject matter is closely related to this consultation and yet they were issued so close to the response deadline.

The HAR are subject to regulatory approval and we urge the RAs to ensure that the firmness principles of the FCA Guideline are retained for transmission right holders on the SEM-GB border.

2.4 Auction Platform

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

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

From discussions at the Dundalk industry forum subsequent to the consultation paper’s publication, we understand that the JAO platform is now regarded as the mostly likely auction platform for the launch of I-SEM FTR products. As the emerging pan-European solution, the JAO platform has the advantage of avoiding stranded investments and implementation costs for I-SEM stakeholders.

With less than two years remaining before I-SEM go live, market participants including ESB GWM require timely access to forward trading and hedging products for October 2017 and beyond. We therefore request that the RAs clarify the implementation milestones for rolling out FTRs on the SEM-GB border. We envisage that the RAs will engage with the Interconnector Owners and confirm that it is feasible for the JAO platform to host I-SEM FTR product auctions prior to go live. We would then support a pragmatic timeline for progressively introducing a full suite of cross-border trading products for I-SEM participants. For example, if the platform is initially limited to FTR Options, these could be augmented at a later date by FTR Obligations (as required by the FCA Guideline) and ultimately by multi-border products (per ACER’s bidding zone report).

3. ISSUES NOT DEALT WITH IN CONSULTATION

3.1 CRM Cross Border Participation

There are a number of potential interactions between FTRs and CRM Reliability Options under I-SEM, as noted in the FTR consultation paper and the subsequent CRM industry workshop. Indirectly, the demand for FTRs may be influenced by the RO supplier hedge and by cross-border CRM participants. Depending on the nature of cross-border participation, there could also be direct linkages between FTRs and ROs. For example, under a generator-led approach, one option would be to restrict overseas participation to FTR holders. Another option, under an Interconnector-led approach, would be for Interconnector Owners to transfer their RO liabilities to FTR holders.

The sequencing of RO and FTR auctions is likely to be key. The FTR consultation paper suggests that the first FTR auction will be held at least 3 months in advance of the first RO auctions, which would appear to preclude some of the options suggested for cross-border participation. We therefore urge the RAs to provide greater clarity on the interactions between the CRM and forwards workstreams.

3.2 Financial Reporting of FTRs

ESB GWM notes that the consultation does not specifically cover the topic of treatment of FTRs under financial regulations, which was referenced as a matter for consideration in the Discussion Paper (SEM-15-10). ESB GWM requests that the SEMC remains cognisant of the fact that the nature and complexity of the FTR products will require additional time and resources on the part of market participants to cater for the implementation and operation of the FTR products. The reporting obligations of market participants will need to be established as early as possible as well as the form and method of such reporting activities. This will allow participants to put in place any required processes and procedures. The feasibility of centralised reporting, by TSOs or by the NEMO, should be investigated.

3.3 FTRs and Trading Renewables

Proof of Interconnector flows is currently required by Ofgem in order for ROI Guarantee of Origins (GoOs) to be used in exemptions to the GB FiT and CfD levy on GB suppliers. It is not clear how such a process will work under market coupling when flows are not determined by participants. ESB GWM requests that the SEMC work with Ofgem on this topic in order to provide market participants with clear guidance.