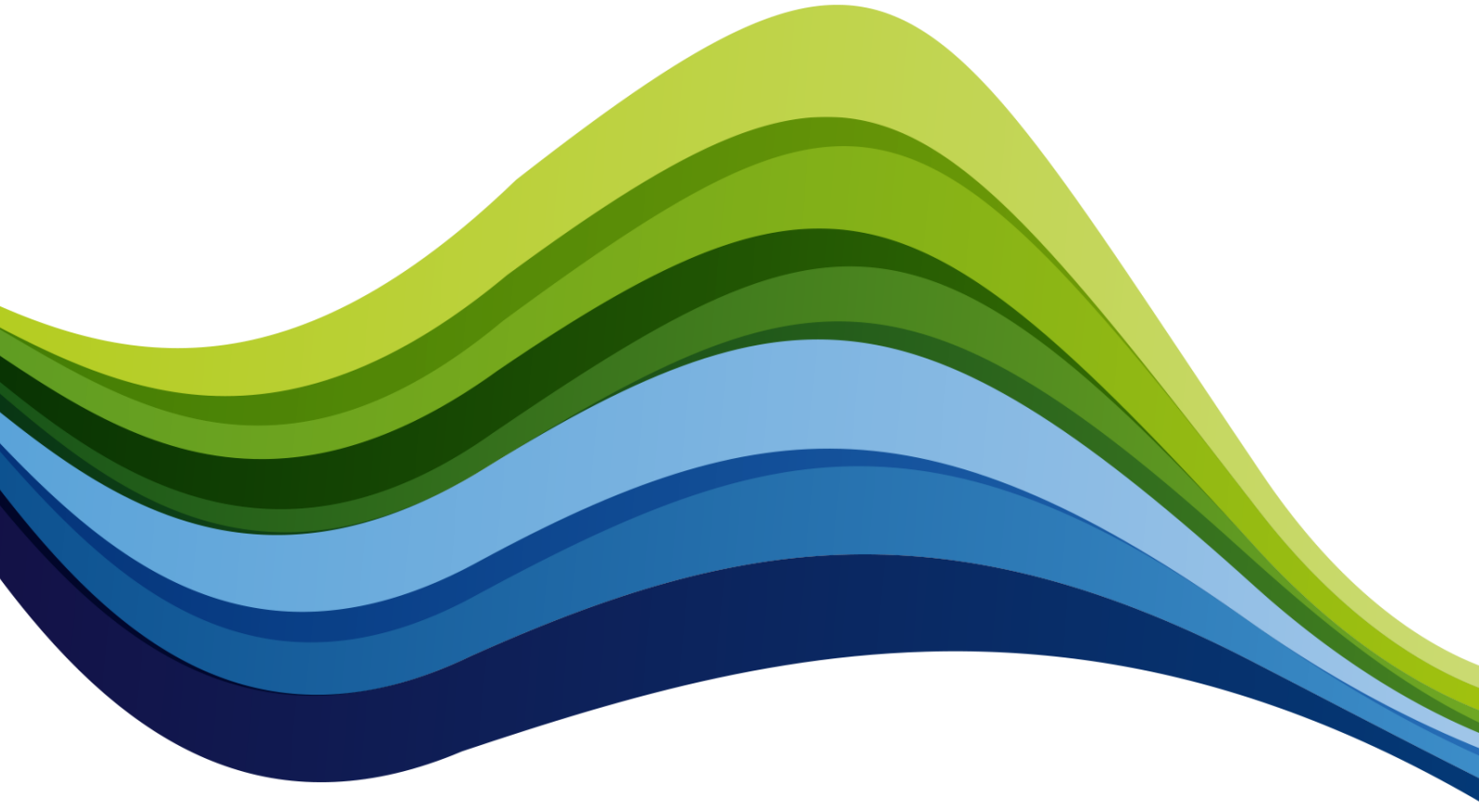
I-SEM

Financial Transmission Rights

If you have any questions in relation to our response, please don't hesitate to contact me at connor.powell@sse.com



Summary

Thank you for giving SSE the opportunity to comment on cross border trading arrangements. Our long-term priority for the businesses in our Wholesale segment is sustainability in energy production through a diverse portfolio of assets. As a major producer and supplier of electricity to final customers in Ireland, SSE depends on a well-designed cross-border trading and hedging arrangements to optimise its portfolio and manage its exposure to wholesale market risk.

Proper access to neighbouring markets will be critical to I-SEM's success. Our response covers each of the questions raised – our preferences are summarised below:

Options vs Obligations	• **SSE would favour the availability of both options and obligations,** subject to the chosen platform having functionality for both. Both have different characteristics and fulfil different market needs.
Product Availability	• **A multi border FTR seems more practical given timelines,** with a harmonised project considered at a later stage, if any benefits for participants are significant enough
Product Pay-outs	• **Technical discounts** from financial transmission rights undermine the advantages of a financial product outlined in the High Level Design.
Auction Platform	• **The RAs should focus on designating JAO as the platform.** Time spent exploring criteria for platform selection would be a waste because the choice seems clear based on cost/development/risk criteria.

Product Design and Availability

Options vs. Obligations

As the paper notes, the key differentiator between forward hedging products is whether they primarily fulfil a temporal or spatial hedging role. The two cross border products described as options fit different roles – we've modified the table on page 19 to highlight similarities and differences:

Attribute	FTR Options	FTR Obligations
Coverage of price spread risk/hedging efficiency	**Selectively capture market spread – buying directional exposure.**	**Perfectly capture market spread – buying fundamentals.**
Liquidity of product	Useable as speculative instrument – less volatility in pricing.	Usable as speculative instrument[1] - more volatility in pricing.
Netting	Not possible – see cost.	Possible – see cost.
Cost at auction	Higher price offset by lack of netting.	Lower price offset by potential for netting.
Credit Cover	Not an issue.	Requires credit cover.
Price shock risk	Doesn't require underlying physical position. Provider hedged.	Requires underlying physical position to hedge. Provider hedged.

SSE would see options and obligations as fundamentally complementary rather than competing products. Obligations will appeal to a market participant with a particular underlying (likely physical) position or risk appetite. Options will appeal to market participants that want to selectively manage their exposure.

The consultation appears to suggest that one product should be favoured over the other, but it seems quite clear that the different products are not a straightforward substitute but instead a complementary suite of products serving different market requirements. Given that the products are equivalent for the seller (the asset owner) with lower valuations offset by ability to net, it seems that there is no value in arbitrarily picking one product over the other. The interconnector owners already manage primary allocations of less accessible[2] physical transmission rights without liquidity issues in SEM - **SSE would therefore favour the**

[1] While the consultation notes that obligations are better suited to physical traders, we would amend this to obligations are better suited as hedging instruments for physical traders. As a speculative instrument, assuming sufficient risk appetite, there is no reason that an asset-less trader would not want to price and hold a FTR obligation – it is effectively just delivers an increased in exposure at a lower value, and with a secondary market in place, there should be a 'stop loss' available if other market participants have a contrary view on market spreads.

[2] PTRs are less accessible for non-physical participants to hold.

availability of both options and obligations, subject to the chosen platform having functionality for both.

Rationale for a single/multi border FTR

A single border FTR would be more straightforward for market participants, assuming that revenue sharing issues could be easily resolved. Given that both interconnectors sit in different jurisdictions with different groups of customers underwriting them, it seems unlikely that, from a practical perspective, a single border FTR can be developed in time for a seamless transition between SEM and I-SEM.

Continuing with the existing approach appears to be more realistic, with a harmonised project considered at a later stage, if any benefits for participants are significant enough[3]. Multi border FTRs fragment the market, but again, the interconnector owners already manage primary allocations of less accessible physical transmission rights without liquidity issues in SEM.

FTR Product Definition

FTRs are a financial product, and should be accessible to any participant as a purely financial product. Introducing physical characteristics like losses explicitly remove one of the advantages FTRs have over PTRs – that they are accessible to a wider range of market participants.

The paper notes that:

"Buyers and sellers of cross border energy will have to be able to hedge the cost of losses, along with hedging energy costs (via CfDs) and congestion (via FTRs)."

But that:

"When price spreads for FTR pay-out are corrected for the loss factors FTR holders also pay for these losses where they are not causing them and have no control over them, although this will affect their pricing of the FTR."

This is almost an administrative question – should market participants or interconnector owners account for losses in pricing/allocation? **SSE believes that it would make more sense for interconnector owners to account for losses –** the paper notes that there is auction revenue adequacy risk but this is not a real issue for the interconnector owners and should be accounted for by the additional revenue generated in the primary allocation. As noted elsewhere in the paper, losses are a minor part of wholesale market risk, which is entirely hedged by the interconnectors being underwritten by customers.

[3] The liquidity benefit from a harmonised product primarily accrues to the interconnector owners who are more likely to capture the full value of congestion expectations, whereas product diversity and staggered auctions from two auction offices are of benefit to market participants. The cost benefit for a harmonised product is not clear cut.

By making market participants account for losses, you:

- Introduce technical characteristics into a financial product.
- Allocate risk to parties that cannot manage technical loss factors (or timely publication of technical loss factors).
- Remove the ability to offer multiple year FTR products (because technical loss factors will not be available).

These are clear disadvantages, which appear to easily outweigh a nominal revenue adequacy risk applying to what are in effect regulated/mutualised assets. The same concerns apply equally to both ramping constraints and unplanned outages – **SSE believes that technical discounts from financial transmission rights undermine the advantages of the product outlined in the High Level Design.** As such, transmission losses, ramping constraints and curtailment risks should be managed by the interconnector owners with the protections applying in the FCA Code.

Auction Platform

Our preference

SSE would express a clear preference for the use of the Joint Allocation Office as the auction platform which is:

- Better progressed than any other alternative;
- Supported by ENTSO-E, ACER and the EC (futureproof);
- Able to support all product types in time;
- Lowest cost.

The only disadvantage outlined in the consultation is that:

"The risk of getting the necessary system requirements in place in time and gaining agreement with existing members will be the greatest of the three options outlined."

We do not see this as credible – the FUIN platform is at a far lesser stage of development and requires a major project with agreement at multiple design stages across the participating HVDC interconnector owners. Both this 'HVDC' platform and a local SEM platform will not be designated a SAP because they explicitly cater to specific rather than general European requirements. Other HVDC interconnectors are participating in the European solution with no issue – we are not sure why JAO does not meet the requirements of FUIN interconnector owners.

Given that the only issue with JAO is the agreement to join, SSE believes that the regulators should focus on designating JAO as the platform and ensuring that the interconnector owners secure that agreement. Time spent exploring criteria for platform selection would be a waste. The choice seems very clear, unless the selection criteria are heavily weighted toward the preferences of the existing SEM-GB interconnector owners rather than the cost/risk/development characteristics outlined above.

Other issues

Financial Regulation

The MIFID II technical standards secure an exemption for PTRs and FTRs from the definition of financial instruments for the primary auction. However, the wording does not explicitly secure an exemption for FTRs traded on secondary markets which would potentially radically reduce liquidity. The regulators and TSOs should be aware of this issue and work with industry, ACER and ENTSO-E to secure an amendment from DG Fisma.