

**Response to SEM Committee I-SEM Consultation Paper
'Measures to promote liquidity in the I-SEM forward market'
17th June 2016**

**On behalf of
AES Ballylumford Ltd and AES Kilroot Power Ltd**

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Queries to

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1 Introduction

As a major stakeholder within the all-island electricity market, AES Ballylumford Limited and AES Kilroot Power Limited (collectively “AES”) welcome the opportunity to respond to the SEM Committee Consultation Document - ‘Measures to promote liquidity in the I-SEM forward market’ of 17th June 2016’ (the ‘Paper’).

2 Summary

AES welcomes the interest taken by the RA’s in promoting liquidity as a route towards improved competition and thus delivering better value for all stakeholders.

AES believes that any actions taken by the RA’s should be based around principles of enablement rather than enforcement. In this context we support the principles outlined in Option 1 with particular emphasis upon easing the burden of credit management between participants.

AES would suggest that counterparty credit risk is currently the main barrier to liquidity and has been so since the 2008 financial crisis. Therefore we support the concept of a clearing house to encourage new and existing entities to participate in forward trading. In order to make optimum use of any security that must be posted by a Market Participant we further support the concept of a “one stop shop” clearing house embedded into I-SEM.

AES is very active in hedging activities around the SEM and the interplay between energy and capacity markets will ensure that AES continues to be an active player in the forward market under I-SEM. From our experience, AES does not believe that the current low level of forward trading is a direct consequence of the failure of Independent Generators willingness to offer enough product. Indeed, we have seen on many occasions product offered by Generators being ‘left on the table’. In our view there is nothing inherent in the SEM design that suppresses forward trading. We are of the view that the core of I-SEM will deliver increased liquidity particularly if intermittent generation such as wind is encouraged to participate in the Day Ahead Market.

3 Detailed Response

3.1 Market Analysis

While the analysis given in the Paper is reasonably comprehensive we think it would benefit from a more detailed assessment of current levels of proxy hedging performed by all participants. The principles of regression analysis as utilised in the creation of the DC Formula is essentially a proxy approach to hedging and a number of Financial Institutions structure very similar products. We would like to see some data on the volume uptake of those products. AES is cognisant of commercial sensitivities and confidentialities as a vast majority of these hedges will be via bilateral trades. However, we think it should be possible for the RA's to gauge the overall volume being hedged by used – e.g. by commissioning a confidential survey.

It is AES's view that the hedging imperative placed upon an Independent Generator without direct access to demand side customers is at least as critical as that of a Supplier without access to Generation. Whilst Generators do not have the obligation to provide power at a fixed tariff they also do not have access to customers who may be prepared to take, or at least share, some of the market risk.

AES is deeply concerned about the Forward Contracting Sell Obligations (FCSO's) as included in some of the options proposed in the Paper. In our view implementation of the FCSO's as outlined would in effect be moving towards an administered market; Generators sell at a fixed tariff, with or without a margin, and Suppliers then resell the same tariff with a margin.

A key benefit of improved liquidity would be to reduce the pressure toward the vertical integration that has been seen in BETTA. Some of the measures proposed in the Paper would actually seem to increase that pressure. Indeed liquidity measures introduced in Betta do not impose any obligation to sell hedging products at a set level of market dispatch. (**ofgem, 2015**)

3.2 Option 1

AES reserves full endorsement until a more detailed proposal is available but we believe, of the Options presented, that this is the only sensible way to proceed. A truly liquid market can only be achieved where everyone is engaged willingly and in a manner which meets their particular business needs.

As stated earlier, AES is deeply concerned about the structure and philosophy behind the FCSO as proposed. In particular we refer to section 5.2.

AES would contend that the reference in the Paper that Generators “other than, mainly ESB” are reluctant to offer hedge products is not accurate. AES would advise the RA’s that AES has been, and intends to remain, very active in the CfD market. Generators also tend to operate under (Board) approved Risk Management Strategies which form part of a robust and essential risk governance policy. AES offers forward products in accordance with such a governance policy addressing issues such as scheduling/dispatch risk, downside margin protection, short/long positioning, types of products and portfolio optimisation across its markets. Many of the FCSO options as proposed would put AES in a position of non-compliance with internal Risk Governance and Risk Management Strategies and, in our estimation, would expose AES to substantially increased market risks in relation to pricing, scheduling and energy margin.

AES would also disagree with the concept outlined in the Paper that being removed from the “volatility” of the DAM is always a good thing. In our view it may or may not be beneficial depending upon underlying market fundamentals and indeed volatility may prove to be a significant source of value for a marginal Generator.

3.3 Concept of Generators as price takers.

AES notes a comment in the Executive Summary stating that there are “asymmetric incentives to trade” between Generators and Suppliers. We would ask the RA’s to provide some supporting analysis for this statement. AES would also query the assertion that Generators have more access to proxy hedges than Suppliers. AES would suggest that Supplier hedging should be less complex as they do not have to factor in Cost of Production (CoP).

Notwithstanding the concerns highlighted above, AES has difficulty in seeing how the issues raised in the paper can be used as justification for the determination that Generators should become price-takers. It seems to us that some of the measures proposed are more appropriate for dealing with

Market Power issues rather than dealing with Market Liquidity issues. Indeed we believe in this context that the Paper has perhaps confused the boundaries between these two issues.

3.4 Hedging Strategy

Prudent behaviour for an independent Generator in a merchant market implies that they should hedge for more reasons than simply cash flow. Like most businesses with merchant risk, AES' current hedging strategy has been developed with all stakeholders in mind and this strategy is approved at board level. It is AES' opinion that any liquidity requirements imposed by the RA's must be consistent with standard business practice. We also advocate that such hedging behaviour (by Generators) is entirely consistent with an open and fair market and indeed it is the ultimate source of true liquidity.

AES would contend that a price-taker selling 70% of forecasted generation forward (particularly if margins are thin) is neither prudent nor appropriate. We believe this is an overly simplistic approach in that it values the Power Plant as a simple function of the forward commodity curve and makes no attempt to assign any "option" value that can be achieved from market volatility through the provision of innovative and flexible products.

3.5 FCSO Structure

To AES, the FCSO as presented is, in essence, a DC in that it is derived and struck in the same manner. We understand that the DCs were designed to take a fixed amount of generation out of the market for reasons of controlling Market Power - essentially as a proxy for asset divestment. AES would suggest that DC's (FCSO's) cannot perform that function and serve as a market stimulant at the same time.

AES would also refer the RA's to the submission made by the Competition Authority on Market Power and Liquidity in the SEM* and in particular the reference to "behavioural remedies".

"The main problem with behavioural remedies is one of effectiveness. Behavioural remedies attempt to make the undertaking act contrary to its own interests. The risk is that the regulatory authorities must keep all market participants on a tight leash which removes the incentives for innovation and investment that are characteristic of competitive markets". (The Competition Authority, 2011)

3.6 Market Risk

As an independent Generator, it is AES' firmly held opinion that the FCSO as proposed places both basis and dispatch risks upon the Generator.

3.7 Basis Risk

As proposed, the FCSO strike price is set by Proxy using forward commodity prices but it is settled on the actual power market clearing prices in the DAM. Whilst AES acknowledges that the methodology of using a proxy does generally perform quite well, it is not perfect and thus, due to basis risk, the accounting standards would usually not be met for hedge accounting. Also once placed a FCSO would not be easily reversible.

AES does not see any reason why the FCSO should not settle against the same parameters used to create the strike price and indeed we see some advantages to this approach. For example, it can be more easily transferred to or compared with a financial product.

3.8 Dispatch Risk

AES notes the reference in Section 3.2 of the Paper to the market dispatch risk faced by a Generator on one side of a CfD. AES would point out that a Generator will only be kept whole if the Generator loses market dispatch when the clearing price equals his Cost of Production (CoP). Under SEM this is rarely the case and the delta above the CoP can be up to £4 per MWh before the Market dispatches the Generator due to the complex bidding requirements (i.e. principally due to the inclusion of a Generator's start costs).

AES believes the expectation is that the current Bidding Code of Practice principles will be relaxed for the I-SEM Day Ahead Market. This being the case, projecting market price and individual unit market dispatch will be less certain. Generators will have to manage their positions much more dynamically than the current SEM.

The second facet of dispatch risk is associated with forced and planned outages. This is magnified when the sell obligation is greater than 50% of a two unit asset.

3.9 Market Scheduling

AES notes that the forward contracting obligation is set at 50% of Suppliers needs with no corresponding reference to the needs of Generators. Using the outturn of the calculation given in

the Paper, this would impose a sell obligation on AES of almost 70% of forecasted generation. We also note that no detail is given as to how this market forecast will be generated. In a gas dominated market, a coal fired Generator will swing in and out of merit in an almost binary nature. Therefore the approach as proposed creates a very high risk of a coal fired Generator being forced into a short position. While this may be acceptable position for a Generator with a diverse portfolio, it could prove to be very challenging for a stand-alone business.

3.10 Balance of needs between Generation and Supply

AES believes the rationale used in Section 7 of the Paper to derive the mix of products to be used would benefit from a more balanced approach between needs of Generators and Suppliers. For example, Generators might prefer baseload CfDs in summer as they help reduce exposure to suppressed overnight pricing whilst, in the same timeframe, a Supplier may prefer mid-merit or peak.

AES would also suggest that if FCSOs are to be introduced then they should never be struck at less than the equivalent price in BETTA. This is for two reasons:-

- It creates a no-cost-no-risk arbitrage for Suppliers.
- BETTA pricing is available as a hedge to all Suppliers and Generators in I-SEM and therefore I-SEM Generators should not be forced to undercut the BETTA price.

3.11 Vertical Integration of ESB

A common feature of Options 3, 4 & 5 is the removal of the ring fencing arrangements associated with the ESB.

The position of AES on this has been consistent since SEM design consultations began in 2006. Ring-fencing is an imperfect means of dealing with market power and, in our view, the only appropriate way to deal with this issue is asset divestment. The logic in the Paper appears to be that as all Suppliers will have access to what is essentially a regulated price there is therefore no need to treat ESB Supply in a different manner. We note that there is no discussion in the Paper on the potential impact on Generators. In summary, the position of AES is that whilst ESB ring-fencing is an imperfect tool, the new measures as proposed in the Paper do not represent a better solution and may indeed introduce additional issues for some Participants. AES therefore contends that the current ring-fencing arrangements should remain.

3.12 Market Maker Obligations

AES would note that none of the options provided in the paper would expose AES to a Market Maker obligation. However, since this is essentially a FCSO arguments we have presented above against FSCO's equally apply.

References

ofgem. 2015. Wholesale Power Market Liquidity: Annual Report. September 2015.

The Competition Authority. 2011. Submission to the SEM Market Power and Liquidity Consultation. Dublin, Ireland : s.n., February 2011. S-11-003.