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Sheena Byrne
Commission for Energy Regulation
The Exchange
Belgard Square North
Dublin 24

Kenny Dane
Utility Regulator
Queens House
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20th March 2017

Dear Sheena and Kenny,

PrePayPower, as Ireland's largest prepay electricity provider, welcomes the opportunity to contribute to the SEM Committee's consultation on the I-SEM Operational Paramters, Credit Cover and Imbalance Settlement Consultation Paper ((SEM-17-009).

Our response focusses on the elements which deal with credit cover within the I-SEM. We have no comments on the elements relating to the Imbalance Settlement Parameters, which deal primarily with generation-facing issues.

We have no issue with the current proposals for the Settlement Recalculation Threshold and the Imbalance Weighting Factor, which does impact supplier settlement.

SEM-O Credit Cover Review

We have no issue with the overall analysis of the historical period, including the demonstration that credit cover is at times under and over-provided within the current market (Figure 4). This goes to show that the current credit cover mechanism, and arguably any formulaic cash/LoC[1] credit cover mechanism, will be both insufficent and inefficient. There are no hard-and-fast laws regarding market collateralisation, merely trade-offs within the context of the overall market structure, the impact on market participants, and the risk of default in the market.

[1] Letter of Credit

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SEM-O Credit Cover Review: Historical Assessment Period and Analysis Percentile Parameter

We do have an issue, however, in utilising SMP as a proxy for Balancing Market (BM) outcome prices to tune credit cover parameters for the I-SEM. We simply have no idea of the volatility of the BM price, and the move to shorter historical assessment periods and utilising a higher percentile coverage of pricing outcomes over that period could lead to highly volatile collateral outcomes.

PrePayPower agrees with the principle that collateral must be carried on the full Metered Demand, assessed against BM pricing outcomes. The arguments are conservative, but sound.

Starting from this prudent conservative position, however, and layering on close-on statistical worst case scenario changing more rapidly than currently leads to the potential that a fully solvent market participant, purchasing the vast majority of its power in the day-ahead market (DAM) or intraday market (IDM), can be placed in technical breach of the Balancing Market.

For the avoidance of doubt, this is not a technical breach arising from reckless imprudent trading in the DAM and IDM, leading to imbalanced exposure in the BM. A supplier with zero invoices in the BM, posting collateral for its entire Metered Demand, could receive material Credit Cover Increase Notices due to sudden volatility in the Balancing Market price. As a supplier, we have no idea of the extent of this credit cover volatility, and in particular how this will vary with the choice of the historical assessment period and the percentile parameter. The choice of historical assessment period and percentile parameter favour faster, peakier changes in requirements.

A supplier that successfully purchases all power in the DAM and IDM under a prudent trading strategy can therefore be in technical default to the Balancing Market against which it has no invoiced exposure. If the increase notice is material and the credit cover cannot be posted in time, the market "protects" itself by putting a trading block for that participant in the DAM and IDM, placing it more than likely with basis risk against its hedging strategy in those markets.

None of these arguments are absolute. It is important that the balancing market is adequately collateralised, however, it should not be done in a manner which places unrealistic requirements on suppliers that in turn could lead ironically to the situation where it forces them into riskier trading strategies.

In summary, PrePayPower does not know, SEM-O does not know, and the SEM Committee does not know whether the pricing inputs into the credit cover methodology are sound. This needs further analysis prior to the start of I-SEM go-live, with modelling of the balancing market price. No one knows to what extent credit cover requirements will change from day-to-day (or potentially more frequently if credit assessment is carried out multiple times per day), and without the materiality of the change in credit cover requirements, participants cannot assess if the time-to-remedy post a Credit Cover Increase Notice is sufficient.

A possible mitigating action in the interim is to soften the time-periods to increase credit cover on a transitional basis where this arises from a BM pricing change until the distribution of pricing outcomes can

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be understood, particularly where the participant continues to actively participate successfully in the DAM/IDM. This would require further changes to the SEM T&SC.

Failing these mitigating actions, PrePayPower supports a longer Historical Assessment Period of 100 days and maintaining the existing Analysis Percentile Parameter at least on a transitional basis until the BM pricing "beds down" and is understood.

Other Comments

- PrePayPower is not in favour of a breach limit set at less than 100% of the Credit Cover Requirement for two reasons.
    - Firstly, if a breach notice is sent when a supplier has posted 100% of its Credit Cover Requirement and its exposure exceeds 92.59% of that posted credit cover, what is the amount of credit cover it has to post to remedy the breach? You might as well add (1/0.9259)%, or 8% onto the overall credit cover requirement. For the avoidance of doubt, PrePayPower does not support either methodology, but if you are going to do it, it is cleaner to post more collateral under the current algebra and set the breach limit to 100%.
    - Secondly, the approach appears to be intended to give the supplier time to remedy the situation, perhaps by reversing out unsecured delivery risk in the balancing market, e.g. by buying more power. There are two issues with this:
        - Firstly, the issue is far more likely to be caused in volatility in BM prices, which is not within the control of the supplier to trade out of; and
        - This should be set not by an arbitrary percentage of total exposure, but rather an analysis of how long a solvent business can raise material levels of collateral with their financing partners. If, for example, a company has a preapproved letter of credit, it can take up to 10 working days to facilitate an increase in the active utilised limit.

- We reiterate our submissions in previous consultations regarding the Undefined Exposure Period. A supplier than only participates in the BM should have the full Undefined Exposure Period of 16 days. If, however, a supplier is participating in the DAM/IDM and has positive traded quantities, it should have a shorter Undefined Exposure Period. If the supplier ceases to trade, defaults on DAM/IDM settlement, or exits a DAM/IDM trading arrangements, the Undefined Exposure Period should immediately increase to a longer Undefined Exposure Period and a Credit Cover Increase Notice should issue accordingly. If the Credit Cover Increase Notice is not complied with, the participant may be suspended earlier rather than waiting for the default in the BM.

- In the absence of any detail on the transitional period while the historical assessment period covers SEM operation, more detail is needed on how the initial credit cover requirements will be set.

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- During the market transition, participants will be still posting full collateral in the SEM (including for future exposure periods), and may also be required to post collateral for the same energy in the I-SEM. In that context, a modificiation is required for the existing SEM T&SC to ensure that no collateralisation is required for the Undefined Exposure Period that goes into the period after the SEM termination date.

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