Response by Energia to SEM Committee

SEM-22-024 Collateral Requirements Consultation

08 June 2022

1 Introduction

Energia welcomes the opportunity to respond to the SEM Committee consultation on Collateral Requirements (SEM-22-024). Exceptionally high wholesale gas prices has led to extremely volatile trading conditions in electricity markets in recent months. The increased collateral demands placed on market participants as a result of these trading conditions have brought into sharp focus the need to optimise collateral arrangements in the SEM. Energia, therefore, appreciates the proactive approach being taken by the SEM Committee in response to these exceptional circumstances.

2 Executive Summary

Energia strongly supports both the proposal to reduce the duration of the Undefined Exposure Period (UDE) to 7 days from 9 and the proposal to reduce the timeframe for Letters of Credit (LoC) to be approved by SEMO with immediate effect.

The undefined exposure period is informed by the length of time it takes to remove a market participant from trading. Improvements to the Supplier of Last Resort process in both jurisdictions indicate that the timelines for supplier suspension periods could be reduced, which would by association reduce the duration of the overall UDE. We note that a similar reduction to the duration of the UDE was effected, prior to I-SEM going live and did not result in an increase in the perception of risk in the market. As discussed later, the requirement for market participants to post collateral in two markets implies that the balancing market is already significantly over collateralised. Reducing the UDE period reduces the extent to which suppliers are posting surplus collateral, reducing barriers to entry in the market.

In relation to LoCs, Energia perceive that a key factor driving market participants to post extra credit cover above and beyond their Required Credit Cover, is a concern in relation to the time taken to process and amend a participant's collateral position. Reducing the timespans for processing LoCs will allow participants to act more efficiently in relation to posting the appropriate quantity of collateral.

2.1 Dual Collateralisation in I-SEM

Presently suppliers are required to post collateral in respect of their potential market exposure in both the ex–ante market and balancing market. This implies that for each unit of power consumed by one of the supplier's customers, the supplier will more than likely have been required to post collateral for that unit twice, once in the day ahead markets and once in the balancing market.

The source of this dual collateralisation problem is that all participants are required to post collateral separately to ECC and SEMO for the ex–ante and balancing markets respectively and SEMO's collateral requirements are not informed by subtracting a participant's traded volumes in the ex–ante market's from their potential balancing market exposure. Participants are therefore obliged to post collateral twice in respect of the same unit, which is inefficient and increases the overall cost of supply to the detriment of final consumers.

Fortunately, Energia believe there are solutions that could be deployed in order to solve this issue. Solutions include either SEMO appointing a (centralised) clearing bank or SEMO providing clearing services for the ex-ante market. Either of which would remove the unnecessary and inefficient dual collateralisation of DAM and BM by market participants. Energia note that such a proposal was originally considered too costly a project at the ISEM design phase, but in the context of the current trading conditions, we believe such a project is likely to deliver benefits for customers once it is re-evaluated.

3 Consultation Questions

3.1 Question 1 Do you agree with the SEM Committee's proposals to amend the Single Suspension Delay Period to 5 days and thereby reduce the Undefined Exposure Period to 7 days?

Energia are in favour of this proposal. It's clear from both the consultation paper and recent market experience that the changes made to the Supplier of Last Resort process in both jurisdictions, allow market participants to be removed from the market in a shorter timeframe than was appreciated by the single suspension delay period. In relation to the potential for the proposed change to increase risk in the market, Energia note the following:

1) As per Energia's comments in section 2.1, the I-SEM market is effectively collateralised twice, by virtue of participants having to provide credit cover in respect of their ex-ante market position and balancing market potential volumes.

2) As the decision paper outlines, when an SOLR is declared by either RA, the effect of that decision as it pertains to settlement is 00:00:00, that same day. This implies that any declaration by the RAs is retrospective and it does not matter whether the RAs declare an SOLR at either 09:00 or 18:00 on a given day, the timestamp will be the same. This implies that the RAs have an additional day to decide on whether or not to declare an SOLR, compared to what was previously understood.

3) For every day within the UDE period, each participant is obliged to provide credit cover in respect of 100% of their volumes. While a participant may default, it is in Energia's opinion highly unlikely that a participant would default entirely on 100% of their traded volumes on a given day. Even were that to happen, the market is fully insulated from the participant defaulting entirely on its traded volumes for a further 4 days.

4) Under this proposal, the RAs would still have five full days to decide on the viability of a supplier, before deciding whether or not to declare a supplier of last resort. It is clear that the RAs would not delay declaring an SOLR in the case of a supplier that was irrevocably insolvent.

5) In the unlikely case that it took longer than 5 days for the RAs to reach a decision to proceed with an SOLR, the expectation would be that the supplier in question, was only in partial default initially. The expectation would therefore be that the amount the participant was in default each day, would not equate to 100% of its daily volumes, implying that there would be a significant amount of collateral left over to cover an additional day's trading. i.e., if the supplier defaulted on 80% of its daily volumes for 5 days, it would still have enough credit cover to insulate the market against a further day's trading. If the

participant default only on 60% of their daily volumes for 5 days, enough collateral would remain to cover an additional 2 days, etc.

6) That when a similar reduction in the UDE occurred in preparation for I-SEM going live, there was not, to Energia's knowledge, any change in perception of the risk profile associated with operating in the market. In other words, the banking sector did not perceive any additional risk to operating in this market and as such did not price in additional premium to market participants in their lending costs.

3.2 Question 2 Do you agree that an increased risk of bad debt in the balancing market is an acceptable trade-off when weighed against the reduced collateral burden on all Participants in the market on an ongoing basis?

As mentioned in our response to question 1 above, Energia do not anticipate that this proposal will increase the risk of bad debt in the balancing market in any material way. The clear benefit to participants of posting less collateral, therefore outweighs whatever additional risk (perceived or otherwise) is created by virtue of this proposal.

As an example of the financial cost versus benefits of this proposal, if we assume that a given supplier must post €10 million per day in collateral for each of the nine days within the UDE, this proposal will reduce this collateral obligation by €20m. It would therefore be hard to imagine how any additional premium charged by an issuer of a letter of credit following this change, would offset the benefit of the supplier having to post as much collateral.

Lastly, Energia also believe that reducing the duration of the UDE reduces the collateral requirements of new entrants, which can only be positive for competition and ultimately customer choice.

3.3 Question 3 In your view, what are the reasons why many Participants in the balancing market are posting extra Credit Cover, significantly over and above their Required Credit Cover?

Energia believe that a key factor which is driving market participants to post extra credit above their Required Credit Cover, is the turnaround time it takes to increase an LoC coupled with managing the market volatility. When there is sudden volatility leading to a Credit Cover Increase Notice (CCIN), there is inadequate time to remedy the CCIN under current processing timelines for increasing an LoC.

In addition, under scenarios where market participants' collateral requirements can be offset by generation, the difficulties of forecasting real-time generation (including constraints) mean that forecast generation cannot be accurately relied upon in respect of managing collateral postings.

Therefore, market participants find themselves in challenging positions of having to post collateral with large headroom in order to avoid having to post cash at short notice to meet CCIN requirements when this occurs.

3.4 Question 4 In your view, are the approval times for Letters of Credit causing Participants to post extra Credit Cover as "headroom" as they believe they may find it difficult to meet the timelines of a Credit Cover Increase Notice (CCIN) with a Letter of Credit?

Energia are firmly of the view that the current approval timelines for LoC contribute to participants posting extra credit as headroom. Prudent participants will post additional collateral to hold sufficient surplus to mitigate the risk of market volatility. The current 4 working day timeframe for SEM to accept an LoC amendment into a participant's market calculation makes reacting to increased collateral requirements or a CCIN via LoC unachievable. Because of this, participants are required to remain over collateralized in the balancing market to avoid requiring cash postings at short notice in the event of a collateral spike.

3.5 Question 5 What are your views on the approval times for Letters of Credit generally? Are there any changes that could be made to the current approval processes that would allow Letters of Credit to be approved more quickly (bearing in mind that Letters of Credit must meet the conditions set out in Agreed Procedure 9)?

Currently Agreed Procedure 9 of the TSC stipulates that a participant seeking to submit an LoC from a Credit Cover Provider and proof that the Credit Cover Provider meets Bank Eligibility requirements must do so *"At least 4WD prior to the date from which the Letter of Credit needs to be accepted".*

The Market Operator has 2 WD from receipt of the LoC and accompanying proof to review the information and inform the participant if they have passed the checks carried out. This timeframe for an LoC to be effective is putting unnecessary pressure on participants to hold more collateral than required.

The markets credit cover requirements stipulate that should a CCIN be issued to a market participant then they have 48 hours to action. Given the current timelines for processing an LoC, this means that if the participant were able to produce an LoC amendment (i.e., increased LoC) on the day they received a CCIN, under the current timeline that increased LoC would not close out the CCIN. As a result, the participant is forced into posting excess cash for collateral and often with headroom to avoid getting exposed. With current market volatility, BM exposure can fluctuate significantly in a short space of time and therefore this is putting even greater requirements on the cash collateral postings, noting the limitations around the LoC process.

A reduction in the time taken for an LoC to be accepted and effective would therefore provide a benefit in making a market participant more comfortable with lowering the headroom in their posted collateral. Energia would therefore recommend that an LoC should be accepted and effective within 1 WD from when it is submitted for both a new and an amended LoC so that a participant can potentially avail of this in the event of receiving a CCIN and that this should be reflected in an updated Agreed Procedure 9. Reducing these timelines will allow participants more flexibility in dealing with high prices and market volatility.