# SEM TRADING AND SETTLEMENT CODE

## Regulatory Authorities' Approval of Credit Cover Parameters for the First Trading Year

## DECISION ON 2007 VALUES AND PROPOSED DECISION ON 2008 VALUES

**28 September 2007**

**AIP/SEM/07/489**

# 1. Introduction

Under the terms of the SEM Trading and Settlement Code (TSC) the Regulatory Authorities (RAs) shall determine certain parameters proposed by the Market Operator (MO) in relation to the calculation and treatment of participants' Required Credit Cover. Paragraphs 6.174 and 8.42 detail these parameters (shown in the table below).

| |
|---|
| Historical Assessment Period for Billing Period |
| Historical Assessment Period for Capacity Period |
| Analysis Percentile Parameter |
| Credit Cover Adjustment Trigger |
| Maximum level of the Warning Limit |
| Fixed Credit Requirement for Supplier Units |
| Fixed Credit Requirement for Generator Units |
| Initial Credit Assessment Price |
| Estimated Capacity Price |

The RAs have received the MO's report which proposes values for the parameters for the First Trading Year, and have undergone a consultation process (AIP/SEM/07/438) with participants on these. The RAs have received comments on the consultation paper for the parameters and have provided all comments received to the MO who has, in turn, responded to them. On the basis of the comments on the consultation paper, the MO responses and the RAs' own considerations, the RAs have reached their decision on the values that should be used for the parameters concerned for the First Trading Year.

The RAs are issuing their determination on these values for 2007 for information purposes and shall convey to the MO the approved values for publication in accordance with paragraph 6.176 and 8.42 (as applicable) of the TSC.

As explained in Section 4 of this paper, the RAs have received a submission from the MO for these parameters, where relevant, for 2008; in all cases the same values are proposed as those for the First Trading Year. The RAs request participants to provide any additional comments on these proposals pertaining to 2008, bearing in mind that the RAs will consider comments received on 2007 values to apply to 2008 unless informed to the contrary. Comments are requested in relation to the 2008 values by 19 October 2007, after which time, subject to any comments received, the RAs expect to determine that the same values as approved in this Decision Paper apply to 2008 and convey this to the MO for publication.

# 2. Comments on the Consultation Paper and the Regulatory Authorities' Response

The RAs received comments from 3 parties on the Consultation Paper. These were:

- ESB Customer Supply (ESB CS)
- Northern Ireland Electricity (NIE)
- Viridian Power and Energy (VPE)

## 2.1. Historical Assessment for Billing Period and Historical Assessment for Capacity Period

### 2.1.1. Market Operator's Proposed Values

The Market Operator has proposed a 45 day Historical Assessment Period for Billing Period, stating that this has the benefit of providing cover to the market without over-burdening the Participant by requiring more Credit Cover than is necessary, and also providing a short term response to seasonal changes. This would mean there would be less necessity to set the Fixed Credit Requirement to a level that would cover this.

The Market Operator has proposed a 100 day Historical Assessment Period for Capacity Period with the justification that this will ensure an adequate sample size is available for calculation of Capacity Undefined Exposure Credit Cover, while minimising the amount of historical data required for calculation and allow a rapid response to seasonal changes.

### 2.1.2. Respondents' Comments

Generally, respondents were of the view that both the Historical Assessment Period (HAP) for the Billing Period and the Historical Assessment Period for the Capacity Period as proposed by the Market Operator are acceptable values. Both **ESBCS** and **NIE** pointed out that these values are based on the assumption that the Supplier Suspension Delay Period (SSDP) would be 20 days, which may not be correct and could require clarification when the RAs issues their Decision.

### 2.1.3. Market Operator's Response

**The Market Operator responded to the above points and to requests for clarification by the RAs as follows:**

*"As a clarification, the SSDP has been confirmed as 14 calendar days as opposed to the 20 working days (or approximately 28 calendar days) which was used as the basis for the credit cover calculations.*

*Given the SSDP has now been confirmed as 14 calendar days, this will reduce the value of the Undefined Exposure and subsequently the Required Credit Cover, but it will not significantly affect variance of the Required Credit Cover overtime. Without performing detailed analysis of the implications of this change in the SSDP, it is difficult to confirm that reducing the HAP proportionally is appropriate".*

### 2.1.4. Regulatory Authorities' Determination

The RAs note that the SSDP has now been set at 14 days. The RAs estimate that taking this change into account would give a HAP for Billing Period of 35 days and a HAP for Capacity Period of 90 days. However, given the Market Operator's view that a reduction in the SSDP value will not have a material affect on the variance of Required Credit Cover at a given time, the RAs accept the Market Operators proposal of 45 days for the HAP for Billing Period and 100 for the HAP for Capacity Period.

## 2.2. Analysis Percentile Parameter, Credit Cover Adjustment Trigger, Maximum Level of Warning Limit

### 2.2.1. Market Operator's Proposed Values

The Market Operator has proposed and justified an **Analysis Percentile Value of** 1.96, which is equivalent to 95%; a percentage value is required under the TSC.

The Market Operator has proposed a Credit Cover Adjustment Trigger of 15%.

The Market Operator has proposed a Maximum Level Warning Limit of 75%.

The justification and analysis of these, as carried out by the Market Operator, can be found in the Consultation Paper on Credit Cover Parameters.[1]

### 2.2.2. Respondents' Comments

Respondents either had no comment on these parameters, or indicated that they were prepared to accept the Market Operator Proposals. **NIE**, while accepting the proposed figure for the Credit Cover Adjustment Trigger, pointed out that they do not necessarily accept that the statistical analysis underpinning this should be completed using a normal distribution.

### 2.2.3. Market Operator's Response

The Market Operator has confirmed that they have no reason based on the comments received on the consultation to change these values.

### 2.2.4. Regulatory Authorities' Determination

The RAs approve the Market Operators proposed values, noting that the 1.96 proposed Analysis Percentile Parameter based on an Analysis Percentile of 95% will be interpreted to be 95% by the RAs as the TSC[2] requires this to be a percentage based value.

[1] AIP/SEM/07/438 of 9 August 2007

[2] Note: TSC Glossary defines this value as "a percentage degree of statistical confidence that Actual Exposures, once determined for each participant, will fall below the estimate of Undefined Potential Exposure"

## 2.3. Fixed Credit Cover for Supplier Units

### 2.3.1. Market Operator's Proposed Values

The Market Operator has proposed a value of €100,000 for the Fixed Credit Requirement (FCR) for Supplier Units, noting that this amount applies on a per Supplier Unit basis as set out in the TSC.

This figure is justified[3] by the Market Operator by calculating a conservative average supplier volume of 1200MWh, this has been multiplied by the proposed Initial Credit Assessment Price for Billing Periods (as set out below as the Estimated Energy Price plus the Variable Market Operator Price plus the Imperfections Price) of €92.636. This is then factored by the duration of the Undefined Exposure Period (28 days assuming a Supplier Suspension Delay Period of 20 working days). Assuming the metered demand may change by 1%, this would give a value of €31,125.696.

Taking the same average supplier volume, considering a step increase of 20%, using the Estimated Capacity Price of €10.18 and taking account of the same duration of Undefined Exposure Period, this would provide a value of €68,409.60.

Adding these two figures together and with a slight rounding off, the justification arrives at a figure of €100,000

### 2.3.2. Respondents' Comments

**NIE** argued that the Market Operator's justification for the proposed €100,000 value is unclear and the cost of this could be seen as a barrier to entry for smaller Suppliers. They further state that in the absence of sufficient justification, the Fixed Credit Cover for Supplier Units should be £35,000 (presume €35,000). NIE also comment that the value should be specified at the Participant level and not the Unit level. They point out that NIE was required to register an Error Unit and a separate Associated Supplier unit under the TSC and therefore would halve to provide the Fixed Credit Cover for these which were registered solely to comply with TSC rules, without any commercial benefit to themselves.

**ESBCS** took issue with the rounding of the proposed figure to €100,000.

### 2.3.3. Market Operator's Response

The Market Operator responded to these comments, and to those requested from the RAs for clarification on the methodology behind this figure, as follows:

*As stated in the Credit Cover Parameters 2007 paper, the calculation of Supplier Units Fixed Credit Cover Requirement takes account of two factors – Settlement Reruns and Step Increases in the Capacity Period Payment sums.*

*The calculated value of €100,000 is therefore the summation of these two components. i.e. €31,125.70 + €68,409.60 = €99,535.30 rounded up to €100,000*

### 2.3.4. Regulatory Authorities' Determination

Regarding Participant comments on the Fixed Credit Requirement in the TSC as a requirement for each Supplier Unit and separately for each Generator Unit, rather

[3] Again, for further detail refer to AIP/SEM/07/438

than a on participant basis, the RAs would point out that the TSC rules use this value as a basis for the requirement to continue to hold credit cover for 14 months in respect of deregistered units; so the approach cannot be changed without quite an overhaul of the treatment of Credit Cover, involving a complex modification to the TSC.

The RAs accept the Market Operator proposals on the €31,125 value of the Fixed Credit Cover Requirement for Supplier Units, however they do not accept that there is adequate justification for including the €68.409 portion relating to Capacity Charges, which has no basis in the TSC (the TSC[4] provides that resettlement exposure is the only area that the Fixed Credit Cover Requirement is required to cover). The TSC's requirement that Parties should maintain the FCR for 14 months after the decommissioning of a Unit implies that the FCR is only to cover changes in payments and charges after they have been paid and before the Final Settlement.

The Regulatory Authorities also note that the Fixed Credit Requirement for Supplier Units will apply to all such units under the TSC. This will include Trading Site Supplier Units. Although Participants who are able to register a Trading Site Supplier Unit have the choice to register such demand as an Associated Supplier Unit and make such a choice on commercial grounds, the Regulatory Authorities believe that this represents a further reason for their move to reduce the level of the Fixed Credit Cover for Supplier Units.

For the reasons stated above and in the interests of not putting in place an undue barrier to entry for new Suppliers intending to enter the market, the RAs have determined that the Fixed Credit Cover Requirement for Supplier Units is €30,000. This figure is based on the Market Operator's calculations for the Settlement reruns element of the FCR and rounded slightly downward.

The RAs consider that this is a suitable value for the SEM for 2007, but would suggest that any participants who disagree with such a figure for 2008 submit comments to the Regulatory Authorities by the closing date mentioned in Section 4 of this paper. If no responses on this issue are received, the RAs are minded to approve the same figure for 2008.

## 2.4. Fixed Credit Cover for Generator Units

### 2.4.1. Market Operator's Proposed Values

The Market Operator has proposed that there be a Fixed Credit Requirement of €10,000 for Generator Units. The justification for this is argued by the Market Operator to be that Generator Units do not pose as significant a Credit Risk in the market as it can reasonably be expected that they will be owed monies in the SEM. The MO notes that there are only a few special cases where a Generator Unit can be seen as posing a risk to the SEM, which apply uniquely to certain types of Generator Units (Pumped Storage Hydro and Interconnector Units).

The MO notes that 'Section 6.245A of the Trading & Settlement Code allows for the Market Operator to remove Settlement Reallocation Agreements that result in a Participant with Generator Units becoming a debtor to the market. This minimises the

[4] Trading and Settlement Code Agreed Procedure 9

risk of a Participant entering into Settlement Reallocation Agreements greater than its earnings and thereby introducing elements of unsecured Credit Risk into the market. However, this clause will lapse 12 months after the market start date, after which time the Market Operator will not be permitted to take any such action'.

The MO's justification goes on to state that 'As a result it will be possible that a Participant with Generator Units could end up as a debtor to the market. Section 6.244 of the Trading & Settlement prohibits Participants with Generator Units from reallocating beyond their expected payments. However, it is necessary that consideration is given to the possibility that a Participant with Generator Units basing their Reallocations on forecast data, may overestimate their expected earnings resulting in the Participant becoming a debtor to the market'.

### 2.4.2. Respondents' Comments

**NIE** argued that the €10,000 proposal is not an appropriate value and point out that paragraph 6.245A of the TSC will not lapse until 12 months after the market start date, so 'the only liability of the Participant with Generating Units is Market Operator charges'. NIE recommended instead that the FCR for Generators should be calculated based on the Participant's Market Operator charges.

**ESBCS** made the point that no calculation has been provided to back up the €10,000 FCR proposal and questioned why there would be a requirement at all for this parameter for the first 12 months of the SEM if all Settlement Reallocation Agreements that lead to a Generator becoming a debtor are to be cancelled; ESBCS went on to ask if this was the only basis for the FCR.

**VPE** noted that if the proposed valued for the FCR for Generator Units are approved, then for every wind farm registered in the SEM, €10,000 must be provided in credit cover. VPE argued against having to put such a level of credit in place for every generator unit, especially in respect of wind farms. Instead, VPE recommended that the Fixed Credit Requirement is at the Participant level. Sterling equivalents were also requested to be provided in respect of the final determined amounts.

### 2.4.3. Market Operator's Response

The Market Operator responded to the above comments, and requests for clarification from the RAs on the methodology behind the proposed value, as follows:

*Taking into account paragraph 6.245A the risk to the market is minimised, however, once this clause lapses in 12 months time, there is a possibility that Generators could become debtors and have an unsecured risk. If the fixed credit cover component was reduced or removed from Generator Units, then Market Participants would need to realise they are taking on the additional risk of another Generator defaulting.*

### 2.4.4. Regulatory Authorities' Determination

The RAs have considered respondents' concerns over the arbitrary nature of this value and the fact that it may pose a barrier to market entry. The RAs are minded to balance the level of collateralisation on one hand, with the risk of too high a credit cover hurdle for new entrants on the other. The RAs consider that above DeMinimis Generators should be encouraged, where possible, to participate directly in the SEM rather than through an Intermediary, and in view of this, do not see any merit in maintaining an unjustifiably high FCR value for Generators.

In addition, as in the case of Trading Site Supplier Units mentioned above, the RAs note that there is a further class of Generator Units which will be subject to the Fixed Credit Requirement for Generator Units. These are the Netting Generator Units of which there is one registered for each Trading Site. Again, this is a further reason why the RAs believe that the Fixed Credit Cover for Generator Units should be reduced.

For the above reasons, the RAs determine the Fixed Credit Requirement for Generator Units to be €5,000.

## 2.5. Credit Assessment Price & Estimated Capacity Price

### 2.5.1. Market Operator's Proposed Values

The Market Operator has proposed an Initial Credit Assessment Price of €102.816. The justification notes that as this is intended to cover all market exposures in the SEM, the Estimated Capacity Price has been included in this figure. The Market Operator calculated the Estimated Capacity Price to be €10.18, using an analysis set at 1.96 as proposed, and the Historical Assessment Period, based across the two months of available data.

### 2.5.2. Respondents' Comments

Respondents were generally prepared to accept this value. **ESBCS** noted that the calculations are inconsistent with the values for SMP, Imperfections Price and Variable Market Operator Price used in the RAs' Supplier Suspension Delay Period. **NIE** accepted the value proposed for the Estimated Capacity Price but noted that the stated value is greater than it will be in reality.

### 2.5.3. Market Operator's Response

The Market Operator responded to these comments as follows:

*The values used for the calculation of the Initial Credit Assessment Price were based on paper 07-246 - SMO Revenue Consultation Paper. These were the latest available values at the time the Credit Cover Parameter analysis was completed. This explains the discrepancy between the values used in the Credit Cover Parameter Paper and subsequent papers published.*

*The values used for the calculation of the Estimated Capacity Price were based on paper 07-246 SMO Revenue Consultation Paper. These were the latest available values at the time the Credit Cover Parameter analysis was completed. This explains the discrepancy between the values used in the Credit Cover Parameter Paper and subsequent papers published.*

### 2.5.4. Regulatory Authorities' Determination

The RAs accept the Market Operator proposed values for the Credit Assessment Price and the Estimated Capacity Price.

## 3. Conclusions

The Regulatory Authorities approve the following Credit Cover related parameters for 2007 and propose that the same values be used for 2008. It should be noted that the Credit Assessment Price and the Estimated Capacity Price are in fact calculated under the TSC on an enduring basis, and are only required to be set as per paragraph 8.42 for the purposes of calculating the Required Credit Cover for the Undefined Exposure Period for new and adjusted Participants for the first Trading Year only. For 2008 and subsequent years, these values are calculated by the Market Operator.

The table below summarised the RAs' determinations for 2007 Credit Cover parameters:

| | |
|---|---:|
| Historical Assessment Period for Billing Period | 45 days |
| Historical Assessment Period for Capacity Period | 100 days |
| Analysis Percentile Parameter | 95% (1.96) |
| Credit Cover Adjustment Trigger | 15% |
| Maximum level of the Warning Limit | 75% |
| Fixed Credit Requirement for Supplier Units | €30,000 |
| Fixed Credit Requirement for Generator Units | €5,000 |
| Initial Credit Assessment Price | €102.816 |
| Estimated Capacity Price | €10.18 |

## 4. RAs' Determination of 2008 Credit Cover Values

The RAs invite interested parties to respond with comments, if any, on the values for the parameters in this paper as proposed values for 2008. The RAs presume that the comments received on the 2007 values apply for 2008. If no comments are received by 19 October 2007, and should the RAs not have any cause in the interim to revise these values, the RAs will notify the Market Operator that the values in this paper, where relevant, apply to 2008.

Comments on the proposed 2008 values should be sent, preferably in electronic form, to:

Philip Newsome,
Commission for Energy Regulation,
The Exchange,
Belgard Square North,
Dublin 24

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The closing date for comments is 19th October 2007