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RE: ISEM Forwards and Liquidity Discussion Paper, SEM-15-010 ('the Discussion Paper')

Dear James, Joe,

Bord Gáis Energy (BGE) welcomes the Discussion Paper and the opportunity to input at this early stage into the structure and focus of the Forwards and Liquidity work-stream.

Liquidity in markets is generally recognized as the ability to trade an asset at short notice, at low cost and with little impact on its price. The Single Electricity Market ('the SEM') has been relatively successful in delivering near-term liquidity in what is a small market with a high level of market concentration. This is particularly evident in SEM's spot market whereby a centralized, mandatory market with a single price, socialized forecasting and balancing and regulatory bidding rules support a market price which reflects the fundamentals of the market and facilitates trading of all types and size of market players. However, the SEM has not succeeded in delivering real liquidity in the forward timeframe. BGE views the ISEM as an opportunity for the market to fix and provide this forward liquidity and in so doing facilitate and support greater competition in the retail market.

In its February 2012 Decision Paper on Market Power and Liquidity, the SEM Committee recognized the importance of liquidity in the development of retail market competition. Since that Decision Paper was published, wind output and Interconnector flows have increased further and the introduction of more onerous financial regulations has seen the exit of financial and other non-physical trading parties from the SEM. Consequently, there has been a reduction in the level of liquidity in the market, particularly in the forwards market, which is notable by the relatively high bid/ offer spreads in non-directed contracts and by the difficulty in accessing/ limited availability of, short-term forward products.

BGE is concerned that liquidity will be further unraveled by the introduction of the ISEM. Specifically:

- Without mandatory bidding in the day-ahead market (DAM), trading of the already limited energy volumes will be dispersed over 3 timeframes;
- In the absence of bidding rules, the position of the incumbent will be less transparent and the ability of other parties to compete with its portfolio will be diminished. The corollary of this is that dispatch certainty will likely be reduced further; and
- The development of near-term trading arrangements in the intra-day[1] and balancing markets and the introduction of penal imbalance prices will introduce complexity and risk in forward trading, potentially reducing parties' appetite to trade.

Collectively, BGE is concerned that these changes will reduce the volumes of power traded in the forward market and/or increase the price of forward trades made available to the market.

To mitigate these risks, this liquidity work-stream must therefore:

- Work with the Energy Trading Arrangements work-stream to maximise and ensure day ahead and intraday market liquidity, as well as transparency in pricing in the day ahead, intra-day and balancing markets; and

[1] Liquidity in the intraday market will be critical for companies seeking to manage their demand and wind forecast risk. Without transparency and confidence in the position of the incumbent in the intraday market, retailers will be put at significant risk, exposing them to balancing prices as a last resort.

- Work with the Market Power work-stream to ensure that the dominance of the incumbent is tempered and in so doing ensure that other market participants can have confidence in the availability, frequency and price of products across all market timeframes from forwards to balancing.

From an Energy Trading Arrangements point of view, the Regulatory Authorities (RAs) should make provisions to review the market after a period of time (12 – 18 months following implementation) with an option to enforce mandatory bidding in the day-ahead market and other such regulatory tools if liquidity is not evident. There should also be mechanisms for ex-post auditing of prices of parties with market power. These types of provisions will act as insurance mechanisms in the market, provide greater confidence in the market inputs and outcomes and in so doing, provide an environment to optimize liquidity in what we recognize is a small wholesale market.

With respect to market power arrangements, whereby we recognize that Directed Contracts (DCs) have been a key part of the market power mitigation measures in the SEM, it should not be under-estimated how critical they have been in providing forward liquidity in the SEM. While DCs have been instrumental in providing much-needed forward liquidity, there remains substantial demand for more hedging products (particularly mid-merit and peak products) at a fair price to support and enhance retail market competition, to the ultimate benefit of the consumer. This demand will become even stronger when we move to more dynamic trading under the ISEM design. The provision of DCs (or their equivalent in an ISEM context) should be regarded as firstly a key part of the Forward & Liquidity work-stream and as a consequence assessed in terms of how it affects market power within the market (as opposed to vice versa it being regarded primarily as a market power mitigation tool).

If collectively these work-streams can drive transparency and confidence in the ISEM market fundamentals it will in-turn provide a good platform to then engage with other non-SEM based counterparties/exchanges and non-physical traders to build on the liquidity, however limited, implicit in the market design.

This work-stream, and specifically the forward market, must also consider how the market transitions from the SEM to ISEM. In the lead-in to the SEM in 2007, little consideration was given to this transition which put suppliers at considerable risk at the time. Given there are now many more suppliers in the market managing this transition is critical to both the success of the ISEM project and also the sustainability of retail market competition on the island. In a truly competitive market suppliers will seek to innovate in their offering of contracts and products to customers. Without a forward market to actively hedge the wholesale market risk, suppliers without access to a broad asset portfolio, will either have to reduce their offerings or price the increased risk into the contracts offered to customers. In short, whereby the ISEM Day-Ahead, Intra-day and Balancing markets may be timed to 'go-live' in October 2017 the Forward market must 'go-live' in some form in advance, and no less than 6 months in advance, of the wider launch of the ISEM.

The remainder of this response focuses on the specific questions posed in the consultation. At this stage, BGE is still in the process of developing its thoughts on how liquidity could best be facilitated both within zone and across borders. We are therefore not in a position to provide detailed solutions but look forward to engaging with the RAs in more detail on this issue over the coming months.

1. Within Zone Liquidity

1) *Are there other issues which have affected forward liquidity in SEM or any comments on the applicability of the issues identified above?*

The provision of directed contracts and the liquidity of the DAM in the SEM have been the main facilitators of forward liquidity in the SEM. Notwithstanding that, liquidity outside of the directed contracts is minimal, even if it has somewhat improved (e.g. via the development of the Tullett Prebon platform). This lack of liquidity is largely due to the dominance of ESB – not just in terms of the capacity that it holds but its dominance within the market schedule – accounting for circa 50% of units scheduled in Q3 2014 according to the RAs' latest data as well as the small size of, and corresponding number of players in, the market. Beyond that, other players have smaller volumes to trade, therefore managing the scheduling risk is more difficult and their potential of actually having an impact on the volumes provided to the market is less meaningful. Without addressing this imbalance, liquidity in the SEM and ISEM cannot be reasonably expected to improve organically.

2) *Which issues are expected to persist with introduction of ISEM?*

As outlined above, the size and structure of the ESB is a significant determinant of liquidity in the SEM. Assuming for the purposes of this response that the structure of ESB will be unchanged, this issue will persist in the ISEM. Added to this, the fact that the day-ahead market will not be mandatory and the bidding rules will potentially be removed, will increase the market power potential across all market timeframes with a subsequent impact on the level of liquidity, and consequentially growth of competition, in the market. Facilitating as much participation in the DAM as possible, including by wind (balanced against the need to minimise constraint costs) will be instrumental in maintaining DAM liquidity.

Also of note, the Harmonised Allocation Rules ('the HAR'), currently being developed at a European level by ENTSO-E, are proposing rules which in BGE's view could potentially increase uncertainty over revenue streams underpinned by Financial Transmission Rights[2], devaluing the capacity or rights held by participants and reducing the value and contribution of the interconnector in providing liquidity to the market. The interconnector currently provides access to a more liquid GB market, which for BGE is incredibly important in enabling us to manage our portfolio and changes in the portfolio on an ongoing basis. Considering that forward trades in SEM only occur bi-monthly this ongoing flexibility is critical for suppliers and anything that inhibits such flexibility must be avoided.

3) *What are the priority issues to address under ISEM and what possible solutions should be considered?*

As outlined in the introduction to this response, BGE is of the view that ensuring the market rules for the day-ahead, intra-day and balancing markets are transparent such that they support robust price discovery and that the market power of the incumbent is tempered are essential if the ISEM is to be successful in delivering a liquid wholesale market and in so doing, facilitating retail market competition.

Also critical to the work-stream is the provision of transitionary forward arrangements ahead of the launch of the ISEM particularly if FTRs will not be auction-ready sufficiently in advance of ISEM go-live. This will be hugely important for all participants, but particularly suppliers in the market who are competing to supply customers and to introduce innovative and flexible products to the market. This was overlooked when the SEM was implemented in 2007 but is even of more importance now given the level of competition and the type of suppliers in the market.

Areas and solutions to be considered include:

- Retaining directed contracts and increasing the volumes, and range of products, of directed contracts on offer in recognition of the role of DCs in providing liquidity and as a means of enhancing liquidity in the forwards market;
- Providing energy release contracts for certain ESB plant to enable at least the contractual creation of other portfolio players in the market who can provide/avail of liquidity and thereby attempt to compete on a more level playing field with the incumbent on an enduring basis;
- Establishing a market maker with a bid/offer spread cap (which could be a form of DC arrangement);
- The provision of some form of bidding rules for the incumbent;
- Capping the volumes traded between the incumbent generator and supplier forcing them to trade with other players in the market;
- Designing day-ahead market rules which incentivise ex-ante trading of wind while balancing the trade-off on constraint costs;
- Providing for a review of the performance of the DAM in terms of liquidity and a mechanism to introduce mandatory participation, if deemed necessary following the review; and
- Ensuring that the balancing rules and prices do not expose certain participants to risks which are difficult/ costly to manage to the benefit of other market participants.

[2] Specifically, BGE is referring to the proposals with respect to the timelines for Long Term Firmness and the curtailment of rights for the GB/SEM interconnector.

4) *What role should directed contracts play under ISEM? What form should they take?*

DCs will still be hugely important on an enduring basis in the ISEM, not least because of the position of the incumbent but also to provide a benchmark price and a minimum level of liquidity in the ISEM.

In setting the volume of DCs, the RAs should not look to measure concentration in the market (by reference to the HHI threshold) but should instead change the tenant of the assessment to review market liquidity. Whereby the approach to calculating the DC volumes would still need to recognise the portfolio advantage held by ESB, it should review it by reference to its capacity to provide and sustain liquidity in the market, and provide a range of much needed products, by virtue of certain key assets it holds.

Access to and demand for the use of liquid products, particularly peak and mid-merit, for hedging risk will become even more important in a dynamic ISEM market and for retail competition. Given that the ISEM will introduce markets which can value peak and flexible generation more dynamically and with more discretion, it will be important that the provision of DCs (or their equivalent) better recognises this demand and provides appropriate reference prices to accommodate this (i.e. the DAM price may not be the appropriate reference price for all DCs).

There are suggestions in some academic circles that call options are a better means of providing liquidity to the market and mitigating market power. The suggestion is that they provide ultimate flexibility to the buyer of the options while also reducing the incentive on the seller to manipulate prices in the reference market. This should be considered and assessed in more detail as part of a review of DCs in the ISEM.

5) *Are market power mitigation measures needed in the forward market? If so, what options are available and how could they be applied?*

In addition to the answer in 4 above, the current approach to allocating eligible DC volumes favours the incumbent supplier and is a barrier to other suppliers entering and growing in the market. Initial allocation of DC volumes amongst suppliers should provide a greater weighting to suppliers below a certain market threshold. To the extent that they do not exercise their option in the first round, the remaining volume can be distributed amongst other interested parties through the supplemental windows.

In terms of mitigating market power further, the options outlined in the answer to question 3 above should be considered and assessed in more detail as part of this work-stream in conjunction with the market power work-stream. Recognising that liquidity is something that should be a market wide provision under an ideal market environment, the ability and confidence of other parties in contributing to this liquidity hinges on how the market ensures that the dominant incumbent cannot exercise its market power, and that price formation in the market will be transparent and reflects the real market fundamentals at any given time.

6) *Is an ISEM specific exchange or an ISEM screen on an existing exchange preferable?*

BGE has no specific preference at this time. However, given the size of the Irish market it is unlikely that the ISEM will be able to attract a **cost effective** solution to an ISEM specific exchange at least in the short-medium term. It may therefore be more advantageous to piggy-back on an existing exchange and benefit from the available economies of scale.

7) *What conditions are needed to support effective functioning of an ISEM exchange?*

An effective exchange requires similar characteristics to a liquid market: it requires a number of players with access to dynamic information and with different risk appetites to trade on an ongoing basis with reference to transparent market price(s). In short, the effectiveness of an exchange can be considered in terms of; a) the available quantity to be traded; b) the speed and frequency of trading; c) the cost of trading, and d) the impact of trading on prices. With that in mind in order for an effective exchange to be established it must be credible to facilitate the trading of relatively large volumes on an ongoing basis by all types and sizes of players, but must not be so complex whereby it requires complex and expensive systems/processes or where price discovery is opaque.

8) *Should development of an exchange be left to the market or is specification from the RAs required?*

Firstly, the indirect role of the RAs in the development of an exchange should not be underestimated. The RAs must ensure that the ISEM market rules and market power provisions provide confidence in the liquidity of the physical markets, which will in turn provide the basis for the development of a forwards exchange. The RAs may also have a direct role to play in developing an exchange through the market maker or enhanced DC provisions. This could form the basis of a merger with other larger, more liquid exchanges in other markets or could provide the basis of local exchange which could facilitate growth and attract new non-physical/financial players over time.

9) *Are there other issues which will affect liquidity in the near-term?*

Given the size of ISEM market and the disaggregated nature of the 3 physical market timeframes, it will be difficult to establish liquidity in the traditional sense in the physical near-term markets. The participation of wind, how supported wind generators are remunerated under REFIT and how parties with capacity contracts are penalised and allowed to trade out risk are other considerations which will impact near-term liquidity in the ISEM. The provision of IDM auctions and a platform to trade capacity contracts should be considered in an attempt to pool what will be limited liquidity in both of these markets. Notwithstanding that, BGE is of the view that the adoption of appropriate measures to ensure a robust forward market will, to a large degree, mitigate the risks of near-term illiquidity.

2. Cross-Border Financial Transmission Rights

10) *What are the advantages and disadvantages of FTR Options or FTR Obligations? What is your preferred approach?*

In BGE's view, FTR options are commercially more akin to the physical transmission rights that SEM participants currently enjoy. That is, they confer a right on participants to arbitrage on the SEM/BETTA price differential with limited exposure to a downside. An obligation would also limit the upside that participants can avail of in return for the price of the FTR. On that basis and without having completed any detailed analysis on the two proposals, BGE's initial view is that an FTR Option would be preferred.

11) *What measures need to be implemented to comply with financial regulation requirements?*

BGE believes that FTRs raise issues not only from a financial regulation perspective but also with regard to REMIT compliance. Regarding financial regulation, specifically the European Markets Infrastructure Regulation (EMIR), the TSOs will have to consider how to comply with obligations including the confirmation of FTRs within strict timelines as well as obligations to report the conclusion/ modification / termination of FTRs within equally strict deadlines. Depending on whether the counterparty to the FTR with the TSO is a financial or non-financial party, further obligations such as dispute resolution procedures and reconciliation processes in FTR contracts may also need consideration.

Under REMIT, FTRs executed by TSOs are trades carried out on an organised market place (i.e. a 'standard' trade), the obligation for the reporting of which will fall on the TSOs in the first instance. This therefore raises the same considerations as are currently being considered by SEMO/ the regulators regarding how to report SEM spot trades for the purposes of REMIT from October 2015 – e.g. what systems are required; what the cost of such systems will be; how the costs of such systems will be recoverable from some/ all market participants etc.

With regard to reporting, it is worth noting that each of EMIR and REMIT provides that there should be no duplication in reporting. The FTR reporting obligations under EMIR and REMIT will come into effect simultaneously and market participants should be fully consulted with regard to for example, under which Regulation reporting should occur with consideration to the least administrative and least costly approach to reporting, the costs of such reporting, and how those costs will be recoverable.

12) *How should transmission losses be factored into FTR design?*

Losses, depending on how they are accounted for ultimately in the market design, are expected to be accounted for by participants in their bids for FTR Options and not in the FTR contract itself. On that basis, the most important aspect from a FTR perspective (without prejudice to BGE's view that losses in the ISEM should be uniform) is that the losses between regions are calculated in a transparent and stable manner such that they do not undermine the value of the option contracts after the fact.

13) What are the ISEM specific issue that need to be considered in development of a Single Allocation Platform?

At this time, BGE cannot identify any ISEM specific issues that may need to be considered. However, depending on the final arrangements for FTRS in the ISEM, the Platform may need to reflect certain ISEM related nuances, for example if it was decided to implement FTR obligations (considering these are not provided for in the proposed market rules or platforms) or if market power issues were identified and mitigating rules put in place to address them.

14) Should development of allocation arrangements be left to the market or is specification from the RAs required?

As with the development of allocation arrangements at an EU level, BGE is of the view that regulatory oversight of the ISEM allocation arrangements should be provided for. Specifically with reference to the Harmonised Allocation Rules that are currently being consulted on by ENTSO-E, there are certain provisions and one SEM specific provision[3] which in BGE's view put the risk of IC availability on IC users as opposed to IC owners, who given their information and expertise are better placed to manage that risk. Putting the risk on IC users reduces the value of IC FTRs, reduces liquidity across the market and principally undermines the initial objective of the ISEM project to facilitate and promote active cross border trading where it is economical to do so.

Recognising that there are physical constraints on the Irish market and that IC users bear some of that risk currently in the SEM with explicit physical capacity auctions, BGE believes that the allocation arrangements should be designed in such a way as to ensure that the party who is best placed to forecast and manage that risk is appropriately incentivised to do so.

A balance between the risks of the IC owners and users needs to be found and at a European level; we believe that Regulatory oversight will be needed in this regard.

15) What are the ISEM specific issues that need to be considered in consideration of firmness?

It is clear from the provisions within the HAR consultation that the IC owners are seeking to minimise their risk in operating the ICs and that SEM IC owners are more concerned about IC capacity availability outside of emergency and force majeure events than other IC owners in Europe. The provision of Annex 12 in the HAR consultation in BGE's view reduces the level of firmness in the SEM market and therefore reduces the value of the ICs in providing liquidity to the market.

The impetus for the Annex no doubt relates to the physical constraints on the Irish system as opposed to the technical capability of the ICs themselves, however, BGE does not believe that IC users should be forced to bear the risk of how the system is operated. Again, this risk is better managed by the IC owners who should be incentivised to optimise IC availability and facilitate system flexibility. Between the provision of DS3 system services and the ability to trade on either side of the interconnectors to hedge potential risks, the IC owners are well positioned to manage firmness, the availability of the ICs and the value they provide to the market in terms of liquidity.

16) Should treatment of firmness issues be left to the market or is input from the RAs required?

As outlined in answer to questions 14 and 15 above, BGE is strongly of the view that a correct balance between the value of risk and the management of risk related to IC availability needs to be found. The ENTSO-E consultation on HAR would suggest that the IC Owners – or the TSOs at least – are in favour of putting that risk fully on IC users, which in BGE's view will undermine the role of ICs in providing liquidity to

[3] Specifically BGE is referring to the provisions for the long-term firmness deadline, curtailment compensation and the provision for curtailment on SEM/BETTA ICs in the event of 'capacity shortages' per Annex 12 of the HAR consultation

the market. On that basis, BGE is of the view that the RAs must provide independent governance in this work-stream to ensure a sensible solution is found in a timely manner.

17) What are the issues relating to revenue adequacy that need to be considered?

As highlighted in the Discussion Paper, this question relates strongly to the question of firmness and who should bear the risk of the technical capability of the system/IC. Again, to the extent that the ISEM project has been initiated to facilitate cross-border flows when economic, it would seem counter-intuitive that the IC allocation rules would put the risk of the technical capability on IC users who do not have the capability to manage the risk.

18) What potential market power issues are linked to FTRs? How can they be dealt with?

At this point in time, BGE is not aware of any market power concerns related to FTRs specifically. However monitoring of the auctions, prices and volumes, should be included as part of the wider market monitoring role (which will likely increase under ISEM and in the context of REMIT).

19) What interactions with other CfDs need to be considered in development of FTRs? What potential implications does FTR design have on these areas of interaction?

Consideration should be given to how the IC owner is allowed to participate in capacity auctions and to the extent that the incentives provided under RO contracts and FTR options are aligned. For example, if there is no incentive on the IC owner to ensure IC availability, particularly at times of system stress, this could have a knock on impact on the capacity market by virtue of the likely knock on effect on ISEM prices.

20) How should transition to FTRs be managed? What requirements are there during the transition phase?

BGE has not fully considered what transitional arrangements for FTRs are required at this time, however, as provided for in the introduction and in response to Q3 above, the transitionary arrangements must be agreed and implemented at least 6 months in advance of ISEM go-live not least from the perspective of facilitating the maintenance and enhancement of retail market competition.

It is anticipated that significant interaction with relevant GB parties including Ofgem and Elexon will be required when adopting rules applicable for a transitory period, e.g. whether changes/ updates are required to participants' obligations under the Balancing and Settlement Code in GB is one such consideration.

I hope that you find the above comments and suggestions helpful to your considerations. BGE is continuing to consider how liquidity and the use of IC FTRs can be optimized in the ISEM and looks forward to engaging with the RAs over the coming months in greater detail. Should you have any questions or wish to discuss any of the above in more detail please do not hesitate to contact me.

Yours sincerely,

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{By email}