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RE: Financial Transmission Rights, Consultation Paper, SEM-15-061

Dear James, Joe,

Bord Gáis Energy welcomes this opportunity to respond to the Consultation on financial transmission rights (**FTRS**) for ISEM.

Forwards liquidity both on an all-island and cross border basis will be a critical element of the new market design to enable market participants to manage their day to day as well as medium and longer term price risks for the benefit of consumers.

Given the current limitations of on-island liquidity there has been increasing reliance on cross-border access to forwards hedging and this trend is likely to continue as European ambitions to maximise cross border trading in all timeframes are realised. Focusing on the cross-border subject of this Consultation, we believe that the following principles should weigh heavily in the Regulatory Authorities' (**RAs'**) decisions pursuant to the Consultation:

- **Liquidity**: the chosen arrangements must maximise the opportunities for market participants to access cross-border trading with a view to ultimately creating opportunities to access the wider pan-EU market to help mitigate the risks of price fluctuations on a long term basis;
- **Harmonisation**: the forwards cross-border solution should not make the island of Ireland any less attractive to trade in on a cross-border basis than any other EU member state and should reflect a progressive step towards integration with the pan-EU market;
- **Risk allocation**: the risk and the cost of managing the risk of cross border financial trading instruments should be allocated to those with best foresight of them and best able to manage and predict them;
- **Cost**: the cross border hedging solution for ISEM should not drive auction participants to have to factor unmanageable risk that cannot be reasonably quantified into the auction price to the detriment of consumers, nor should solutions such as the allocation platform result in stranding of costs or inefficient investment also to the cost of the consumer.

The remainder of this response focuses on our views on the particular questions raised in the Consultation and rationale therefor.

1. **Which offers the greater benefit to the ISEM/ GB market: FTR Options or FTR Obligations?**

Bord Gáis Energy's preference is for the adoption of FTR Options for the ISEM market.

Firstly, we believe that the usefulness and potential success of FTR Options is less contingent on appropriate and sufficient levels of liquidity on the island itself, as compared to FTR Obligations.

As there is limited downside risk with FTR Options, and prices do not necessarily need to be locked in at either side of the interconnector, liquidity on the Irish island (and in GB) is not a necessary pre-requisite for effective functioning of the FTR Option hedge. On the contrary, FTR Obligations by their nature demand access to liquidity on both sides of a border. With FTR Obligations, given that there is no choice of protection against the "downside"; FTR Obligation holders will consistently have to lock in prices both in the GB and ISEM markets. Otherwise, the FTR Obligation holder faces uncapped risk of the downside when downside payments arise – whether you are an asset backed or asset less trader, no party would be prepared to take on this level of risk in the market particularly if you are seeking to provide customers with stable end prices. The following example sets out the risk you are exposed to if you are the holder of an FTR Obligation for export ISEM-GB in the situation when you have not locked out the price. Any "-" in the below table represents money paid:

Forward Timeframe Activity					Prompt Outurn								Example of
Forward	Forward	Forward	Forward	Forward	Prompt Outurn	Prompt Outurn	CFD Payment	Prompt Outurn	Prompt Outurn	Prompt Outurn	Prompt Outurn	Prompt Outurn	
ISEM forward purchase	ISEM Sales	FTR	Betta sale	Hedged Margin	ISEM forward purchase	ISEM Prompt Sale		FTR	Betta buy back cost	FTR Spread Payment	Betta buy back Margin	Hedge	
-60		-6	70	4	-60	30		-6	-80	50	-10	4	Twoway obligation - perfect hedge
-60		-6	70	4	-60	30		-6	-20	-10	50	4	Twoway obligation - perfect hedge
ISEM Prompt purchase	ISEM Sales	FTR	Betta sale	Margin	ISEM Prompt purchase	ISEM Price		FTR	Betta Price	FTR Spread Payment	Betta buy back Margin	Hedge	
		-6		-6	0	80		-6	-30	-50		-56	Twoway obligation - No hedge
		-6		-6	0	80		-6	-120	40		34	Twoway obligation - No hedge

As highlighted in the above example, where potential uncapped exposure to downside risk exists, forwards liquidity on both sides of the interconnector, including in the ISEM, is necessary to enable FTR Obligation holders to lock in their prices at both ends of the interconnector and provide some element of stability to end consumers.

Notwithstanding the efforts on-going to increase on-island liquidity for ISEM, we are concerned that choosing FTR Obligations risks undermining the opportunities for forwards hedging cross-border for market participants should the on-island liquidity measures be unsuccessful or take some time to reach fruition. FTR Obligations very potentially undermine the increasing reliance on cross-border trading to mitigate price risk, placing even more pressure on ensuring a sufficiently liquid on-island market materialises. Consequently, access to pan-EU markets would be limited and it would represent a backward step rather than progress towards pan-EU integration. On the contrary, FTR Options protect consumers from downside risk; do not require a suitably liquid on-island market in the short term (as compared to FTR Obligations); and, given the prevailing choice of FTR Options over Obligations by other EU Member States, reflect a more progressive step towards pan-EU integration. FTR Options are therefore the preferred solution for FTRs in ISEM.

Secondly, related to the above point, with low on-island liquidity in ISEM, FTR Obligations would better suit those with a long market position in the Irish market compared to those that are short. These long parties will be best placed to ensure they can lock out prices at both ends of the GB-ISEM interconnectors (not having to rely on liquidity in the Irish market, outside of their own portfolio, to the extent that their competitors will), and create the “perfect hedge”. This raises consequential market power concerns with knock-on effects on competition and consumer pricing.

Thirdly, FTR Options require limited or no credit cover/ collateral requirements as compared to FTR Obligations (given the exposure to downside risk under the latter) which will free up market participants credit for other hedging opportunities.

Finally, there is a real risk that the necessary rules for FTR Obligations will not be delivered on time for when ISEM market participants require forwards CFD trading to occur in preparation for ISEM go live. This is in light of the fact that the Forwards Capacity Allocation (**FCA**) Guideline and related Harmonised Allocation Rules (**HAR**) which are nearing completion currently only refer to FTR Options. If ISEM chooses FTR Obligations, we understand that the drafting and delivery of the rules for FTR Obligations will have to occur within the next 12 months from now. We do not believe that this is a realistic timeframe for fully informed consultation to occur on an EU wide basis and we are not in a position to support a delay to the adoption of forwards cross-border hedging solutions when the benefits of such a delay are unconvincing and potentially very costly if hedging opportunities are dampened even in the short term.

2. **What arrangements would be preferred: one FTR between the ISEM and GB or one FTR per interconnector?**

We believe that one FTR between ISEM and GB is the most favourable choice for ISEM.

Concentrating auctions on a per border basis will positively maximise forwards cross border liquidity and ISEM parties’ hedging opportunities. It will also reflect a progressive move towards harmonisation of cross border forwards liquidity products on a pan-EU basis which in turn, by opening market participants up to other means of hedging, will contribute to long-term risk mitigation and the costs thereof.

This position is however heavily contingent on our view on the correct allocation of the risks of losses, ramping and curtailment on interconnectors, all of which risks we believe should rest with the interconnector owners. We believe a harmonised approach to the treatment of these 3 risks is necessary to reduce the complexity of administration and bid compilation in FTR auctions and related pay-outs. Otherwise the complexity involved in accounting for and sharing the burden (between interconnector owners) of curtailment and losses per interconnector, where per border auctions apply, would be extremely onerous not only for the interconnector owners but for market participants attempting to factor in the risks of such outcomes into auction bids.

Concentrating FTR Options into a single auction per border adds depth to the hedging market, but this approach is only reasonably feasible if the cost of losses, ramping and curtailment sit with the interconnector owners. Our view on this issue is further discussed in our answer to question 3 below.

3. **Should any of the following be discounted from the FTR product pay-outs?**

    a. **Interconnector losses**
    b. **Ramping constraints**
    c. **Curtailment**

We believe that the risks of managing FTR Options in terms of allocation and operation and the costs thereof should lie with the party best able to predict, control, quantify and manage them. In this instance, we consider the interconnector owner to be the appropriate party to manage each of these three risks.

Curtailment and Ramping

Bord Gáis Energy's views on curtailment must be read in the context of our significant concerns around the Irish interconnector owners' proposals to extend the application of caps to FTR curtailment compensation to any curtailment situation that arises regardless of the cause.

Pursuant to the 2014 version of the FCA, the European TSOs have drafted the "voluntary" HAR. Our concern relates to the fact that while the body text of the voluntary HAR[1] provides that curtailment can occur in times of Force Majeure, Emergency and System Security[2] and that curtailment compensation caps can apply in the case of Emergency and System Security, the Irish interconnector owners go even further. In the SEM-GB Border specific annex to the voluntary HAR (Annex 12), the Irish interconnector owners seek to introduce an additional category of curtailment to which the caps for curtailment compensation can also apply. This additional category is called "Capacity Shortage" and is deemed to arise if it is "due to insufficient physical capacity being available in any settlement period in a given direction for reasons which cannot be attributed to an event of Force Majeure, an Emergency Situation or a System Security event…"[3] It is evidently an extremely broad category of curtailment lacking definition. Permitting this to apply will ultimately undermine the value and usefulness of FTRs given that market participants cannot be expected to reasonably predict when curtailment, for any reason whatsoever, might arise on either Irish interconnector. Market participants are likely to over estimate this risk and cost thereof, and undervalue the FTR option price which will ultimately severely undermine the usefulness of the FTR instrument as a hedge for congestion and price risks in the first place. We urge the RAs to consider the ultimate negative impact this will have on forwards liquidity and the consumer. We further urge the RAs to consider that the voluntary HAR may become the precursor to the official HAR to be adopted next year and that considerably more consultation and discussion is required between the RAs and industry prior to the finalisation of these rules, particularly situations in which curtailment can occur and curtailment compensation caps apply.

Ultimately, placing the risk of curtailment on market participants for situations that go beyond what will apply pursuant to the FCA and the body of the HAR effectively puts the burden of predicting and valuing what we perceive to be unquantifiable (and undefined) risks on market participants. This should not be permitted. Curtailment risks must be well defined by relevant parties (TSOs, interconnector owners) to allow for their effective management and in order to fully realise the value of interconnector assets and the potential access to liquidity they can offer.

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1 Dated 21st August 2015
2 Each of which are defined in the draft voluntary HAR, Article 2
3 Article 2(6) Annex 12, draft voluntary HAR

With regard to ramping, we concur with the SEM Committee's minded to position on this. Market participants should not reasonably be expected to model the risks of potential ramping of the interconnector at the time of FTR Option auctions particularly when ramping is likely to occur more often in future on implementation of Euphemia in the day ahead market as flows may be expected to change on a more regular basis. Notwithstanding that the responsibility for the technical operation of the interconnector lies with the TSOs, ramping risks are best understood and better managed by the interconnector owners who should reasonably be expected to be consistently monitoring, understanding and gauging the performance of their assets in terms of potential ramping needs and scenarios.

It is ultimately in the interconnector owners' interests to estimate ramping and curtailment incidences (beyond those well defined pursuant to EU rules) given that if the burden is put on market participants, these risks and costs are unquantifiable and may be overestimated by market participants resulting in higher auction clearing prices, higher prices for consumers, and an undervaluation of FTR Options all of which undermines forwards liquidity.

Losses

With regard to interconnector losses, notwithstanding that these risks are relatively stable from year to year we do not accept the RAs' rationale for the inclusion of losses in FTR pay-outs. The RAs appear to believe that putting the risk of losses on market participants is a better allocation of risk than leaving it with the interconnector owners and that a lower price for the FTR may be offset by reduced liability for pay-out on the market spread. On the contrary we believe that the higher price that would outturn for FTR Options in auctions, by virtue of market participants not having to account for potential FTR pay-out reductions due to losses, should adequately protect the interconnector owner for the amount of Options auctioned given the predictability of losses. It is critical however that the loss factors on interconnectors remain static for at least one year at a time (the lifetime of the FTR Option) and that these factors are known ahead of each yearly auction.

In conclusion, a harmonised approach to all three issues (ramping, curtailment, losses) is favoured, which together with a single auction per border should not only maximise access to cross-border hedging opportunities but also minimise the risks and costs thereof, as well as represent a progressive step towards pan-EU market integration in line with the Target Model. If deductions from FTR pay-outs are however applied, this in our view demands that FTR Option auctions would have to occur on an interconnector basis to mitigate the complexities of equitably sharing pay-out risks between interconnector owners and of market participants in FTR auction bid compilation.

4. **What are the important issues to be considered in deciding on the development of an auction platform?**
5. **What is the preferred approach in relation to the establishment of the ISEM FTR auctioning platform?**

We believe that the Joint Allocation Office (JAO) should be the platform that applies for allocation cross border FTR Options on a border basis in ISEM, for the following reasons:

- The EU TSOs appear confident that the platform will be ready in H1 2016 thus on time for ISEM hedging;
- The JAO caters for FTR Options and of the three options it represents the lowest cost solution;
- There are no stranded costs foreseen given that JAO is likely to be the Single Allocation Platform which is ultimately required by the Target Model. A local platform or the FIUN platform by comparison are costly solutions initially and also appear likely to be overridden by the JAO option in time.

We would however welcome further regular updates on what the JAO looks like and the progress that our regional neighbours in GB and France are making given that ISEM should ensure that we are on the same platform of at least our GB and French neighbours.

In conclusion, we believe that FTR Options are the better solution for ISEM given the protection from the downside for consumers and the lack of significant reliance on on-island forwards liquidity for them to work compared to FTR Obligations. We consider that ramping, curtailment (beyond curtailment well defined pursuant to EU rules) and losses best sit with the interconnector owners given that they have/ have access to the information, experience and control to account for these issues altogether better than industry. Significantly more consultation is however required between the RAs and industry with regard to the scenarios in which the interconnector owners can cap curtailment compensation pursuant to EU rules on the issue. The allocation of

FTR Options should be on a per border basis to concentrate and maximise liquidity – however if any of the losses, ramping or curtailment risk is placed with market participants it seems that separate auctions would likely be required given the complexity in administering and sharing FTR pay-out reductions between interconnector owners. Finally the JAO platform is the least costly option and will allow for cross-border hedging to occur on time for ISEM go live.

I hope that you find the above discussion, suggestions and views helpful but please do not hesitate to contact me should you have any queries.

Yours sincerely,

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{By email}