Integrated Single Electricity Market (I-SEM)

Financial Transmission Rights

Consultation Paper

(SEM-15-061)

Power NI's Response

19th October 2015

Introduction

Power NI welcomes the opportunity to respond to the Consultation Paper (SEM-15-061) published by the Regulatory Authorities (RAs) in relation to Financial Transmission Rights (FTRs) for cross border hedging in the Integrated Single Electricity Market (I-SEM).

Before focussing on the specific features of FTRs, it is worthwhile to recap as to why forward market liquidity, of which FTRs are one element, will be a key determinant of the success of the I-SEM project in delivering tangible benefits for the end consumer. The majority of customers, both domestic and commercial, have a preference for energy tariffs with price certainty and stability to insulate themselves from the volatility of wholesale energy markets. Demand for fixed price tariffs is a feature of the competitive retail market, and as a non-vertically integrated supplier, Power NI is wholly dependent on forward liquidity to manage risk effectively and deliver price stability for customers.

Liquid forward markets have the potential to deliver a robust forward curve, give effective market entry and exit signals, and deliver choice, innovation and sustained competition in the retail market. It has been widely acknowledged that in this aspect, SEM has under-delivered. In our response to the Forwards & Liquidity discussion paper (SEM-15-010), we highlighted a number of aspects of SEM, such as the relatively small and concentrated market and uncertainty in plant scheduling, which have contributed to a forward market characterised by a lack of liquidity and scarcity pricing. Given that many of these fundamental features will remain in I-SEM, it is imperative that every opportunity to encourage forward market liquidity is capitalised upon, in order to deliver a better result for consumers.

FTRs represent one such opportunity to deliver an improvement to the forward markets. FTRs remove the need for a supplier to trade physical positions in both I-SEM and GB markets, and will be linked to what should be a transparent liquid market price i.e. the day-ahead markets. In Power NI's response to this consultation paper, we outline our viewpoint on the specific questions raised, however in general our view is that any decision in connection with FTRs should be taken with the intention to simplify the product and maximise liquidity, unless there is a clear reason not to. It is appreciated that there will be other impacts from the decisions on FTRs, however this is an opportunity to address liquidity – other concerns (e.g. revenue adequacy for interconnector owners) can be tackled by other methods (e.g. transmission tariffs).

Additional Aspects

A number of other issues relating to FTRs are not directly covered by the questions set out in the consultation paper and should be addressed as soon as practicably possible. For instance, given that any decision on the type of FTRs (and indeed the use of FTRs as a whole) is conditional on the agreement of OFGEM, it is of concern that their interaction in the process has not been clear thus far, and this needs to be clarified to give certainty to the decisions being made.

There is also a concern with regard to the transitional arrangements for I-SEM go live. While FTR auctions in early 2017 may be logistically challenging, particularly given the dependencies on progress on the relevant codes and allocation platform at a European level, the requirement to hedge retail tariffs and contracts beyond I-SEM go live will arrive much sooner than this. This is a general concern that suppliers face a cliff edge in hedging products from Q4 17, and there needs to be consideration for interim measures to facilitate and stimulate trading of forward products at the earliest practical opportunity. In particular, it is likely that some form of regulatory mandated trading will be essential while the market is established; potential options for this were outlined in the Forwards & Liquidity discussion paper, such as market maker obligations, and these possibilities should be explored in more detail at the earliest opportunity, in advance of a formal consultation. It is likely however that an extension and expansion of the scope of the Directed Contract regime will be required to facilitate forward trading.

Another area requiring attention before the FTR auctions is the product offerings themselves. To maximise hedging opportunities, particularly for non-vertically integrated players, more emphasis needs to be put on longer term capacity products than is currently the case. While it is important to provide shorter term products as well e.g. month ahead, to facilitate other trading strategies, developing a liquid secondary market for FTRs should provide for this, and hence allow for the maximum amount of capacity to be made available as annual or seasonal offerings, which can then cascade into quarterly and monthly products in the secondary market. The following responses to the questions raised in the consultation paper give Power NI's view on the specifics of FTRs which are most likely to create a liquid financial market, which in turn will create more opportunities for secondary trading beyond the initial auctions, which should facilitate the trading strategies for all kinds of participants.

Options & Obligations

The analysis presented on the relative merits of FTR Obligations and Options is comprehensive and before expanding on specific details, it is worthwhile to note that Power NI's view is that either product has the potential to contribute to the hedging requirements of suppliers in I-SEM, however Obligations would better support the liquidity objectives, because their valuation is less complex, as discussed below.

Obligations are attractive from the point of view of a supplier hedging a retail position in I-SEM; a forward contract in GB combined with an FTR (assuming at this stage no discount for the issues discussed later in the paper) should represent a perfect hedge against the I-SEM day-ahead price. In itself this is an attractive hedging opportunity for a supplier in I-SEM, but in addition, it should provide direct competition to I-SEM CfDs, which could put downward pressure on the premiums observed in SEM CfD trading. Equally options could fulfil this function, however in terms of pricing simplicity and transparency; obligations are more easily comparable to I-SEM CfDs.

Following this through, Obligations would also therefore encourage the development of a benchmark forward curve. Again, on the assumption that the FTR is not complicated by the need to discount for certain assumptions related to the physical characteristics, an implied I-SEM forward curve could be derived from GB forward prices and the FTR prices. Note this does not remove the need for liquidity and a forward curve for I-SEM CfDs but the two should be complementary. Again, options are capable of delivering the hedging requirements for suppliers, however valuation of the FTR is more complex, as the pay-out is dependent on the relative within day price shapes of the two markets, and hence it does not translate naturally into a transparent forward curve. The increased risks of forecasting both day-ahead markets at hourly level could also be reflected in participant's auction bids and hence result in a reduction in the value realised at the auction for options. Also potentially, it could exacerbate Market Power issues, as larger players with generation market share and better information may be better placed to price options.

Where obligations have a potential downside is the provision of credit cover. While the credit requirement for options is easy to understand, as the maximum cost to be covered by collateral is the auction premium itself, obligations have the potential for downside risk. In a scenario where the spread between the day-ahead markets is volatile, this could lead to a requirement for collateral which increases cost and acts to dampen liquidity. This could be mitigated to some extent, if the credit requirements for FTRs were netted as part of a wider I-SEM credit management function, however if the potential credit impact is seen as a fundamental issue by market participants in general, this would have a negative impact on liquidity and in that scenario, options would be clearly favourable. It would be helpful if the RAs/IC owners were able to give an indication as to what potential credit terms for an obligation could be. Given that credit is a key concern for participants in general, it would also be worthwhile to give priority to addressing the potential scope of netting across I-SEM markets.

Another potential issue with obligations is their deliverability given the challenging timelines presented by a planned early 2017 FTR auction. Given that obligations are not currently being catered for by the JAO platform, which would appear to the preferable enduring solution, they may require a specific interim platform not required by options.

In conclusion, FTR obligations are an attractive product purely from the point of view of a supplier's hedging requirements, however options could equally fulfil this need, albeit with greater pricing risk. Power NI's preference is for FTR obligations however in the event that acceptable credit terms and netting across I-SEM markets are not possible, options would be an acceptable alternative. Regardless, it would be prudent to facilitate both variants at this stage until all of the practical details surrounding the relevant codes and auction platform are fully understood.

FTRs per Border / per Interconnector

The consultation paper identifies a number of issues relating to the decision as to whether FTRs should be traded per interconnector or as a single product at the I-SEM border, however before considering the relative strength and validity of the specific arguments presented, it is worth reiterating the principle that to deliver the liquid, competitive market envisaged in the I-SEM high level decision, each decision in this area should be taken with the intention of maximising liquidity, unless there is a clear reason not to. With regard to FTRs, this means simplifying the product to the greatest extent possible so that it is a purely financial instrument that fulfils its intention; allowing market participants to choose exposure to a neighbouring day-ahead market instead of the I-SEM market.

As is the case with the other technical characteristics which are considered in the paper, splitting the FTR into one product per interconnector will not in itself mean that FTRs are not an attractive proposition to participants, but it would represent a missed opportunity to further encourage liquidity. Operating with a single FTR per border has a number of key advantages which can only have a positive impact on liquidity;

- it concentrates liquidity into a single auction type
- it sets a benchmark forward price for FTRs
- could simplify market entry by having a single set of access and credit rules which will encourage competition
- more attractive to asset less traders
- the process is simplified for market participants to price one product and trade one product from the auction itself, right through to settlement
- more likely to facilitate a secondary market

Given that these advantages would contribute to the desired objective of a liquid competitive market, we have considered the disadvantages detailed in the paper to determine whether there are issues which make a single FTR clearly impractical. Firstly, the arguments around future proofing FTRs should be secondary to delivering an ideal solution for the current I-SEM high level design. Should another interconnector materialise, the extension of a revenue sharing agreement between interconnector owners could be a condition to their approval to operate in I-SEM. Also, the argument that there would be less product diversity is not valid; the same volume of interconnection is available and not having the constraint of the capacity and physical characteristics of an individual interconnector will no doubt create more flexibility to offer the product mix that meets the requirements of all market participants.

The final point is that implementing a revenue sharing agreement between the interconnector owners would undoubtedly be a complex process, with a number of valid issues identified. However, there is no conclusive evidence that this could not be achieved, so it would be prudent to examine this in greater detail before accepting it as a valid reason to split liquidity between the interconnectors.

In conclusion, similar to the technical issues analysed in Q3, operating with one FTR per interconnector does not present a fundamental problem, however it would represent a missed opportunity to simplify one element of the FTR and encourage a liquid, competitive market.

FTRs and Physical Characteristics

Given the arguments outlined above, and our preference for a single financial product to provide maximum support to liquidity, it follows that our preference is that FTRs are not discounted for the operational characteristics discussed in the paper. However, as each element potentially impacts the product in different ways, the following section contains our analysis of each characteristic independently.

The concept of discounting the FTR pay-out for the impact of losses will be familiar to participants as this is reflective of the current physical transmission rights. Provided that participants have access to firm published loss factors for the period in question, they will discount their bids accordingly. By taking this approach, it is essential that loss factors are known for at least the period of the products being sold, including where any multi-annual products are traded. While this is not likely to significantly impact interest in FTRs (given the proviso on loss factors is met), applying the principle that decisions should be taken to maximise liquidity unless there is a clear reason not to do so, Power NI believes losses should not affect FTR pay-out. The key arguments against this are centred on revenue adequacy for the interconnector owners, which in this particular case should not be a significant concern. If losses are not included in FTRs, their value is directly increased, hence there should be no impact on the net value to the IC owners. In addition, as complexity is removed from the product, the likelihood of asset-less traders and a secondary market increase, this could mean that by not discounting FTRs for losses could potentially be a net benefit to the interconnector owners.

Overall, Power NI believes there is a strong case for excluding losses from FTR pay-out. However, the other characteristics discussed may have a greater impact. Ramping is clearly an issue which has an impact on the potential income from the physical congestion rent. However, factoring it into FTRs creates a number of issues; from operational concerns such as the additional overhead of settling on a daily ex-post calculation, to the more fundamental concern that an FTR holder is then exposed to commercial risk over which they have no control. This would impact FTRs as a hedging tool and hence would be counterproductive to promoting liquidity.

In the case of unplanned outages and curtailment, Power NI understands there will be less flexibility in terms of the FTR product definition, given that they will be subject to the Forward Capacity Allocation guidelines, however it is important that curtailment and its impact is clearly defined in the I-SEM context, for example, Power NI believe that FTR pay-out should not be discounted for events such as black start tests, as these should be financed by the interconnector owners. In general, Power NI believes that costs associated with firmness, as with the other physical characteristics discussed, should be excluded from FTR settlement where possible, and if necessary addressed by other mechanisms, e.g. transmission tariffs.

Auction Platform

Power NI welcomes the approach taken by the RAs to keep market participants abreast of developments in terms of the trading platform as it is clearly prudent to progress each option as a contingency at this stage. FTRs will be critical in terms of supporting forward market liquidity and hedging in I-SEM, so any platform will need to be capable of facilitating the product mix required by the market, with the acknowledgment that the move to a Single Allocation Platform (SAP) should be a key consideration.

Given that the JAO platform is widely viewed as a project leading to the SAP, Power NI would be minded to give support to exploring this option to understand if it meets all the requirements of the FTR product and the challenging timelines to deliver an early 2017 auction, with sufficient lead in time for participants to test the platform. However, if there is a level of uncertainty that the JAO platform will deliver the requirements on time, other options should be progressed in parallel as a potential interim or fall-back solution. Regular updates on this matter and further opportunities for input from participants should ensure that implementation issues are addressed at the earliest opportunity, which will be crucial given the deadline.

Apart from the main functionality of delivering auctions that comply with the desired FTR product, consideration should be given to any other features which facilitate simple and efficient trading. For instance, automation of reporting requirements under REMIT/EMIR, a standardisation of contract terms and user agreements, netting of credit (potentially as part of a wider I-SEM credit management function) could all contribute to reducing overheads for participants, and will make FTRs a more attractive prospect to both physical players and asset-less traders, enhancing liquidity all round.