



Energy for
generations

ESB Group Response: Integrated Single Electricity Market (I-SEM)

Forward Market: Requirements for Central Services

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1. INTRODUCTION

This document sets out ESB Group's response to E-Bridge "I-SEM forward market liquidity measures – removal of trading barriers – specification of service requirements and questionnaires" paper. We hope our responses to this informal consultation are helpful in tackling a number of challenging areas that will impact all I-SEM participants. We anticipate this paper will form part of the broader consultation on the design of the I-SEM forward market, and to that end we reserve the right to change our positions in this wider context once the formal consultation is published.

2. QUESTIONS FOR I-SEM USERS

In this section we have set out our responses to the questions directed to I-SEM users.

Q1: Do you agree with the general description of existing trading barriers in SEM as provided in chapter 2?

In principle credit charges are a barrier to trading. However credit charges including risk capital are a genuine cost in all transactions, particularly where market participants are small, or financially not robust. A pool arrangement for credit across different contracts would indeed be more efficient and transparent, assuming the market was inherently large and deep enough to generate the projected benefits, after implementation costs were accounted for. Again in principle exchange based trading encourages liquidity and provides a fair transparent playing field and a robust settlement price for portfolio analysis. The success of any exchange will be based on the cost of transaction on the given exchange versus the alternative. Our concern would be that the credit arrangements for a centralised exchange may not necessarily reduce the credit cover costs facing suppliers. Indeed given the nature of exchange based credit arrangements (discussed further in Q2), where daily cash margining is a common feature, all participants, but especially smaller participants, may actually find these costs are too onerous.

In addition we would strongly dispute any suggestion that the form in which NDCs are sold is a barrier to trade. The Tullett Prebon platform is a multi-lateral trading facility (MTF) which offers any trading entities the ability to offer and bid for CfDs. While we accept that this is outside any energy regulatory purview, we do not accept that NDC price discovery is "negotiated privately" rather than something that occurs through a competitive process on a centralised broking platform and for which transacted prices are reported. The introduction of the Tullett Prebon platform into SEM was a positive step in the forwards market. The fact that other sellers of CfDs have not materialised in SEM (until recently) has not been a function of the existing infrastructure of forward trading but was rather a function of other participants' willingness to bear risk, which in turn was influenced by the SEM market design and the Directed Contract regime for market power mitigation.

Q2: Are there any specific trading barriers in the SEM forward market for you which are not covered by the general description? Please specify.

It is worth noting that the likely credit arrangement on an exchange will consist of an initial margin, variation margin, and in some cases a contribution to the default fund. The initial margin is usually based upon the volatility of the contract and is meant to provide for security in case a participant defaults and does not pay their variation margin. Variation margin is akin to the Marked to Market value of a participant's portfolio. The contribution to the default fund is to protect the exchange from default and is a function of a participants traded volume. In addition participants will pay clearing fees which will be a function of how liquid the market is, i.e. small if significant volume is transacted, higher if transacted volumes are small. The frequency at which margin contributions have to be made should also be

considered. We would note also that, regardless of the success of any liquidity initiatives for I-SEM, the overall volumes traded forward will inevitably be small compared to GB or other European markets, which indicates that the fees for I-SEM participants will most likely be proportionately higher.

In this context, it is worth considering ICE NBP futures and UK Electricity futures. The NBP futures contracts are very liquid. Currently the Initial margin for NBP contracts range from approximately 9% up to 17% i.e. substantially in line with the 15% credit cover currently required from CfD purchasers in the SEM. The variation margin for Electricity futures ranges around 7%. As mentioned previously these are set based upon the historic volatilities of the contracts and the fact that the exchange is traded and margined daily. If the trading windows are less frequent than daily the initial margin would likely need to increase. The variation margin will be a function of the market price versus the portfolio of contracts a participant holds. This is unlimited. In an exchange scenario the collateral a participant may be asked to lodge will be transparent but potentially unlimited. A way of controlling this would be for a participant to unwind their contracts and removing any hedges they may have in place.

For these reasons we think there would be value in adding an extra question to central service providers in section 6. The high level question should indicate the indicative fee structure for one or more central services and for the eventual assessment of their benefits and costs.

The calculation of the collateral required for a portfolio of contracts is not a simple exercise. Each contract has a different volatility, different time to expiry and different correlations with each other so may not fully offset each other. Usually a SPAN (Standard Portfolio Analysis at risk) valuation is performed which takes into consideration all these factors. Also this is not a “fixed” methodology as the SPAN formula will need to adjust over time as volatilities and correlations between contract changes.

We would also add that Directed Contracts (DCs), while serving a purpose in SEM, are a trading barrier. As DCs are allocated to suppliers, there is no trading for them and no liquidity as a result. Suppliers therefore have very little incentive to invest in trading capability. Removing a large portion of liquidity from the forward market through DCs has an unintended consequence of reducing forward market liquidity, which further reduces the incentives for parties to trade in that market, and encourages participants to trade in other more liquid markets.

Finally the SEM market design coupled with many market participants’ understandable unwillingness to bear scheduling and dispatch risk, has not been identified as a barrier to forward trading, although we believe it is a significant factor.

Q3: Which aspects of the central services described in chapter 2 are you in particular interested in? Why?

From a theoretical perspective a centralised market place for standardised contracts with a single counterparty, standardised administrative procedures and faster transactions times, is highly desirable. From a practical perspective, as noted in our answers to the above questions, the costs of such services, in such a small market, where margins for many participants are already under pressure, is of the utmost importance. This is a major priority for ESB, particularly given that we will have a mandatory FCO placed on us as a consequence of the I-SEM Market Power Decision and are likely to have to trade regularly with more parties than any other participant. As a result, the costs of central services may be as - if not more - significant for ESB than for other participants. In our view, the benefits of central services must be carefully evaluated against the cost they impose.

Q4: Which aspects are you missing that you consider of interest for all market parties? Please specify.

As noted previously, the specific arrangements for collateral and fees under central service provision and what determines them (i.e. volatility, traded volumes etc.) has not been addressed. The assertion that an

exchange will automatically result in lower collateral and transaction costs for participants will need to be demonstrated in advance before any such arrangement is adopted.

In our view when considering any exchange or service it would be important that:

- It should be built based on standard technologies available in the marketplace
- It should also utilise standard interfacing protocols and APIs
- It should not require a huge management overhead by the parties using the platform
- The cost per user should not be restrictive.

Implementation timelines should also be taken into account when assessing the available options. Is it feasible that a centralised exchange (with clearing) could be implemented in advance of I-SEM go-live, or is a more pragmatic solution something that utilises the existing infrastructure for forwards trading?

Whether a central platform is exclusive or not is of specific interest to ESB and all other market participants. The RAs will need to carefully evaluate this. We think there are two options:

- 1) A non-exclusive platform
- 2) An exclusive platform, where market participants have a say in the procurement

Is it more beneficial for participants to be permitted to enter into forward contracting arrangements that are most suitable to their needs? If a lower cost alternative is available then is it not better that that should be permitted? These are the main reasons in favour of a non-exclusive platform. Given the above, it might be pragmatic to permit participants the flexibility to transact in a manner of their choosing, which reduces costs but does not impact transparency. It is important this evaluation considers the wider trading and hedging activities that market participants undertake. Either way we would consider that any central platform should either be exclusive or non-exclusive for everyone.

This does not necessarily result in a loss of transparency as under EMIR all financial derivative transactions must be reported to financial regulators. We would consider that such information could be made available to energy regulators if sought (in fact we would note the current information sharing that takes place in relation to EMIR and REMIT between financial and energy regulators). Alternatively bilateral trades cleared centrally should lead to no loss in transparency. However we would caveat this argument with regard to our points on liquidity volumes and the impact on costs as noted previously.

If the platform is to be exclusive we think it would likely require some form of procurement by the RAs to find the most cost effective service provider. It is in all market participants interest to have a say where they trade, especially if that platform will be exclusive. This is particularly important to ESB as we are likely to be the largest participant due to the FCO imposed on us. For this reason we would only accept an exclusive platform if we, and other market participants, can play an active role in the procurement process.

Q5: Which aspects are you missing that you consider of specific interest for you? Please specify.

As the largest participant and one who will have a mandatory FCO in I-SEM, ESB is likely to face significant costs from any centralised services. This could have a significant impact on ESB's treasury operations and therefore the cost of credit cover is not just an issue facing suppliers purchasing contracts. ESB has access to substantial Letter of Credit, and other funding facilities. However there is a significant cost to such facilities, in terms of commission and commitment fees payable to the banks underwriting these facilities, transaction costs in negotiating facilities from adequately rated counterparties,

implementation costs in ensuring the ability to net margins, and administrative costs in ensuring the efficient deployment of these facilities on a daily basis as required.

While these costs have generally fallen in the years since the financial crisis, our experience then would lead us to be cautious about the risk of building a trading platform premised on the ongoing availability of such credit facilities at an acceptable cost. As such, we have a particular interest in ensuring that the overall costs faced under centralised services are not greater than the alternative, and that high transaction costs do not ultimately distort or curtail the forward trading environment, rather than facilitating it.

Q6: Please score below solutions in order of expected benefits for I-SEM in the table below.

In the below table we have scored each solution in order of expected benefits, where 1 indicates the lowest benefit and 4 indicates the highest. This scoring is based on our understanding of the options in the table. Our remarks provide further detail on our understanding, and our scoring should be interpreted in the context of these remarks.

Nr	Description	Scoring				Remark
		1	2	3	4	
a	A central forward trading platform offering no CCP services					We would consider this option to be akin to the status quo and would argue that that the barrier to trading is not the existing infrastructure but DCs and SEM related issues in relation to dispatch risk.
b	A central forward trading platform offering CCP services but no collateralization across market time frames and products					We consider that the only difference between a and b is the cost of credit. Ultimately liquidity will depend on the cost of credit. If it can be demonstrated that the cost of credit under b is lower than this would score higher.
c	A central forward trading platform provider offering CCP services and collateralization across market time frames and products					We would consider this to be an improvement due to the ability to net across different timeframes etc. But this it is also dependent on the overall cost.
d	A central collateral provider for clearing of trades on central trading platforms					We consider this option could include an OTC platform with central clearing. This may be the best outcome in that costs are lower while transparency and price discovery is assured.

Q7: Please indicate scoring of the type of trading platform in terms of expected benefits for the I-SEM forward market in the table below.

In the below table we have scored each solution in order of expected benefit, where 1 indicates the lowest benefit and 4 indicates the highest.

Nr	Description	Scoring				Remark
		1	2	3	4	
a	OTC trading platform (ref. today's Tullett Prebon's platform)					Dependent on costs
b	Anonymous trading platform (PX like)					Dependent on costs
c	A trading platform supporting both OTC and anonymous (PX like) trading					Dependent on costs

Q8: Do you have any other remarks on the central service requirements? Please specify.

A solution which builds on existing trading infrastructure where possible is our preference, rather than aiming for a more sophisticated trading platform and CCP mechanism, which, although theoretically attractive, may involve implementation costs and delays disproportionate to any benefits arising.

Ideally if the market is exchange traded it would be preferable from a generator perspective that the chosen one would also clear gas/fuel contracts. This would allow a generator to potentially net some of its cross commodity exposure. This benefit to generators would be reflected in the price of its CFDs contracts, so would be of value to all market participants.

3. QUESTIONS TO CENTRAL SERVICE PROVIDERS

ESB has not responded to the questions directed to central service providers in section 6 of the E-Bridge document.

The one comment we wish to make relating to this section is to encourage the addition of an extra question. As noted in response to question 2 directed to I-SEM users above, the standardisation and centralisation of central services is highly desirable to the extent it is cost effective for all participants. We therefore believe a careful evaluation of the cost and benefits of the provision of any central service is warranted. To aid this evaluation we would encourage E-Bridge and the RAs to include an additional question relating to the potential fee structure a central service providers may require in order to provide one or more of the requested services. Below, is an example of such a question.

Q6. Can you outline the possible fee structure that you would need to provide one or more of the requested services?