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Dear Gonzalo and Joe

PrePayPower, as Ireland's largest PAYG electricity provider, supplying over 110,000 homes, welcome the opportunity to contribute to the SEM Committee's "Measures to promote liquidity in the I-SEM forward market" Consultation Paper (SEM-16-030).

PrePayPower believe that the establishment of a fair, transparent and deeply liquid forwards market is fundamental to the success of the I-SEM project.

We are disappointed that this paper is being used to suggest the removal of ring-fencing on ESB / Electric Ireland. Contemplation of the removal of such a fundamental market safe guard would need examination in its own right. The merger of the largest supplier and generator in the market would be subject to examination by the Competition and Consumer Protection Commission. Removal of the ring fence should be examined in no less stringent a manner.

Moving on to look at the liquidity in the forwards market issue, SEM provided a liquid spot market, however, the volumes and products available for the forwards market were totally inadequate. In order to avoid the recurrence of such issues we believe that:

- The regulatory authorities need to ensure that I-SEM deliverys sufficient liquidity to allow suppliers to hedge power at desired volumes across all timeframes to a minimum of 18 months ahead
- Of the options presented the Market Maker Obligation is the option most likely to provide a fair, transparent and deeply liquid forwards market
- Collateral under the I-SEM must be purely on a mark to market basis with no initial collateral requirement
- This work stream has commenced very late, and its findings must be implemented quickly in order to ensure that participants on all sides of the market will be able to manage risk through the market launch.

Our response is not confidential and may be published in full. If you wish to have further communication in relation to our submission, please don't hesitate to contact me.

Yours faithfully,

Cathal Fay, CEO, PrePayPower

Section 1 –
Does the Consultation Paper correctly set out the nature of the problem to be solved? Is it correct that the lack of liquidity characteristic of the SEM will not be satisfactorily rectified through incentives inherent in the I-SEM design?

SEM did little to provide a liquid forwards market. To address this for I-SEM there are a number of key steps that must be taken. Firstly there is no Master Agreement for trades under the SEM that defines a common set of terms and conditions under which all market participants can trade. Instead market participants are left to construct these themselves, which is both time consuming, unwieldy and impractical incurring significant legal fees and leading to a variety of agreements, that act as a barrier to market entry and development. This should be addressed via establishment of a balanced standard contract for I-SEM.

As noted in the consultation paper, the current 15%, levels of collateral are extreme, to the extent that if one needs to trade with seven different counterparties you could end up posting more money in collateral that the value of the power you are purchasing. Additionally, the fact that many contracts have collateral as a one way requirement with only the buyer, but not the seller, posting collateral is highly penal to buyers. It is imperative that collateral requirements under I-SEM are solely on a mark to market basis, with no upfront collateral requirement, both sides posting collateral against the market value of the contract and full payment made in the event of default.

The collateral required in the Irish Market is contrary to international market norms. It should be noted that in the ISDA and EFET contracts, which the standard contracts are for the NBP gas market amongst others, collateral is solely on a mark to market basis. Such standing internaltional norms should be used as the reference point against which to develop contracts in the Irish market, rather than the historic levels.

Furthermore, noting the current collateral requirements, we must be sure that fees for trading platform(s) under the I-SEM market don't end up taking their place, so that what is gained by reducing collateral requirements is not then lost to platform fees. Rather, there is in fact an opportunity to optimise and minimise collateral requirement required for each counterparty under the Forwards, Day Ahead, Intra Day and Balancing markets to bring them in line with international norms. It is imperative that this is actively pursued to reduce barriers to entry and in turn to enhance the development of a fair, transparent and deeply liquid forwards market.

Current forwards contracts are completely inadequate for suppliers. Of the regulated contracts under the SEM the Directed contracts (DCs) provide cover over an appropriate timeframe, though in very small quantities, whilst the PSO auction provide better, though decreasing, volumes but only for the front quarter. This means that an organisation is allocated only 4.5% of its required volume of hedging a year ahead and 9% of its required volume 6 months ahead. Whilst it is possible that some volume can be picked up in Supplementary auctions this is not guaranteed and only occurs when full

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allocations are not taken in the Directed Contract (DC) auctions by other participants. A further 25% of a suppliers demand can be picked up in PSO auctions, though this is only at the quarter ahead stage leading to significant time risk for a supplier.

Additionally, product availability is dominated by baseload product, with few peak products being offered, adding shape risk to a supplier's previously noted problems. To illustrate this, for Q1 17, PrePayPower entitlement of peak product is less than 1% of our requirement. Peak hedging products are desirable, and the market demand for such products appear to have been overlooked in the consultation paper's analysis.

It is essential that under I-SEM forward contracting volume is available a) far enough ahead b) in large enough volumes and c) in the right products, to allow suppliers to fully hedge themselves at least 12 months in advance. If this is not the case suppliers will end up having to pass these risks on to the end consumer, driving up prices.

PrePayPower believe that whilst the volumes available for Directed Contracts are way below what they need to be, the pricing mechanism – as noted by the consultants appointed to the working group on this topic – has proven its worth and should be maintained. For the avoidance of doubt we also believe the calculation of DC volume allocation, should continue to be on the basis of the MIC.

Section 2 –

Does the scope of the Consultation Paper set out the full range of potential liquidity promotion measures that should be considered for implementation? If other regulatory interventions are considered appropriate please set out the nature, rationale and parameters of such intervention.

In the first section we noted that too little volume is available under the Directed contracts, whilst for the PSO a declining amount of volume is available too late. Additionally, the Baseload, Mid Merit 1, Mid Merit 2 and Peak products have become the standard trading products under the SEM. However, as noted above the DC and PSO auctions are dominated by baseload product, whilst peak product is almost entirely absent.

To increase liquidity, participants on all sides of the market need to be comfortable that they can trade into and out of positions, rather than hanging on to whatever volume they have been able to acquire. To improve this more volume needs to be made available, especially in peak product, and more products also need to be made available.

PrePayPower would recommend

a) The peak product is expanded from 17:00 – 21:00 to 17:00 – 22:00 and from October – March inclusive to all calendar months
b) That the Mid Merit 1 product is no longer reduced by 20% on non-business days and that it is extend to 24:00 rather than ending at 23:00
c) That a new Mid Merit product, stretching from 10:00 -24:00, is also made available

Noting the time and volume risks mentioned above, it is essential that whichever option(s) are selected, the products must be available farther ahead of time to allow both generators and

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suppliers to be able to trade into and out of positions, which will increase both liquidity and competition.

Section 3 –
Respondents are asked to provide their views on the rationale, parameters and potential effectiveness of each of the regulatory interventions described and explained in the Consultation Paper.

PrePayPower notes with great concern a number of items in the consultation paper that define the volume to be made available under either a Forward Contracting Sell Obligation (FCSO) or a Market Making Obligation (MMO). The idea that a supplier can simply go 10% unhedged and is essentially willing to hope for the best on such volume is highly unreasonable.

The ability to hedge using FTRs is highly limited. Given that the options basis for FTRs has, unwisely in our view, been chosen, it means that these are difficult and extremely complex to price as a hedging mechanism, with a level of sophistication required that is far beyond that of small suppliers or, for that matter, generators. Given the limited availability of the Moyle and EWIC interconnectors in recent years it remains to be seen how feasible an option this even is. To ask companies to hedge 20% of their volume by such methods is simply not reasonable.

The change from SEM to I-SEM is the most a fundamental change to the power market on the island of Ireland in the last decade, and whilst we note that the paper suggests that suppliers hedge 20% of their volumes through Proxy hedging, it remains to be seen whether such hedge will work under I-SEM with the removal of the bidding code of practice. At the very least such an approach is subject to basis risk and therefore cannot take the place of power hedging as suggested in the paper.

Following on from this, it is unreasonable to expect that such temporal issues, such as the link between commodity and power prices, will continue into the long term future and PrePayPower assert that the only hedge for power, which will certainly work, is a power hedge itself. Consequently we believe that the volume to be made available under both the MMO and / or the FCSO should be increased to 100% of supplier's requirements.

Section 4 –
What are the important issues to be considered in each of the options? In what way might the options be made more effective? Please set out your views on the rationale for, and value of the parameters employed to determine, the quantity of the obligation in each option.

The fundamental principles of any market are that it is fair, transparent and deeply liquid, allowing all participants to compete as equals to the overall benefit of the end consumer. To this end we are concerned that addressing the need for such a market has come very late in the I-SEM project process.

It is vital that its implementation be adhered to in order to prevent the I-SEM market becoming a "cliff edge" for market prices that could lead to, potentially significant, risk premia being factored into prices, which would be penal to end consumers. In this respect, the previous lack of co-ordination and preparation for the forwards market is of significant concern to us. Furthermore, it is important that the go live of the market doesn't lead to participants having to foot a significant IT bill.

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Section 5 –
What is the preferred option and why do you consider it preferable?

PrePayPower believe that there are a firm set of principles that must be adhered to in determining the structure of the forwards market under I-SEM. Firstly the ring-fencing of ESB / Electric Ireland must remain as removing it would reduce competition in an already highly concentrated market. Even with ringfencing in place ESB / Electric Ireland have the benefit of an existing hedge at a group level.

We are very concerned that if the sale of power is not sufficiently targeted, Electric Ireland could use its financial muscle to eliminate competition from the market. Consequently purchasing of power contracts by Electric Ireland needs to be very closely monitored to prevent abuse of market power through the back door.

Following on from this, the market needs to be *proven* to be deeply liquid enough for ring fencing to be removed, rather than this being done and hoping that it is so, with this all the dangers that this entails.

Given these issues, PrePayPower believe that the Market Maker Obligation provides the best basis to establish the desired fair, transparent and deeply liquid forward market but, for the reasons stated above, believe that the ring fencing on ESB / Electric Ireland *must* remain.

The different options suggested in the paper are analysed below

- Option 1 essentially is as today, it does not provide additional volume, is not targeted and is highly unlikely to be effective
- Option 2 provides greater volume than Option 1 but we have serious concerns, as noted above, as to how targeted and effective this option will be. It could also lead to a lack of transparency if a secondary forward market is not developed and could lead to the exercise of market power through the back door.
- Option 3 provides better, though still not sufficient, volume, which is in a form unlikely to promote further liquidity, but rather just an expanded version of the existing DC and PSO set up. As noted, for reasons mentioned above, the removal of the ring fencing on ESB / Electric Ireland is not acceptable to PrePayPower at this time
- Option 4 also provides better, though still not sufficient, volume, though this time in a method more likely to stimulate a liquid market. However, once again, the removal of the ring fencing on ESB / Electric Ireland is not acceptable to PrePayPower at this time
- Option 5 is a slightly watered down version of Option 4 and provides fewer of the benefits of Option 4 with all of the problems.

We therefore want a modified version of Option 4 for the reasons stated above, with:

- 100% volumes for suppliers to be offered

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- Subtly changed peak and mid-merit products, as described above
- Mark-to-market bilateral collateralisation of all products under a standardised market agreement format
- Vertical ring-fencing to remain for ESB
- DCs to remain, using the current pricing mechanism, with any other competitive auctions having particularly close monitoring of Electric Ireland's bidding behaviour
- A Market Maker Obligation to be placed on the four largest parties

Note that we believe that the case for removal of vertical ring-fencing of the ESB simply has not been made within the paper. Given the fundamental risk posed to the fundamentals of the market, clear evidence must be presented as to why such a change is deemed necessary. A merger between the largest supplier and generator in the market would be examined by the Competition and Consumer Protection Commission. The removal of the ring fence must be examined in similar light.

Futhermore, we believe market power issues will exist with ESB even after the imposition of directed contracts. ESB is in a unique position to have relatively greater certainty over their ex ante volumes in the market, placing them in an advantageous position as the largest party. Within that context, different treatment of ESB in terms of a higher percentage of the volumes to be obligated to participate in ex ante hedging timeframes is entirely reasonable.

Section 6 –
What parameters of the regulatory intervention option should be determined by the Regulatory Authorities and which should be left to market participants to determine?

Noting the consultants appointed to the working group on this topic believe that Directed Contracts had fairly reflected price under the SEM; PrePayPower believe that the Regulatory Authorities should continue to define the price and allocated volumes of Directed Contracts as they currently do, and that the DC price formulation and allocation should remain as they have under the SEM.

We believe the Regulatory Authorities must closely monitor purchasing in OTC markets to prevent the exercise and abuse of market power through the back door as highlighted in Section 5 above.

Section 7 – Summary and Conclusions

In summary, PrePayPower believe that the establishment of a fair, transparent and deeply liquid forward market is the most fundamental issue in the implementation of the I-SEM market and the one that will most strongly define whether the I-SEM project as a whole succeeds or fails.

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The Market Maker Obligation is the best option but ring-fencing on ESB / Electric Ireland must be maintained
PrePayPower believe that the optimal market solution is one where the ring fencing on ESB / Electric Ireland is maintained and where a Market Maker Obligation is implemented. We have concerns over how targeted and transparent the I-SEM forward market may be and call on the Regulatory Authorities to ensure that the market is free, fair and transparent, such that larger participants cannot cross subsidise themselves leading to the potential elimination of smaller participants, reducing competition and increasing the cost to end users.

PrePayPower believe that vertical integration for ESB / Electric Ireland is not appropriate at this period of time as the I-SEM market is not yet in existence and ESB remain in a position to exercise market power. Whilst it is hoped that a fair, transparent and deeply liquid forward market may at some stage negate this market power, this remains an ambition rather than a fact. PrePayPower believe that until such time that a fair, transparent and deeply liquid forward market does exist, where ESB / Electric Ireland cannot exercise market power, and would be unable to affect this by integrating, then vertical integration cannot be considered.

There is no guarantee that retail prices for consumers would fall due to the vertical integration of ESB and no quantitative or qualitative analysis for this has been provided. With no evidence of a benefit to the end consumer, and the much heightened risk of the ability to exercise and abuse market power, the vertical integration of ESB cannot be considered at this time.

A single Master Agreement applicable to all counterparties should be implemented
In order to maximise market efficiency and deliver the optimal price of the end user PrePayPower strongly advise that a single master agreement be defined for forwards trades under the I-SEM market setting out a common set of terms and conditions under which all counterparties can trade with one another on a fair and equal basis.

Collateral must be solely on a mark to market basis with no initial collateral requirement
We believe that the current requirement on buyers to post 15% collateral up front with sellers is unreasonable.

As in well-established and respected markets like the NBP, under its ISDA and EFET contracts, collateral must be exclusively on a mark to market basis with both sides posting as and when required, and determined only by the strike price of the deal and the current market price.

Current market products and timescales do not allow risk to be hedged adequately, this must be corrected under I-SEM
Current market products do not allow market participants to manage time or shape risk adequately, with DC auctions providing volume at the right timescales but in the wrong amounts, i.e. too little volume, whilst PSO auctions provide reasonable, though declining, volume only a quarter ahead.

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Currently a supplier is entitled to only 4.5% of its requirement 12 months ahead, 9% six months ahead and with the possibility of securing a further 25% at the quarter ahead stage. This presents significant and unacceptable risk to suppliers who must be able to hedge all their volume *no later than the year ahead stage*.

The power available in both auctions is dominated by baseload product with peak product almost entirely absent, as is also true of the OTC auctions. To illustrate this, we are able to hedge less than 1% of our Peak demand through our DC allocation, there is no Peak product available under the PSOs and it is no longer traded in the OTC auctions. This exposes suppliers to shape risk, which is exacerbated by the fact that there is no peak type product available at all in the summer months.

We recommend a redefinition of products as outlined under Section 2 in order to deal with this risk and ask the Regulatory Authorities to ensure that all these products are available in whatever route(s) to market is / are chosen.

We disagree with the analysis in the paper which downplays the important of peak product hedging to suppliers.