Explanatory Note: I-SEM CfD Product Offerings and Proposed Contractual Arrangements for Directed Contracts (DC)

BACKGROUND

In preparation for the I-SEM Go Live date of 23 May 2018 (I-SEM Go-Live), and further to requests from the Regulatory Authorities, ESB has undertaken a review of the SEM DC Framework Agreement, and DC Subscription Rules.

I-SEM PRODUCT FOR DC (ISEM Product)

I-SEM has introduced a new variable into the Capacity Markets, i.e. the RO which creates a new cash pay-out exposure for generators i.e. ESB (the "Seller"). This does not exist under the current SEM. As instructed by the Regulatory Authorities (RAs), the I SEM Product accounts for this exposure. As such the ISEM Product will compromise of selling a 2-way CfD (ISEM CfD) linked to a Commodity Call Option. In this way, the generator will buy protection from the supplier (the "Buyer"), thereby capping its RO cash payout exposure for the relevant Calculation Period.

The Commodity Reference Price under the I-SEM CfD will be the SEMOpx DA Hourly Index. The Strike Price under the linked Commodity Call Option will be the RO Index Price Source as published for the relevant Calculation Period.

The rationale to structure the I-SEM Product in this way (i.e. 2-way CfD and linked Commodity Call Option) is based on financial regulation requirements to promote transparency in the CfD markets (cf CBI Consultation Paper 107).

PROPOSED CONTRACTUAL OFFERING

MINIMAL CHANGE RATIONALE

We note that SEM Committee has followed the policy of minimal change to facilitate I-SEM. Indeed, this was the key consideration in our rationale for proposing to move to an industry standard contract in line with those used in other European Markets. Following review of contractual approaches used in similar niche energy markets, ESB has determined the most appropriate contract to use as a basis for I SEM is the Financial Energy Master Agreement (FEMA) (see below). Moving to this industry standard contractual approach supports the minimal change view insofar as no new legal terms were introduced other than those acknowledged under similar industry standard agreements (e.g. Force Majeure, Illegality. Change in Tax). Such introductions are equitable between the buyer and seller and are relevant and in fact necessary given how the contract currently operates and reflects lessons learned from the existing contract. It should also be noted that in drafting the FEMA proposal, subject to the changes proposed in the Subscription Rules, no changes have been made to the methodology and process flows under the current SEM DC with the exception of those required to meet current regulatory requirements which are already in practice (cf Section 3, 5, 7, 12; including but not limited to Schedules 6,7 and 8 of the SEM DC).

The FEMA approach supports the sentiment of removing barriers to entry by providing an industry standard contractual approach which facilitates "harmonisation of terms and conditions of Master Agreements, adequacy of collateral requirements" (cf. SEM-17-015) . Of note, such an approach supports liquidity in the market and has the potential to improve hedging opportunities for all market participants. This is of particular import in view of the potential for increased hedging opportunities resulting from market coupling with GB.

It is ESB's view that retention of the current SEM contracts would require significant restructure and redrafting to address the ISEM Product and existing ambiguities and technical inconsistencies due to the multiple amendments that have been made to the contract over the past 10 years. Due to its highly bespoke nature, such a solution would also require continual contractual management, restatement and restructure depending upon the nature of any subsequent changes as the I SEM market evolves over time in contrast to the FEMA which lends to itself to accommodate such changes. In addition, the existing contract as structured does not support negotiations around credit arrangements in line with industry standards, a point which has been raised as a major obstacle by suppliers. In short, ESB are of the view that retention of the SEM contract is not a robust solution for the ISEM Product for all parties.

Further detail on the proposed contractual arrangements is outlined below. For a term by term comparison to the existing SEM arrangements please refer to the SEM v ISEM Contracts - Comparative Matrix appended hereto.

FRAMEWORK AGREEMENT

In view of the above, ESB therefore proposes moving to the industry standard International Swap Dealer Association (ISDA)-based approach used to document cash-settled derivative products i.e. CfDs which will allow harmonisation of Irish hedging products with other EU target zones. This functional model includes:

a) An umbrella framework agreement based on the Nordic Association of Electricity Traders (NAET) Financial Energy Master Agreement (FEMA), which has been used in the Nordic financial power markets since 2000;
b) A Schedule setting out relevant credit terms, documentary requirements (e.g. annual financial, signing authorities), notice and payment details along with regulatory requirements for each contractual counterparty;
c) A Credit Support Annex (CSA) based on that used by the European Federation of Energy Traders (EFET), setting out margining methodology and collateral requirements in accordance with the Subscription Rules;
d) A Confirmation which comprises a 2-way CfD and Commodity Call Option (defined below) aligning to the ISDA 2005 Commodity Definitions, with which many of the I-SEM counterparts are familiar. The Confirmation captures the commercial terms as published in the Information Paper for the relevant I-SEM product offering;

SUBSCRIPTION RULES & INFORMATION PAPER

e) Subscription Rules, as marked, used to set out the ISEM product descriptions, pricing and margining methodologies, Subscription Window logistics and worked examples; and
f) The Information Paper, i.e. "term sheet" used to set out the material parameters, including commercials for the relevant product offering in line with market standard practice

Like the ISDA, the above proposed approach has the advantage of providing for flexibility and future-proofing to facilitate new products and future changes to the I-SEM without requiring termination of the framework agreement (as is the case in the current CfDs). It also facilitates consideration of any subsequent cross-product master netting arrangements to aggregate collateral.

ESB has received relevant copyright approvals for the use of each of the FEMA and CSA by NAET and EFET, respectively.

CREDIT ARRANGEMENTS

ESB is voluntarily proposing to change the rounding requirement under I-SEM CfD product offerings from €20k to €10k. ESB will also consider, on a by-counterparty basis, requests from counterparties participating in cross-product contractual trading arrangements to aggregate margin, thereby reducing transaction costs for market participants.

CONCLUSION

At the request of the SEM Committee, market participant comment on the proposed contractual offering for the ISEM product described herein are now welcome prior to SEM Committee arriving its decision.

Attachments for market participant comment:

(1) SEM v ISEM Contracts - Comparative Matrix (see Appendix 1 attached)
(2) DC FEMA Framework Agreement, Schedule; CSA and Confirmation Template
(3) DC Subscription Rules – Marked and Clean versions

Appendix 1 – Comparative matrix

SEM MODEL	ISEM CfD DC FEMA MODEL
COUNTERPARTY:	COUNTERPARTY:
ESB: "SELLER"	"Party A"
COUNTERPARTY: "BUYER	"Party B"
SEM CfD:	FEMA:
Clause1: Definitions	Part 1 INTERPRETATION (a) Definitions
Clause2: Commencement and Term	RECITALS
Clause 3: Transactions and their Confirmation Procedure	Part 2 TRANSACTIONS (a) (Procedures)
	Part 2 TRANSACTIONS (c) (Confirmations)
Clause 4: Representations and Warranties	Part 3 REPRESENTATIONS
Clause 5: Payment Obligations and Contract Quantity Reduction	Part 2 (d) Calculations
Clause 6: Indexation	Part 4 MARKET DISRUPTION EVENTS
Clause 7: Billing and Payment	Part 2(d) Invoicing; Payment; Disputes and Account Details
7.5 Interest	Part 2(d) Invoicing; Payment; Disputes and Account Details
Clause 8:Confidentiality of Information	Part 11 MISCELLANEOUS (h) Confidentiality
Clause 9: Non-issuance of SMP	Part 4 MARKET DISRUPTION
Clause 10: Liability/Exposure Calculation and Payment Assurances	Part 11 MISCELLANEOUS (i) Liability
Clause 11: Termination	Part 5 EVENTS OF DEFAULT AND TERMINATION EVENTS
Clause 12: Disputes	Part 8 DISPUTES (cf Part 2(d) Invoicing Disputes)
Clause 13: Governing Law and recourse to Courts of Competent Jursidiction	Part 9 GOVERNING LAW AND JURISDICTION
Clause 14: Taxes	Part 2 (i) Specified Information; (j) TAX
Clause 15: Assignment	Part 11 (f) Binding Effect and Transfer
Clause 16: Notices	Part 7 EVENTS OF CHANGE (a) Notice
Clause 17: General	Part 11 MISCELLANEOUS
Schedule 1:Definitions and Rounding	FEMA Part 12 DEFINITIONS and SUBSCRIPTION RULES
Part 1:Defined Terms (FEMA/CSA)	FEMA Part 12 DEFINITIONS and CSA (Appendix 1 Defined Terms)
Part 2:Rounding Rules (SUBRULES)	SUBCRIPTION RULES (cf. 5 PRICING OF CONTRACTS)
Schedule 2: Buyer and Seller Information (FEMA SCHEDULE)	FEMA SCHEDULE including Part 3 Documents to be Delivered; Part 4 Notices, PART 5 Payment Details, Part 7 Credit Support Documents (where applicable); Part 8 Financial Regulatory provisions
Schedule 3: Difference Payments	FEMA: Part 2(d) Calculations
Schedule 4: Credit Exposure Calculation (CSA/SUBRULES)	CSA/SUBSCRIPTION RULES (cf 8 Management of Credit Cover)
Schedule 5: Examples of Difference Payment	FEMA: Part 2(d) Calculations; SUBCRIPTION RULES (cf 5,8)
Schedule 6: Confirmation Letter (ILLUSTRATIVE) (CONFIRMATION TEMPLATES)	CONFIRMATION (2-way CfD and linked Commodity Call Option)
Schedule 7: Letter of Credit (DELETED)	DELETED - CSA Clause 14
Schedule 8: EMIR Portfolio Reconciliation	FEMA SCHEDULE Part 8 (e) EMIR Port Rec Protocol