



Energy for
generations

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12 October 2017

Kevin Baron
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Re: ESB GWM Recommendation for DC Master Agreement for I-SEM

Dear James and Kevin,

I refer to your email of 2nd October regarding the follow on from the SEM Committee's consultation on the Directed Contract Master Agreement and associated documents for I-SEM.

At the outset we would like to reiterate the points from our consultation response regarding the opportunity that we have now to put in place foundations for a well-functioning forward market. ESB GWM has proposed a suite of documentation which is representative of the ISDA-based industry standard contracts used in the EU energy markets including but not limited to the Scandinavian electricity markets. ESB GWM intends to use these for our own non directed contracts and proposes that they be used for directed contracts and PSO CfDs should they be required.

The Financial Energy Master Agreement (FEMA) has been used in the Nordic financial market since 2000. The Nordic market is widely held up as the benchmark for successful financial forward electricity markets and any action that I-SEM can take to align itself with Nordpool should be positive.

We have reviewed the consultation responses that you shared with us on 2nd October 2017. There was a general theme that more time would have been useful to review the documentation but we understand that the RAs have had to weigh this request against the overall timelines of the project. In spite of the limited time however, it does appear that many respondents did manage to review the documentation and a significant amount of detailed comment was received.

Within the comments we believe there are two distinct themes. The first question is whether to move to the proposed new suite of documentation and the second is what changes should be made to ESB GWMs proposed documents. We have dealt with these in turn below.

Move to FEMA Approach

ESB believes that there was in general a high level of support for the move to a more standardised suite of documentation. From our reading of the responses we received, there appears to be only one company expressing a view that the proposed approach is unsuitable. These concerns were expressed by Viridian Group. ESB GWM believes that Viridians' concerns centre on two points:

- The FEMA approach is not used in GB
- Insufficient time has been afforded for review of documentation

Regarding the first point, ESB GWM agrees that the FEMA contract is not widely used in GB. However, this is not because of the FEMA itself but instead relates to the underlying market arrangements in GB. BETTA is a bilateral contract market and forward trading tends to be predominantly physical contracts based on GTMA which is constructed for physical products not financial. Physical forward contracts are not possible in I-SEM in much the same way that they can't be traded between bidding zones in the Nordic market. Therefore when looking for a benchmark market it is instructive to look at a heavily traded financial forward market like Nordpool. At the same time, ESB GWM is of the view that the FEMA can be and is used for financial forward power trading in GB.

Regarding the second point, the consultation period is a matter for the RAs. In any case, The fact that the FEMA contract is an ISDA-based contract which does mitigate risks around times to review. ESB GWM is using the FEMA for non-directed contracts and expects that others will use it also and therefore all players looking to forward trade in I-SEM will ultimately be familiarising themselves with the contract.

It should be noted also, that while concern regarding copyright of the FEMA contract was raised in the consultation response, appropriate copyright approvals have been procured from each of NAET and EFET by ESB WM for use of each of the FEMA and CSA by all I-SEM market participants.

Given the above, it is ESB GWM's view that using the FEMA for Directed Contracts is a strong step in the right direction towards laying effective foundations for an I-SEM forwards market.

Proposed Changes to FEMA Documentation

As discussed above, ESB GWM is of the view that overall, the consultation responses would support the move to a FEMA based approach for Directed Contracts in I-SEM. If this point is ultimately accepted, then the focus moves to what changes should be made to the documentation based on the consultation responses and further consideration by ESB GWM. Within the comments the RAs received, we believe there are a number of significant issues and a number of more operational contractual changes. In an annex, we have set out the detailed comments from respondents and the ESB GWM response to each. We cover the more high level points here.



Truncation

One respondent suggested that there should be no “truncation” of the CfD and that insufficient justification has been set out for the proposed approach. The SEM Committee has previously opined on this point and stated in CRM Decision 1 (SEM-15-103) that changes would be required to two way CfDs to accommodate the RO. ESB GWM is therefore of the view that this issue was not the subject of consultation. In any event, ESB GWM is required to offer its plants into the capacity market and is required to offer Directed Contracts and so could be exposed to a double pay-out during a scarcity event.

Use of a Call Option

A number of respondents to the consultation expressed concerns with the use of a separate call option and expressed the view that the two way CfD strike price could be capped at the RO strike price. This proposed solution would in effect create an embedded option. The Specification prohibits ESB from trading such a product. While we note that there are differing opinions on how to manage the RO interaction with the two way CfD, ESB GWM has put forward our approach on the basis that we believe it to be best practice and that we believe it's in line with the Ministerial Specification. We also believe that any contract mandated by the RAs that requires amendments to the Specification could risk our ability to offer contracts in December 2017.

Credit Arrangements

A number of respondents raised queries with the approach to credit arrangements for the Directed Contracts. In SEM the Directed Contracts are fully collateralised with cash or a letter of credit and no alternative forms of credit cover are permitted. For I-SEM, ESB GWM has offered to allow alternative forms of credit cover on a case by case basis. While this approach was welcomed, some respondents have suggested that it affords too much discretion to ESB GWM. As ESB is mandated to offer DC contracts and carries all of the risk, without discretion as to the counter party, it must retain full control over its credit exposures. Any counter party can, if it so wishes, continue to provide collateral with cash or a letter of credit as is the case in SEM.

As discussed above, there were a significant number of detailed comments received on the suite of documentation published for consultation. ESB GWM has listed these comments in a separate amended and we have sought to respond to each comment. We have also updated the suite of directed contract documentation to reflect the changes we propose to make arising from the consultation.

Conclusion

ESB GWM believes that the move to I-SEM provides a great opportunity to move to an industry standard arrangement for forward contracting in I-SEM. The FEMA has been used in Nordpool since 2000 with Nordpool being the benchmark market for financial forward liquidity in Europe.

We believe that the responses to the consultation provide a basis to move forward with the FEMA approach. The main concern levelled at the FEMA was based on the fact that it's not

widely used in GB. However, forward contracts in the GB market tend to be physical in nature and therefore using contracts specific to physical delivery. The I-SEM will not have forward physical contracts and so it's instructive to look to markets where forward trading is financial.

We strongly urge the SEM Committee to move forward with the FEMA based approach and take this opportunity to lay foundations for a functioning forward market to develop. We remain available to discuss any aspect of this submission with you.

Yours Sincerely,

Francis O'Donnell
ESB GWM

Attachments:

- Matrix of Respondent Comments
- FEMA/CSA and Confirmation Template (further marked)
- Subscription Rules (further marked)