

I-SEM High Level Design for Ireland and Northern Ireland from 2016

Moyle Interconnector Ltd response to draft decision paper

July 2014

We welcome the progress of the regulatory authorities in publishing a draft decision for the future of the electricity market on the island of Ireland. While we recognise that this is a significant step towards target model implementation we have a number of concerns about the appropriateness of the specific decisions for our market and the underlying rationale for these. This response focuses solely on the areas that directly concern interconnector trading.

In our response to the I-SEM HLD consultation and in discussions with the RAs we were broadly supportive of a modified version of 'Option 3' but expressed concern about the risks of selling FTRs on the interconnectors while introducing a new market. We note that the RAs have not accepted these points in their draft decision (since it utilises FTRs). While we are doubtful that the RAs will decide to facilitate physical forwards interconnector trading we do wish to restate and elucidate our concerns around moving from physical to financial transmission rights before addressing other relevant areas of the draft decision paper. This response is therefore in 4 parts:

1. Summary of key issues
2. PTRs vs. FTRs
3. Comments on the proposed energy trading arrangements
4. Comments on the proposed CRM

1 Summary of key issues

- We remain of the view that making the transition of long term transmission rights from PTRs to FTRs from I-SEM go-live is a high risk approach, the benefits of which are probably overstated. PTRs should be facilitated at least until the market is established and well functioning.
- If FTRs are to be introduced these should be in the form of FTR options rather than obligations. The latter have no tangible benefits but clear downsides for the Irish market.
- Reflecting the overall balance of I-SEM supply and demand in the DAM price is fundamental to the proposed market arrangements. It is difficult to see how this can be achieved without mandating an appropriate level of participation in the DAM.
- More information is required in order to provide significant comment on the proposed arrangements for intraday and balancing but it is important that interconnector capacity is effectively valued and able to participate in these timeframes.
- The proposed CRM is at too early a stage of development to assess properly. As it stands we are not supportive as it does not value interconnection and is likely to distort cross border trade.

2 PTRs vs. FTRs

Paragraph 6.4.8 sets out *‘the main arguments put forward by respondents and interconnector owners in bilateral discussions to maintain the current form of Physical Transmission Rights (PTRs)’*. We note that the points shown are from un-agreed minutes of our bilateral meeting which do not fully convey our views. We have restated these points below with our additions:

- The status quo in Europe and the FUIN region at present is for TSOs to auction PTRs and inconsistency with other close borders seems unattractive.
- Use of FTRs means that all interconnector trading/hedging opportunities in I-SEM will be linked to the day ahead market coupling arrangements which are to be newly established in I-SEM. All interconnector trading therefore hinges on this being effectively delivered and Euphemia being capable of properly accounting for SEM/I-SEM specific requirements, including sophisticated bids, while delivering an optimal coupling solution with GB.
- Introducing market coupling has significant inherent risks and to adopt FTRs (thereby putting all interconnector capacity into the day ahead market) increases the potential impact of this.
- FTRs should only be used when market coupling arrangements are reliable and well established.
- FTRs are priced based on day ahead market price spread which introduces greater risk to capacity pricing and hence revenues if the arrangements are not reliable and well established.
- Resulting potentially reduced or incorrect value attributed to interconnector capacity would reduce social welfare.
- PTRs with Use It Or Sell It (UIOSI) are the equivalent of FTR Options so should deliver at least as much social welfare as the latter since they allow participants to access more hedging opportunities in addition to the day ahead market.

The crux of the above concerns is that immediately switching to FTRs on day one of a new market incorporating market coupling is a major risk. We accept there are theoretical benefits of FTRs but would prefer a more gradual phased introduction to ensure these are delivered i.e. when market coupling and functioning forward financial markets are well established. We note that when the decision was taken to introduce FTRs in the Iberian market this recognised that there was already an appropriate degree of mature market integration¹ and that will not exist on day one of I-SEM.

In addition to the points set out above, we do not agree with a number of the points made in the paper around the benefits and justification of FTRs over PTRs:

- The draft HLD impact assessment provides quantitative analysis of the benefit from efficient interconnector flows and presents headline figures (Table 2) for the benefit of efficient day ahead interconnector flows under the preferred option. This is rather misleading as the benefits presented are not relative to the other proposed options nor the current SEM – they are the benefits of efficient interconnector flows when compared to scenarios modelled solely to show the cost of consistent inefficient behaviour. We would not expect to see this level of inefficient behaviour in any well designed implementation of the target model. It is well established that the current SEM arrangements, including long gate

¹ Study carried out by the MIBEL Regulatory Council: Long term joint management mechanism for the Spain-Portugal interconnection – proposed implementation. May 2010.

closures, ex-post pricing and the need to estimate uplift in formulating bids, result in inefficient flows. With market coupling a key feature of the target model, this should eliminate inefficient flows under all options. It is clearly virtually impossible to accurately quantify the forecast benefits of FTRs over PTRs as assumptions of trader behaviour are required which would be conjecture and could be manipulated to get any result. It is therefore important to highlight that these benefit figures do not specifically show the advantage of FTRs over PTRs and that any such advantage is likely to be fraction of this².

- Paragraph 6.4.11 states that a key advantage of FTRs is that they don't require harmonised nomination rules. We don't see that avoiding harmonised nomination rules is a particularly notable advantage when the overall goal is European integration and Harmonised Allocations Rules for interconnectors will be required anyway under either FTRs or PTRs.
- Reference is made in the report (6.4.7, 6.4.16) to the use of FTRs in the Iberian and Italian markets in the context that these are similar to what is being proposed for I-SEM. This is incorrect as they are internal to their markets. The Italian participant in the HAR stakeholder group has suggested that the current practice of FTR Obligations on the internal Italian bidding zone borders cannot be used as a real benchmark since the coverage of the additional financial risks related to the issuing of FTR Obligations are entangled with complex market arrangements, credit coverage and contractual settlement arrangements set up for national dispatching services and imbalances. The Italian market does not use FTRs for cross border trade. Similarly the Iberian market ("MIBEL") is well integrated with joint governance from Spain and Portugal so use of FTRs on that border is internal to the market (the equivalent of issuing FTRs on the North-South Interconnector) and not equivalent to the SEM-Betta border where we have different governance regimes in the markets i.e. We have no control over decisions of the neighbouring market so there is greater potential for misalignment, for example through differing CRM regimes. The paper also notes that FTRs are in use in several US markets - we do not know enough about these markets to know whether this represents 'international best practice' or value the relevance of this to European integration versus current European practice.
- Paragraph 6.4.12 makes reference to the risk of 'locking out' 20% of the market from the day ahead energy clearing process by offering PTRs. We feel this risk is rather overstated as it assumes that the entire interconnector capacity is offered in the forward timeframe which would not necessarily be the case. Any negative impact of this would assume traders make inefficient decisions rather than maximising their trading profit (i.e. by achieving a better outcome than they expect to see in the DAM). This may be the case for a fraction but should not be assumed unilaterally. In addition, any nominated flows in the 'wrong' direction will simply be corrected by market coupling in the DAM as they result in more available capacity in the 'correct' direction.

² Will be dependent on, inter alia, volume of PTRs issued, whether traders buy power in the forward market, whether the outturn is that this is a better option than waiting for DAM, liquidity of forward physical and forward markets at either end of the interconnector etc.

- Paragraph 6.4.18 discusses the (lack of) additional risk to the interconnector owners through issuing FTRs instead of PTRs. While we recognise that revenue risk to the interconnector owner is limited due to TUoS, when we talk about risk we are not solely focused on revenue risk. We are also concerned about risk of lost consumer benefit in the area where we are well placed to provide insight, although we are cognisant that this is obviously primarily the regulator’s concern.

It is stated that the value of a transmission right should be the same whether it is a PTR or FTR so consumers are best served by the transmission right that brings greatest efficiency to the energy market [i.e. FTRs]. We do not necessarily agree with this point - the value of a PTR can be the price spread at the point in time it is issued if there is a forwards energy market, which may be greater than the value that the trader expects the DAM to realise. The counter to our point is that the same value can be locked in using a combination of FTRs and CfDs however this brings additional complexity and is predicated on there being liquid financial markets at both ends of the interconnector – there is no guarantee that this will be the case, especially in the market that the local regulatory authorities have no control over.

This section also refers to firmness rules being the same for FTRs or PTRs under the draft Forwards Capacity Allocation (“FCA”) network code. While this is broadly correct it does not recognise the potential impact of the Long Term Firmness Deadline (“LTFD”), after which firmness increases. While the FCA allows for a LTFD for FTRs³ the rationale for this is less clear cut as they are purchased purely as a financial hedge. PTRs have a clear point in time where they should become more firm (i.e. after nomination) whereas we see a risk that regulatory dogma could move towards FTRs being fully firm from the point of sale (or at least a longer period than would apply for PTRs). Firmness risk may therefore not turn out to be identical for FTRs and PTRs and a CBA of any additional firmness risk should be considered.

This brings us to the issue of firmness in general. As we have previously stated it is important that there is clarity on how firmness will be underwritten. The financial structure of companies bearing this risk and how it can be managed needs to be taken into consideration. While we expect a cap on firmness costs for curtailment prior to the long term/day ahead firmness deadline, there is expected to be no such cap for curtailment after this point. While this is a pertinent issue for Moyle as a mutualised business with limited resources, underwriting the fullness of open ended liabilities is an issue for any company exposed to such liabilities. Given the size of the interconnectors relative to the Irish market an extreme price event could feasibly be caused by an interconnector trip in I-SEM, if this occurred shortly before day ahead gate closure. If the trip occurred after the firmness deadline the interconnector owner would be exposed to unlimited firmness payments on a day ahead price that has been driven up by the trip event! Measures need to be identified such that this cannot happen.

- Finally, FTRs are more likely to be captured under the Markets in Financial Instruments Directive 2004/39/EC (MiFiD) and European Market Infrastructure Regulation (EMIR). This is an issue being investigated by ENTSOE which the RAs should be aware of as it may result in extensive costly obligations being placed on TSOs issuing either type of transmission right.

³ Between 2 and 19 hours ahead of day ahead gate closure

3 Comments on the proposed energy trading arrangements

The summary of decisions in the paper states “the I-SEM design is characterized by liquid financially traded forward contracts”. This is obviously critical to the functioning of the market by facilitating forward hedging. The paper also recognises the failure of SEM to deliver such a forward market while stating that the SEMC “will also consider additional measures to foment liquidity of financial instruments in the forward timeframe within the detailed market design phase of the I-SEM”. At this stage we would like to understand better how forward liquidity is expected to be delivered – there should be a commitment to deliver a liquid market for financial instruments in the forward timeframe as this seems a reasonably bold assumption on which to base other I-SEM decisions.

We are concerned by the decision to relax the requirement for mandatory participation in the DAM. A non mandatory DAM is inconsistent with the decision to offer FTRs and force all interconnector trade into the DAM. This is such a critical area that it cannot be left to chance that there will be adequate participation to facilitate effective price formation. Measures must be identified that either allow the likes of wind generation to participate in the DAM without suffering from adverse outcomes or to incorporate the likely effect of wind in the day ahead price while mandating that other forms of generation and demand must participate. We do not have a strong view on how this is achieved but stress it is a critical issue that needs to be addressed. For the DAM to provide an appropriate price it must reflect the whole generation mix relative to all-island demand.

We note that reference is made to not retaining the BCOP in its current form. While we recognise that this is not possible given the market changes and Euphemia bidding requirements we are of the view that there should be some equivalent arrangements in place as suggested in the paper such as bidding principles with effective ex-post monitoring.

Our comments on the RA rationale for decision making on the Energy market, other than the points covered above, are as follows:

- Paragraph 6.4.5 points out the decision for financial forwards trading is divergent from most of Europe while noting what happens in the Iberian and Italian markets. The relevance of these examples is unclear beyond noting that SEM is not alone in adopting an unusual approach as neither market is the same as what is proposed here. As stated above we welcome that developing forward liquidity is to be investigated (paragraph 6.4.6) but reiterate that there needs to be commitment to deliver this in time for I-SEM going live given its importance to a properly functioning market of the type envisaged by the draft decision.
- Notwithstanding our foregoing arguments against FTRs versus PTRs, we can at least understand the RAs rationale for favouring FTR options. While there is no draft decision on FTR options versus obligations our position is very much in favour of options at the present time. The example of how FTR obligations could deliver benefits in paragraph 6.4.13 is

highly theoretical, very unlikely to occur and the tangible benefits are unclear versus obvious unattractive qualities of FTR obligations.

Historically there has been little value for interconnector capacity in the NI-GB direction given the clear positive price difference in the opposite direction. If we assume this position generally prevails in future (which is fairly reasonable given our geography relative to the rest of Europe) then an FTR obligation in the NI-GB direction would have a zero or negative value since the prospective holder would forecast that they will be paying out significantly more in market spreads than they receive. For this reason no one would purchase an FTR obligation in the NI-GB direction and the purported “netting” of FTR obligations to increase liquidity would not occur.

Our perspective on the negative impact of FTR obligations is explained as:

- 1 Value import capacity decreases due to additional risks of payouts as well as receipt of congestion revenue
- 2 Value of export is zero (or negative) as payouts are clearly greater than receipts
- 3 Impact on market stays the same as both provide full interconnector capacity to DAM so only difference is that you have eroded the revenue from selling capacity rights which is lost to consumers. It is unclear that there would be consumer benefit from obligations providing a more effective hedge.

FTR obligations might be worth exploring in future if prices significantly converge such that there isn't a clearly dominant flow direction and market integration is more entrenched. Since the market design doesn't hinge on the choice of FTR options or obligations the type of products could change in time with no restriction on both being offered.

- With reference to paragraphs 6.4.19 and 20 an early decision on transmission rights is important for interconnector owners. The Harmonisation of Access Rules (“HAR”) process is well underway and we need to be involved in the appropriate workstream of this project as well as preparing for the significant change that I-SEM will bring to interconnector businesses in any case. It is worth noting that the ENTSO-E's HAR working group has recognized the complexity of implementing FTR obligations, that their access rules will necessarily be significantly different from those of PTRs and FTR options and are therefore focused on developing HAR for PTRs and FTR options.
- Paragraph 6.4.32 discusses the various offer submissions possible in Euphemia. We have previously expressed our concern that formats such as including Minimum Income Conditions could adversely affect market coupling with GB. We would reiterate our view that detailed analysis of Euphemia is required and that bidding/price formation should be consistent with GB to ensure equivalent price formation for market coupling. SEMC should specify acceptable formats of bids for I-SEM if detailed assessment suggests there may be issues with certain bid types in Euphemia.

We have limited comments on the intraday and balancing markets given their relative lack of discussion. We welcome that the RAs are investigating implicit intraday auctions as this is the only feasible method for valuing interconnector capacity under the target model, as required by the Framework Guidelines, that we are aware of. It is important that intraday capacity is properly

valued so that the availability of 'free' capacity intraday does not impact participation in earlier timeframes. With regards to the balancing market, we would simply welcome more information as to how cross border participation in the balancing market will work.

4 Comments on the proposed Capacity Remuneration Mechanism ("CRM")

In our view the proposed CRM has too many unanswered questions to be addressed in the detailed design to allow a proper understanding of the proposal's likely impact. However, from the information available this does not look like a decision we can support as we expect that it will negatively impact cross border trade.

The key for us is that the CRM should not distort interconnector trade and allow cross border participation. As it stands it appears like neither of these requirements will be met.

While the RAs have stated that they would consider interconnector/cross border capacity somehow participating in the CRM, it was stated at the June stakeholder decision that this has not yet been achieved with reliability options implemented elsewhere. Since there doesn't appear to be any suggestions for how this would work, we can only anticipate that it won't.

Our concern around the impact on cross border trade is that the mechanism will dampen prices in I-SEM. When there is not an identical CRM at the other end of the interconnector then this clearly distorts trade. If a generator in I-SEM receives an option fee then this will contribute to recovery of its (fixed) costs. This generator can therefore afford to offer lower prices into the energy market than if it had not received this fee and still have full cost recovery. In a competitive market where many participants hold reliability options ("ROs") this will push down energy prices as Irish generators operating on a level playing field seek to maximise their running times and profit. Interconnector trades into Ireland are not on the same playing field as they are coming from a market with a different capacity mechanism that has a different effect on energy prices. This CRM therefore could be completely contradictory to the theme running through the HLD decision of increasing efficient interconnector trading.

The magnitude of the effect of an RO based CRM will depend on the various decisions of the detailed design which need to be clarified to properly assess the proposal. We have a number of comments and questions on these prospective decisions and other issues as follows:

- The capacity requirement and how this is calculated is key. If ROs are available to virtually all generation the distortion of cross border trade described above will be maximised. Clarity is needed on what the methodology for calculating the capacity quantity will be. In addition, what will happen if the required quantity is not reached due to non-participation? What if it is reached but option fees to be paid are excessive? The RAs recognise that the latter point is a risk due to market power but whatever mitigation measures are put in place are likely to be important to understanding the impact of the CRM.
- The capacity requirement calculation should recognise the capacity value of interconnectors. If they are included in the calculation of required/available capacity they should be capable of being rewarded as such – if they are not rewarded but are included in the capacity

requirement calculation then generation will be overvalued and over-rewarded in the capacity market.

- We note the explanation that the strike price for ROs is usually a premium to SRMC of the most expensive provider on the system. It is obviously important that the strike price is set high enough that it does not become an effective price cap that is frequently impacting the market price. If it was set too low it would become a cap as generators have no incentive to bid above the strike price (assuming their entire capacity is linked to a RO which could easily be the case). We would welcome more detail on how the strike price will be formulated i.e. a single price for the market? Different prices for different technologies?
- Paragraph 8.4.12 states that spot prices should not be unduly affected as they do not require bidding in particular way. The latter point may well be the case but this does not mean that generator bids will not be impacted by the presence of the RO – parties may well choose to bid in a certain way given that they will have received an upfront contribution to their cost base.
- Paragraph 8.4.21 mentions the possibility of an additional penalty for non-delivery, over and above the payment made when the reference price exceeds the spot price. We feel that this would be too penal a regime and create another barrier to cross border participation as cross border participants cannot control interconnector availability. This could be mitigated if there was a liquid secondary market (which would no doubt need to be fostered by the RAs) or, more easily, if ROs could be relinquished if the holder is going to incur excessive penalties.
- With respect to paragraph 8.4.22, the eligibility rules should require that issuers of ROs have a credible present or future source of physical power. It would be perverse to allow purely financial players to participate in a mechanism that aims to secure adequate physical capacity.

It is difficult to see how interconnectors can be an integral part of this capacity mechanism and efficient short term interconnector trading in the presence of the CRM is a fundamental requirement. If an answer cannot be found for these problems this CRM should not be implemented.