

Trading and Settlement Code

**ISEM Operational Parameters Credit
Cover and Imbalance Settlement**

SEM Committee Consultation

SEM-17-009

Power NI Response

20 March 2017

1. Introduction

Power NI welcomes the opportunity to respond to the Regulatory Authorities (RAs) Trading and Settlement Code Operational Parameters, Credit Cover and Imbalance Settlement Consultation Paper.

As the RAs are aware, Power NI is the largest electricity retailer in Northern Ireland. Power NI is part of the Viridian Group which has within in its portfolio, a retail position in Northern Ireland and the Republic of Ireland, as well as a significant thermal and renewable generation presence.

Power NI is however a separate business. Power NI's legal, managerial and operational separation is mandated via licence condition and it is within the context of being a supplier without vertical integration; that Power NI has approached the Energy Trading Arrangements Rules Working Groups, fed into the workshops, assessed the issues presented and now responds to the first Trading and Settlement Parameters Consultation Paper.

2. General Comments

The credit cover parameters consulted upon within this consultation are an important issue for suppliers and the analysis undertaken on behalf of the RAs by SEMO is helpful in attempting to make evidence based decisions.

There is a danger however that each parameter is considered individually and a holistic view of collateral is not taken. The aggregate effects of the parameters chosen must form part of the RAs decision making process and unfortunately such compounding effects are not highlighted in the analysis paper.

It is equally important to consider the full market design and impacts of other decisions on the likely collateral position prior to considering the individual parameters. While it is correct to state that the ISEM Balancing Market will have many of the same characteristics of today's SEM there are wider design implications to consider.

While the development of ex-ante markets theoretically was intended to increase working capital obligations (which in itself is an issue) and reduce credit requirements the implementation has not facilitated such an outcome. Ex-ante markets with a significant price cap make it difficult for suppliers to contemplate being a price taker due to the pre-funding requirements. The ISEM Balancing Market also assumes that all future volumes will be bought in that timeframe however does not consider generation in the same manner. This significantly reduces the offsetting netting capability of participants. Initial estimations suggest that the levels of credit required under the ISEM will be significantly higher than under the SEM under existing parameters and prior to any of the changes proposed. This is particularly problematic for suppliers.

Power NI would welcome the RAs revisiting the issue of offsetting generation collateral in the Balancing Market. Under the current drafting the ISEM will have more collateral posted than the SEM, a market acknowledged to be typically over collateralised. For the avoidance of doubt, the SEM Committee should not consider earlier payments as a solution to collateral issues. Earlier payments create greater problems for suppliers as this is a working capital issue and cash typically costs more than collateral. Power NI instead would strongly recommend that the RAs look to reduce the burden on suppliers (and ultimately customers) by exploring ways of appropriately crediting expected generation in the Balancing Market.

3. Recommended Values for ISEM Credit Cover Parameters

SEMO on behalf of the RAs have assessed and recommended values for ten credit impacting parameters. In the assessment overview SEMO have highlighted the effects of the Christmas/New Year Period and its associated variance increase. Power NI would like to take this opportunity to highlight that specific issues such as Christmas/New Year should not merit a change in parameters. It is a function of the delayed market invoicing and bank holidays and not an inherent issue of under collateralisation. It should also be recognised that Supplier Settlement Amounts will move dependent upon a range of factors including wholesale fuel prices and the impact of wind on SMP. Fluctuations are an inherent part of the market design and a mindset which seeks to never have any period of under collateralisation will result in material periods of over collateralisation.

Given that the SEM market tends to be on an over collateralised position the justification for a change which would result in increased collateral requirements must be compelling. In responding to the RAs Consultation Paper Power NI has assessed each of the ten parameters in turn and attempted to make a holistic assessment of their aggregated impact

3.1 Fixed Credit Requirement for Suppliers

Power NI concurs with SEMO's assessment of the drivers behind the fixed credit requirements for suppliers and agrees with the assessment of the effects of resettlement expected in ISEM in comparison to the SEM. For this reason, Power NI considers the recommended retention of the current SEM parameter as appropriate.

3.2 Fixed Credit Requirements for Generator Units

Power NI also supports the retention of the fixed Generator Unit requirement at the current SEM level.

3.3 Fixed Credit Requirement of Netting Generator Units

Power NI also agrees that the fixed credit requirement for Netting Generation Units should fall away under ISEM arrangements.

3.4 Fixed Credit Requirements for Capacity Market Units

The ISEM design mandates the creation of this new unit type. Setting the credit cover parameter to €0 would appear as a reasonable requirement for ISEM go-live.

3.5 Number of days in the Undefined Exposure Period for each Undefined Exposure Period

The number of days set as the Undefined Exposure Period is derived from regulatory policy and approach. It is a parameter which is not within the control of SEMO and as expected SEMO are not in a position to present statistical supporting analysis.

The requirement is well understood, the undefined exposure period seeks to ensure that a participant has sufficient collateral in place to cover the time taken to exit the market. This is particularly relevant for supplier units who usually owe monies to the marketplace. As discussed at a number of Energy Trading Arrangements Rules Working Groups, the term 'Supplier Suspension Delay Period' is somewhat misleading as it gives the impression it may have some form of temporary nature. What is in fact happening during this period is that the RAs are deciding on whether to revoke the licence of a supplier and activate the Supplier of Last Resort process. This is a permanent decision by the RAs and is terminal for the supplier affected.

Such a decision is not taken lightly by either RA. The decision directly impacts customers, potentially closes down a business (if the supplier affected has no other aspect to its business it is likely that employees will be made redundant) and has a highly disruptive affect on the retail market.

In considering the parameter it is important to recognise that the RAs are only going to become aware of the issue following notification from the supplier that they are going into administration or by SEMO following payment defaults. This means that the Supplier is already in a highly distressed state and in all likelihood in an unrecoverable position. This is not an indication of financial difficulty or some momentary issue but a declaration of a major issue with viability of a business.

Once aware the RAs are required to make a decision and it is likely to be taken quickly. Cognisant of the effects of debt in the marketplace the relevant RA must act decisively to protect other participants and customers.

As the RAs are aware such an event occurred in Northern Ireland on December 2016. Highlighting the fast moving nature of such an issue the RA, in this case the Utility Regulator (UR), took only one day to assess the suppliers situation and issue the Notice of Revocation. There was then a procedural day until it was effective and the Supplier of Last Resort

process was activated. As a timeline therefore the UR became aware of an issue on Day Zero, made the decision on Day One, Day Two was the procedural day and all customers were automatically switched on Day Three. This means that on Day Three the Supplier affected ceased to incur costs in the SEM.

It is noteworthy that this took place before the Supplier had sufficient Default Notices to trigger the request to come from SEMO. It was in fact triggered by the Supplier going into Administration.

This example highlights both the importance of the Undefined Exposure Period and the timelines involved. Power NI considers the 14 Day period as excessive and mandating a posted credit level significantly in excess of what in reality is required. Such over collateralisation is a significant cost of participation and cost to consumers.

Power NI does accept that the example in Northern Ireland was an event which was implemented in the fastest possible timeframe and therefore an Undefined Exposure Period of 3 days should be considered as the minimum level. The appropriate level to give some degree of buffer is ultimately down to the longest period the RAs consider they would allow a highly distressed, defaulting supplier in the marketplace before taking decisive action. Individual circumstances will always come into consideration however Power NI believes it is unlikely the RAs would allow such debt to be accumulated for any longer than 7 days.

Power NI therefore recommends that the RAs do not accept the proposed 14 Day parameter and approve a shorter 7 day value. Power NI strongly believes that this more accurately reflects the maximum time a regulator would allow wholesale debt to amass and is in the interests of consumers in terms of cost.

3.6 Number of days in the Historical Assessment Period

As the analysis illustrates, the number of days in the Historical Assessment Period drives the responsiveness of the calculation to changes in market conditions. Sudden price spikes will result in periods of under collateralisation if not preceded by a period of falling prices e.g. December 2015/January 2016. Power NI does not consider this to be overly problematic for the market but rather a function of spot markets dealing with fluctuating wholesale fuel prices and plant outages. To move to a shorter assessment period will increase the volatility in the calculation. Credit volatility is disruptive and adversely impacts a supplier's relationship with its bank. Typically banks prefer credit stability as it is often seen as an indication of the stability of the business. To increase the volatility within the credit cover calculation will result in suppliers simply factoring in greater headroom in their posted amounts. This in turn will lead to further over collateralisation and avoidable cost.

The analysis shows that the market is typically over collateralised. Increasing volatility and credit requirements to cover a small number of reasonably isolated events is unhelpful for a market which in nearly ten years of operation has not had a bad debt event.

3.7 Analysis Percentile Parameter

Within the analysis and recommendation in relation to the analysis percentile SEMO have concluded that moving from a 95% to 98% confidence percentile would not create a “burdensome increase in the credit cover required by a participant”. As stated above no parameter should be concluded upon without a comprehensive assessment of the cumulative impact. Additionally, Power NI view any increase in credit cover as a result of changing parameters as burdensome as it would require increased collateral posted when inherent market conditions have not changed.

Based upon an assessment of the first six weeks of 2017, on a like for like basis Power NI would have to increase posted collateral by c1.5% as a result of changing this parameter alone. This is a significant amount of collateral both for a single participant and across the market.

Given historic values and out turned over collateralisation Power NI does not believe that the case has been made to increase the analysis percentile. A degree of reasonableness must be taken into consideration when assessing market requirements and Power NI believes a standard 95% percentile confidence level leaves a level of risk which it is reasonable for the market to bear.

3.8 Credit Cover Adjustment Trigger

Power NI understands that the Credit Cover Adjustment Trigger currently uses the calculated required credit cover amount in its assessment. Such a figure is subject to significant variation through the normal operation of the market e.g. paying invoices, capacity invoicing and weekend/non working day effect on the calculation.

It is unclear if SEMO are proposing to move this calculation from assessing out turned credit requirements or metered demand. Clarity on this point is particularly important in determining the appropriate parameter. Should the assessment remain on required credit cover then it is likely that a participant’s exposure will move significantly dependent upon trading activity.

Utilising the Reallocation Agreement for example will allow a participant to reduce its invoiced exposure however if the generation unit has an ex-ante position this will not be available. A generation unit which therefore drops into and out of the Balancing Market will move its related supplier’s invoiced credit requirements. This is similar to today and the effect of a generation unit getting a SEM position however in the ISEM a suppliers own trading strategy will also impact its Balancing market exposure if it has invoiced volumes moving into and out of the Balancing Market as a result of ex-ante trading.

Power NI would support the trigger using metered demand over the historical assessment period as this will provide a more consistent and accurate representation of underlying market changes potentially impacting collateral rather than simple timing or trading issues.

Making such a change will provide the market with a more accurate indication of a change, which is what the adjustment trigger attempts to capture. Power NI however does not see merit within the analysis for changing the adjustment trigger to such a low figure as 10%.

Set at such a low level will result in unmerited changes in status with the associated burden which this brings.

3.9 Level of the Warning Limit

The Warning Limit is designed as an aid for participants to highlight that their posted collateral level headroom is eroding. It is the participants responsibility to manage their collateral position as they see fit within the absolute requirements set out in the Trading and Settlement Code. For this reason Power NI believes that SEMO should not be mandating a pre-set Warning Limit Level.

Under the SEM arrangements participants initially had not understood that the Warning Limit could be individually adjusted. This was highlighted as a large number of Warning Notices were being issued as participants sought to tightly manage their credit cover to minimise cost. As a result the Warning Notice lost its effectiveness as a highlighting tool.

To ensure its effectiveness and as collateral posting is the participants responsibility Power NI believes that the Warning Limit should remain individually configurable as it is in todays SEM.

3.10 Level of the Breach Limit

The level of any Breach Limit is intrinsically linked to the design approach taken in relation to the 'time to remedy'. The ISEM design includes the concept of being suspended from ex-ante markets because of insufficient collateral in the Balancing Market. What is not clear at this stage is whether this happens at the point of a Credit Increase Notice being issued or in the event of a participant receiving a Default Notice, 2 days later for failing to adequately respond. Clarification on this point is crucial in determining the Breach Limit. Should the RAs determine that a participant will only be suspended from the ex ante markets following default (and not automatically following the issuance of an increase notice) then Power NI can see merit in adjusting the Breach Amount to cover the 2 day remedy period.

The analysis presented however focused solely on the SEM figures and did not refer to remedy period impact on ex ante trading. Should the intention be that a participant will be suspended from ex ante trading on issuance of an increase notice then Power NI strongly opposes a change in the Breach Limit to 92.59%. This is in effect mandating a 7.41% headroom figure be maintained by all participants. This is an unnecessary cost and burden on suppliers when the entire calculation including the Undefined Exposure and Analysis Percentile is designed to ensure sufficient collateral is in place and arguably results in significant over collateralisation. There is no justification for a requirement of over collateralisation plus 7.41%.

Amending a Breach Limit is justifiable if the credit cover calculation was on a simple spot basis. The fact that the Trading and Settlement Code contains such a detailed assessment and confidence percentile renders a Breach Limit less than 100% an unnecessary duplication.

3.11 Collateral Conclusion

The issue of collateral is an important issue for the market and especially relevant for suppliers. It places a burden on participation, influences a businesses relationship with its bank, carries cost for consumers and in the ISEM design could result in suspension from the ex-ante markets. It is therefore of fundamental importance that the calculation seeks to collateralise the marketplace in a reasonable manner, is equitable and avoids unnecessary volatility and cost to consumers. It is important to recognise that any marketplace has to bear some degree of default risk. Participants understand this as no market can be entirely risk free.

Each of the proposed amendments to the parameters put forward in the paper increase collateral requirements on suppliers and do so without fully recognising the compounding effects. It is unfortunate that collateral requirements have not been modelled to include some assumptions of the impact of the ISEM design especially in relation to the netting benefits of generation which will no longer be available in the undefined exposure calculation.

Power NI recommends that the Analysis Percentile, Adjustment Trigger, Warning Limit and number of days in the Historical Assessment Period remain at SEM levels. Furthermore, Power NI strongly recommends that the number of days in the Undefined Exposure Period is reduced from 16 to 7 and that the Breach Limit remains as 100%.

4. Recommended Values for ISEM Imbalance Settlement Parameters

In assessing the areas of imbalance settlement SEMO have again highlighted the design similarities between the current SEM and the ISEM Balancing market. Power NI once again concurs with this view.

SEMO have highlighted a number of new parameters mandated under the ISEM design however have proposed that they are set to one or zero so as to insure they will not be effective at the beginning of ISEM. Power NI supports this approach.

The only changed parameter proposed by SEMO is to the Settlement Recalculation Threshold. The recalculation threshold is particularly important to small participants who have been subject to some form of error in the marketplace and seeks to balance a timely response and correct against the administrative burden that ad hoc resettlement places on all participants. Power NI sees merit in the adjustment being changed to a monetary amount and considers €15,000 as a reasonable sum.