



Response to SEM-12-004

***Proposals for Implementation of the European Target
Model for the Single Electricity Market Consultation
Paper***

on behalf of

AES Ballylumford Ltd and AES Kilroot Power Ltd

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Queries to

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Introduction

AES Ballylumford Limited and AES Kilroot Power Limited (collectively "AES") welcome the opportunity to respond to the Single Electricity Market Committee's ("SEMC's") Proposals for Implementation of the European Target Model for the Single Electricity Market Consultation Paper ("the Consultation Paper").

Summary

European market coupling will be the most significant change to the SEM since its inception in 2007. AES therefore welcomes the publication of the Consultation Paper, the accompanying 'Pathways to the Target Model' paper and the workshops and meetings hosted by the SEM Market Integration Project team which have attempted to help participants understand how the SEM might comply with its requirement to couple with the European electricity markets by 2016. AES also welcomes the Regulatory Authorities' efforts in highlighting the fundamental differences between SEM and the Target Model, securing the two-year compliance extension in the Capacity Allocation and Congestion Management Framework Guideline ("CACM FG") and its ongoing work in compiling the necessary evidence to ensure that the two-year compliance extension is granted for the SEM.

While the participant engagement has been very helpful, and while AES fully understands that it is too early to present options in detail, the process to date has nonetheless highlighted that assumptions on the high level principles need to be presented to participants for them to be able to adequately assess the options. Unfortunately AES does not consider the options to be presented in sufficient detail for a high level decision to be made at this time and would caution the SEMC on attempting to narrow down the options in the absence of a decision on high level principles. Details of the outstanding issues and information gaps are included in the NEAI response which AES fully endorses.

AES also believes that time and understanding has moved on since the SEM Market Integration Project Initiation Document ("PID") was published in August 2011. At that time the CACM FG had just been published and it was unclear the nature or extent of the transitional arrangements that were required to be in place by 2014 in order to secure the extension for compliance to 2016. The Project timetable was therefore drafted with a view to deciding on transitional arrangements and/or market redesign by February 2012 and implementing the transitional arrangements by 2014.

Since then it has become clear that neither the SEMC nor participants saw the benefit of implementing changes by 2014 unless they were part of the necessary steps to achieve the enduring compliant solution by 2016. It would also appear that this view is not at odds with that of the European Commission ("EC") provided that SEM has a process in place to achieve compliance by 2016.

Prior to publication of the Consultation Paper and the workshops and meetings with members of the Project Team, AES, and we suspect many others, had hoped that it might be possible to retain SEM with minimal change. What has however become apparent is that even the options that were classified as evolutionary are likely to require significant changes to the SEM.

AES therefore believes that in light of developments since the PID was published the SEMC should review and reassess the PID and its accompanying timetable. Given that minimal change to the SEM now looks remote AES believes that the SEMC should establish a holistic project which starts with high market level principles and objectives rather than progressing with the bottom up approach adopted to date. AES does however wish to make it clear that it is not discounting retaining SEM but rather that high level principles and objectives for future market arrangements should be established. These should ensure both compliance with the Target Model and a market which works for electricity consumers, generators and suppliers on the island of Ireland, prior to deciding on the solution to be adopted.

AES also believes that the SEM Project Team should be adequately resourced for the next phase of the Project which is likely to be substantive. This should include the use of third party experts with knowledge and experience of a range of electricity market designs and both the technical and commercial implications of such. AES believes that one of the shortcomings in the process to date is that it has been heavily influenced by the Single Electricity Market Operator (“SEMO”) and the Transmission System Operators (“TSO”) in both Northern Ireland (“NI”) and the Republic of Ireland (“ROI”). As such the options presented are based around arrangements which might technically couple SEM with the rest of Europe but which are severely devoid of the commercial implications and risks.

The next phase of the Project must also include a mechanism to enable the views and concerns of market participants to be incorporated in the process. Such a process was considered necessary during the design of SEM and currently operates at a European level through the ACER Electricity Stakeholder Advisory Group¹ (“AESAG”). Balanced engagement should reduce the likelihood of self-interested views being taken forward and improve the quality and efficiency of the process.

Comments

High Level Design

The SEM High Level Design (“HLD”) was set 7 years ago in 2005 and will therefore be 11 years old in 2016. Much has happened in the intervening period such as the strength and breadth of

¹ AESAG is the name for a new version of AHAG (the European Ad Hoc Advisory Group). “AHAG has proven to be not only a suitable place to generate consensus (cf. the agreement on the target models proposed by the PCG), but also a very valuable way to get informed input from stakeholders in a way that is certainly more efficient than typical consultation processes...AESAG will comprise representatives of the European Commission, CEER and of the relevant stakeholder organisations of the European electricity sector including the transmission system operators, power exchanges and market participants (consumers, traders, electricity companies).” (AESAG Terms of Reference)

the EU influence, NI and ROI commitments to achieving 40% of electricity consumption from renewable sources (predominately on-shore wind) by 2020, a doubling of interconnector capacity from 450MW to 900MW (almost 10% of dispatchable generation on an all-island basis), deterioration in the economic climate, the system costs and experience of adapting the SEM market model for intra-day trading (€11m² excluding participant costs).

As the Consultation Paper states at that time the SEM HLD “was judged by the Regulatory Authorities to be a robust, internally consistent set of rules that meet the regulatory and government objectives and under which the new wholesale market could successfully operate.”³ It is therefore imperative that any future market design is equally compliant, robust and internally consistent. The danger with starting to alter elements of the SEM is that it may no longer meet these objectives. The experience of altering the market systems for Intra Day Trading also shows that the market system costs and time associated with what appear to be relatively straightforward changes can be significant. Furthermore if the SEMC continues with the current bottom up approach it is in danger of making decisions which will have a significant impact on the future of participants without holistically considering the changes and their implications. There is also the risk of progressing down a route to such an extent that we pass the point of no return because time has overtaken us.

Assessment Criteria

The Consultation Paper states that the original assessment objectives for SEM design (security of supply, competition, environment, stability, efficiency, practicality/cost, equity and adaptive) are as relevant in 2012 as they were in 2005 and AES does not dispute this. However given the significant changes that have occurred since 2005 AES does not believe that the assessment criteria should be automatically retained without revalidation and consideration of what other criteria may now be relevant. For example it is important to ensure that the future market is non-discriminatory and that participants in SEM complete on a level playing field with their counterparts in Europe. It is also important to ensure that the financeability of participants is considered and that the market facilitates the development of sufficient renewable generation to meet the 40% renewables targets that have since been set.

Target Model

While the CACM FG and draft Network Code covering the Day Ahead and Intra Day timeframes has been published the FGs for the Forward and Balancing timeframes are still in development. The requirements of the Target Model will therefore not be known with certainty until the Network Codes (“NCs”) have been approved by Member States through the comitology process. It would therefore appear premature to make changes to SEM until the SEMC is certain of the Target Model requirements.

² SEM-11-083 Approval of SEMO Intra Day Trading Costs

³ P9 SEM-12-004 Proposals for Implementation of the European Target Model for the Single Electricity Market

While SEM expects to be granted a 2-year extension pushing compliance out from 2014 to 2016 the rest of Europe is working to a very tight timeline to achieve compliance by 2014. The SEMC should therefore make maximum use of the extra time available by robustly considering the changes that will be required to SEM and learning from the problems encountered by other Member States and revise the Market Integration Project timeline accordingly. An added difficulty is that at a European level the Day Ahead and Intra Day timescales are starting to slip. Therefore while the Regulatory Authorities (“RAs”) must clearly demonstrate progress to the EC they must strike the right balance between satisfying the EC and making decisions too early.

Outstanding Issues

While at the start of the Market Integration Project market participants were told to assume that the Capacity Payment Mechanism (“CPM”) and other aspects of SEM would remain unchanged the intervening time has shown that such simplistic assumptions cannot be made. AES therefore welcomes the acknowledgment by the SEMC that 4 key pieces of work are required prior to determining next steps. These are:

- Challenging the requirement for central commitment and dispatch;
- Understanding how complex and simple bidding could work together in practice;
- The treatment of renewables regarding imbalances; and
- How the CPM would work in practice.

While AES welcomes the commitment to complete the outstanding work AES would caution against tendering and completing it in piecemeal fashion as a holistic view of the interaction of the different elements is required.

The TSOs are also reviewing the extent of compatibility of the SEM and Price Coupling Regions algorithm.

Project Resource & Participant Engagement

AES acknowledges the significant resource commitment made by SEMO and TSOs in the development of their Project Pathways. While the Pathways have stimulated much debate it would appear that SEMO and the TSOs have simply tried to blend market models from a process point of view without considering the commercial implications and risks for participants, particularly when dealing with 4 different time periods. This highlights a lack of participant input in the process.

It is also clear that SEMO and the TSOs are strongly advocating central dispatch with negligible consideration of self dispatch, thereby raising a concern that they are protecting their own interests rather than what may be best for the market overall. AES accepts that SEMO and the TSOs must manage an island system with limited interconnection and high penetration of wind but believes that as the issue of central v self dispatch is fundamental to determining future

market arrangements both options must be robustly considered. AES therefore welcomes the RA challenge of the requirement for central dispatch.

Going forward AES believes that third party experts with the knowledge and experience of a range of electricity market designs should supplement the Project Team. This will bring strength and depth to the next phase of the project and ensure that the commercial implications of operational proposals are considered. The next phase of the Project must also include a mechanism to enable the views and concerns of market participants to be incorporated in the process in order to instil market confidence.

Legal Framework

The Consultation Paper states that if the SEMC were to conclude that the SEM cannot be adapted to achieve compliance with the Target Model it is likely that primary legislation would be required to implement a new market. Given that early indications are that more radical changes may be required AES would urge the RAs to engage with their relevant Departments at the earliest opportunity and ensure that they are kept up to date with the development of the project since they will ultimately be responsible for compliance.

Conclusion

AES is committed to working with RAs and the NEAI to achieve compliance with the Target Model by 2016 and welcomes the work and engagement to date. AES strongly recommends that the SEMC review its next steps for the Project and develop a set of high market level principles and objectives rather than progressing with the current bottom up approach. AES does not discount retaining SEM but rather advocates the establishment of high level principles and objectives for the future market. Responses to the Consultation Paper questions can be found in the appendix.

Appendix

Consultation Questions:

1. Do you agree that the SEM has met its objectives to date?

While AES broadly agrees that SEM has met its objectives to date it does not see the merit in continuing to focus on its historic success. The fact is that SEM cannot be retained in its existing form and therefore the focus should be on identifying the design elements of SEM that should be retained in any future market.

2. Do you think that any further work should be done on the above projects [Dispatch and Scheduling, Demand Side Management, Market Power and Liquidity, Generator Locational Signals, Capacity Payment Mechanism Review, Ancillary Services and Facilitation of Renewables] separate to or as part of the Market Integration Project?

AES believes that the next phase of the Market Integration Project should be to review and revalidate the high level design for the all-island market in order to establish the key market principles going forward. The key issues raised through other SEMC projects should therefore be considered as part of the high level design review rather than as independent, discrete projects.

3. What elements of the Target Model are most relevant for the island of Ireland and the FUI region?

AES considers all aspects of the Target Model to be relevant for the SEM given the significant differences in market structures.

4. Are there other aspects of the European Internal Electricity Market that should form part of this consultation?

If, as AES believes, the next phase of the Market Integration Project should be to review and revalidate the high level design for the all-island market in order to establish the key market principles going forward then all aspects of the European Internal Electricity Market should be considered holistically. Since the Framework Guidelines for the Forward and Balancing markets have not yet been published the requirements of the Target Model in these timeframes are unknown. AES believes that it would be premature to finalise any market design until the requirements of these elements of the Target Model are known.

5. Is continuous trading as applied in the Elbas market in Scandinavia an appropriate model for Ireland, given the levels of wind expected on the system by 2020? What elements of the emerging design of the NWE Intra Day project (e.g. congestion pricing) are most relevant for Ireland?

AES believes that potential models cannot and should not be assessed until a high level design and market principles have been established for the market going forward. AES does however believe that trading as close to real time will be important particularly to enable wind to balance commercial commitments with physical output.

6. What is your opinion on Financial Transmission Rights versus Physical Transmission Rights as the best approach for interconnectors on Ireland and Northern Ireland borders?

AES agrees that there are benefits from the use of Financial Transmission Rights over Physical Transmission Rights for the allocation of interconnector capacity however the costs and benefits of both approaches need to be considered holistically as part of any market design.

7. What elements of the SEM design are in your opinion not compatible with the Target Model?

AES concurs with the key differences between SEM and the Target Model set out on p24 of the Consultation Paper. The nature and extent of the differences highlight the difficulty in trying to evolve SEM. This has also been borne out by the complexity of the options in the Consultation Paper and hence the strong request to establish a high level design and market principles prior to developing out the options presented in the Consultation Paper.

8. What elements of the SEM design can and should be retained when implementing the Target Model in Ireland and Northern Ireland?

AES considers there is insufficient detail at this stage to say definitively what elements of the SEM design can and should be retained as this will depend on the high level principles and objectives of the market going forward and their relative priorities. Any future market must however work both commercially and operationally for both conventional and renewable generation. While it will be important to ensure that future market arrangements facilitate the achievement of renewable targets in both NI and ROI these will only be achieved if wind is supported by adequate flexible conventional generation. AES' preference is for the retention of capacity payments supported by ancillary services payments which reflect the value of the services and flexibility provided. How capacity payments would fit in with future market arrangements is unclear at this stage and AES welcomes the analysis that the RAs intend to do on this.

Future market arrangements need to remain cognisant of the fact that the NI/ROI system is an island with limited interconnection and a dominant incumbent. It will also be important to ensure that participants are able to compete with their European counterparts on a level playing field and that they can adequately finance their businesses in order to ensure security of supply.

One of the most significant decisions to be made is whether or not central dispatch is an essential requirement because of the unique circumstances on the island. Unfortunately this issue was not adequately explored in the Consultation Paper or the supporting SEMO/TSO paper and AES welcomes the RAs intention to robustly challenge the SEMO/TSO view of the requirement for central dispatch. It is also essential to understand whether central dispatch is compliant with the Target Model.

9. What point on the spectrum of market designs is most suited to Ireland and Northern Ireland?

AES considers it premature to point to the type of market design suited to NI and ROI in the absence of a decision on the principles and objectives of the future market and in the absence of an exploration of the central v self dispatch issue.

10. Do you agree with the SEM Committee assessment framework proposed in Section 6?

While the existing SEM assessment criteria provide a useful starting point and while AES is in broad agreement with them AES does not believe that these should be automatically retained without revalidation and consideration of what other criteria may now be relevant. For example it is important to ensure that the future market is non-discriminatory and that participants in SEM are not disadvantaged when competing with their counterparts in Europe. It is also

important to understand what compliance with the Target Model actually requires although this will not be known with certainty until the Network Codes have been approved by Member States.

AES is also confused by the inclusion of 'Protection of Consumers' as one of the assessment criteria and is unclear what this means. The Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 lists the Protection of Consumers as the principal objective of the SEM and states that this shall be achieved by promoting effective competition. AES therefore sees Protection of Consumers as the objective of the SEM rather than one of the detailed assessment criteria through which it will be achieved.

Furthermore the definitions of the assessment criteria are likely to have evolved over time and these need to be understood prior to finalising the assessment criteria.

11. Is the ranking of criteria/objectives the right one? Is the application of weighting factor appropriate? What weighting would you give each one?

AES believes that the assessment criteria should be weighted with legal requirements identified as the primary objectives. The weightings will have to be reviewed once the criteria are finalised. It will also be important to review the SEM legislation to ensure that it is compatible and consistent with EC regulations.

12. What other criteria, if any, should the SEM Committee apply when making its decision on implementing the Target Model?

The SEMC should ensure that the future market is non-discriminatory and that participants in SEM are not disadvantaged when competing with their counterparts in Europe. The definitions of the assessment criteria should also be reviewed and updated as these are likely to have evolved over time and these need to be understood prior to finalising the assessment criteria.

A robust cost benefit analysis should also be carried out on alternative implementation mechanisms and considered as part of the assessment criteria. To date there has been some focus on the estimated costs for changing the market engine however the commercial 'costs' of such changes could be significantly greater. Hence the need to capture and review the commercial costs of potential options rather than simply the market engine costs.

13. Do you support any of the evolutionary options for the SEM in Section 7?

AES is unable to either support or reject any of the evolutionary options at this time due to the lack of key commercial assumptions to support the options under consideration. For example it is unclear how commercial positions are accounted for in the various time frames, how firm market prices are established and the extent to which imbalance prices are penal. Unfortunately the options appear to have been presented from a technical coupling point of view without considering the commercial implications and risks for participants.

In addition AES finds the 'evolution'/'revolution' terminology misleading as even the evolutionary options appear to suggest significant changes for market participants. AES would therefore suggest avoiding this distinction in the future. AES would also suggest defining terms such as EA1 and EA2 which appear to have a different meaning from their use in Intra Day Trading.

14. Are there any other options that you think would better meet the objectives?

Since the high level objectives for the future market have not been established it is not possible to identify options that might meet these. AES therefore believes the next phase of the Project should be to review and revalidate the high level design for the all-island market in order to establish the key market principles going forward.

15. Are the options in Section 7, in your opinion, consistent with the Target Model?

AES is unable to express an opinion on whether the options presented in the Consultation Paper are consistent with the Target Model due to the lack of key commercial assumptions to support the options under consideration. AES would however question whether central dispatch and the Contract for Difference option are consistent with the Target Model and welcomes the SEMC's further work in these areas.

16. Are these options presented in sufficient detail for a high level design decision to be made?

Unfortunately the options are not presented in sufficient detail for a high level design to be made. It has also become clear that the options are much more complex than had been envisioned and that even the evolutionary options are likely to incur significant changes for participants. AES therefore believes the next phase of the Project should be to review and revalidate the high level design for the all-island market in order to establish the key market principles going forward.

17. Do you agree with the assessment made by SEMO in Section 7 and how do the above options measure up against the assessment criteria set out in Section 6?

AES does not consider there to be sufficient commercial detail on the options to adequately assess them.

18. Should a pilot project be set up to explore the possibility of Option 4 (CFD) by end 2012?

AES does not believe that a pilot project should be set up to explore the possibility of Option 4 (CFD) in isolation to the establishment of a high level market design.

19. Should the SEM be replaced by a completely new set of electricity trading arrangements in 2016?

AES does not consider there to be sufficient information to express an opinion on whether the SEM should be replaced by a new set of electricity trading arrangements in 2016. AES therefore believes that the next phase of the Project should be to review and revalidate the high level design for the all-island market in order to establish the key market principles going forward.

20. What are the advantages and disadvantages of the revolution approach discussed in Section 8?

Clearly there may be benefits from starting to design a market with a clear slate rather than adapting a current design as you are not constrained by existing rules and principles. The perception is also generally that the costs of establishing a new market will exceed those of adapting the current market however the experience of altering the market systems for Intra Day Trading also shows that the costs and time associated with what appear to be relatively straightforward changes can be significant. Furthermore in adopting a bottom up approach there is a danger of making decisions which will have a fundamental impact on the future of participants without holistically considering the changes and the implications.

21. What are your views on the BETTA options discussed in Section 8?

AES believes that the relevant principles and design features of BETTA and other markets should be considered in determining the high level design of the future market rather than necessarily joining or adopting these markets as these markets will themselves have to make changes in order to comply with the Target Model.

22. What are your views on implementing a Nord Pool or MIBEL-style market in Ireland and Northern Ireland?

AES believes that the relevant principles and design features of Nord Pool or MIBEL-style and other markets should be considered in determining the high level design of the future market rather than necessarily joining or adopting these markets as these markets will themselves have to make changes in order to comply with the Target Model.

23. Do you agree with the summary assessments in Table 4 of each of the 7 options against the listed criteria?

AES does not consider there to be sufficient commercial detail on the options to adequately assess them.

24. Which option, if any, do you think best meets the criteria?

AES does not consider there to be sufficient commercial detail on the options to adequately assess them however it does not appear that any of them are workable options in their current format.