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20th April 2012

RE: Consultation on the Proposals for Implementation of the European Target Model for the Single Electricity Market (“the Consultation”) SEM-12-004

Dear Philip, Jean-Pierre,

Bord Gáis Energy (BG Energy) welcomes the opportunity to respond to the Consultation on the “Proposals for Implementation of the European Target Model for the Single Electricity Market” and commends the constructive engagement by the Regulatory Authorities (RAs), Market Operator and Transmission System Operators (TSOs) with industry to date. BG Energy looks forward to a continued high level of engagement as the Regional Market Integration Project (“the Project”) progresses.

1. Introduction

The legal parameters by which Ireland¹ will be bound to comply in implementing the European Electricity Market Target Model (“the Target Model”) are set by the Network Codes on Capacity Allocation and Congestion Management (CACM Network Code), Forwards and Balancing, together with the idiosyncratic characteristics of the Irish market (the Single Electricity Market - “SEM”). Legislation provides for all of these key parameters to be considered in parallel.

On this basis, BG Energy believes that a review of the current High Level Design (“HLD”) principles, objectives and criteria should be undertaken, in light of the new European requirements, in order to assess to what extent the SEM can fulfil these objectives in its current form or what level of change is required to SEM to do so.

The success of SEM to date is largely attributable to certain of the SEM attributes that were implemented in line with the current SEM HLD – such attributes include efficient pricing mechanisms; the necessary market power and liquidity measures together with the facilitation of renewable generation and market competition.

In light of this, this response focuses on the core SEM attributes that have operated successfully and which should be considered in any market design going forward. The appropriate assessment criteria for the new market design (as proffered in the Consultation) is also discussed, as are additional key

¹ References to “Irish” or “Ireland” throughout this response refer to the island of Ireland, comprising Northern Ireland and the Republic of Ireland

concerns identifiable from the potential market design options mooted in the Consultation. In light of the gaps in detail in the Consultation's proposed options highlighted after many workshops and bilateral meetings, BG Energy cannot comment on the viability of any of these options and limits its comments to discernible high level issues. Finally, BG Energy's opinion on the appropriate next steps for this Project is highlighted and the response concludes with the key issues that should be taken into account in the any market redesign.

2. The Legal Parameters of the New Market Design

As suggested above, the legal parameters within which the market must operate must be considered *in parallel with* the principles according to which the market's unique characteristics require it to operate.

BG Energy wholly agrees with the overarching aim of the Target Model, to set *fair rules for cross-border exchanges* in electricity and to facilitate market integration through enhanced competition.² Though not yet finalised, the CACM, Balancing and Forwards Market Network Codes will require Member States to abide by five basic market requirements of four separate timeframes and harmonised day-ahead and intra-day gate closures.

While a new market design for Ireland must be cognisant of the Target Model's objective to optimise interconnector flows, the legislation also permits Member States to take into account "the particular characteristics of national and regional markets"³. Furthermore, under the well-established EU principle of proportionality⁴ Member States do not have to adopt measures that go beyond what is necessary for achievement of the objective in question. Thus Ireland needs to adopt a market design that is essentially appropriate for the specific requirements of this all-island market while being mindful of the above noted Target Model obligations.

3. The Performance of SEM to Date

3.1 SEM Objectives and Fundamental Market Attributes

SEM's principal objective is that "*wholesale electricity trading arrangements should deliver an efficient level of sustainable prices to all customers, for a supply that is reliable and secure in both the short and long-run on an all-island basis.*"⁵ This objective reflects one of the proposed new core objectives, that of Consumer Protection. The current five supplementary SEM objectives include: ensuring security of supply; promoting competition; renewable, sustainable alternative energy promotion; enhancing demand side participation and minimisation of transaction costs for participants and consumers.

BG Energy believes that these are all continuing objectives of the SEM going forward. Progress on meeting these objectives has been achieved through the application of fundamental market attributes adopted to further the objectives. The key features that have been central in this regard, which should be incorporated into any new market design, are discussed hereinafter in terms of how they have been implemented in the SEM.

² Regulation (EC) No. 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity, Article 1

³ *Ibid.*

⁴ Treaty of the European Union, Article 5

⁵ AIP/SEM/06/05 The Single Electricity Market (SEM), Proposed High Level Design, 31 March 2005

3.1.1 Recovery of Generation Production Costs

The pricing mechanism in the SEM, which accounts for short-run marginal costs as well as start-up and no-load costs through the uplift mechanism *ensures that revenues payable to generators accurately and fairly reflect the costs of production*. Otherwise the incentive to generate diminishes and may result in early mothballing or premature exit of the market by affected plants, to the detriment of liquidity, competition and prices. Exit of such plants also poses a security of supply threat particularly in light of the high Renewable Energy (“RE”) levels anticipated by 2020 and the corresponding need for a full fleet of thermal generation as a back-up to intermittent RE.

On a related point, the provision of market referenced contracts for difference (CfDs), are also an essential part of the market design and the provision of retail market competition on the island. This is in light of the fact that when energy revenue comprises both shadow and uplift price elements, fuel hedge contracts do not provide adequate risk management protection for retail market participants.

Recovery of uplift and access to such CfDs should be features of the new market design in light of their central role in securing supply, allowing for appropriate hedging, price efficiency and stability, and overall supporting the development of competition in the retail market.

3.1.2 Capacity Payment Mechanism (CPM)

CPM and energy market revenues were adopted as the SEM HLD considered that on balance it is more appropriate to implement a market with greater stability, less volatile prices and greater security of supply.⁶ This feature of the market has proven effective and efficient since the implementation of the SEM in 2007. As the levels of intermittent generation have increased, the level of energy revenues in the SEM have gradually and significantly eroded. The CPM revenues have thus been seminal in ensuring adequate revenues for generators in the market and in satisfying the SEMC’s duty to ensure electricity license holders can finance their activities.⁷

BG Energy cautions against any further erosion of the CPM revenue stream. Any changes to the status quo would be particularly harmful in light of the current market uncertainty. They would give rise to unpredictability of revenue streams, undermining of investor confidence, inhibiting project financing and threatening generation adequacy, which will ultimately be reflected in consumer prices. The future CPM is a workstream which must necessarily run in parallel with this Project and with extensive industry engagement.

3.1.3 Market power and liquidity

In BG Energy’s view, the core features of and requirements for the Irish market have largely remained the same since the SEM HLD was determined. There is still one large dominant player in the generation market, with a broad portfolio of assets. As such, necessary market power mitigation measures have been applied in the SEM to counteract the potential of market abuse. Were market power unchecked this could have potential detrimental knock-on effects on consumer prices depending on the final market design chosen. In the absence of any structural solution, as suggested in the RAs’ recent Market Power and Liquidity Decision Paper, continued regulatory intervention must be incorporated in the new market design. Current SEM measures have provided essential outcomes for the SEM which outcomes must be ensured in the new market design. These include:

⁶ AIP/SEM/42/05 The Single Electricity Market (SEM), High Level Design Decision, 10th June 2005

⁷ Section 9(2)(b) Electricity (Single Wholesale Market) (Northern Ireland) Order 2007, Section 9BC(2)(b) Electricity Regulation (Amendment) (Single Electricity Market) Act 2007

- a. Market participation and competition on a level playing field and price transparency:
 - i. The Bidding Code of Practice (BCOP) is instrumental in this regard and has contributed to price transparency, incentivising new competitors and incidentally diluting the incumbents' role;
- b. Market power mitigation:
 - i. Directed Contracts, PSO and Non-Directed Contracts, as well as the market monitoring role of the MMU have been key in mitigating potential market power abuse in the SEM to-date. Similar measures and initiatives would be seminal in any future market design.
- c. Market liquidity:
 - i. As a mandatory market, the SEM is reasonably liquid and as such provides a transparent reference price for the market. Given the size of the Irish market and its participants, the same level of liquidity would be difficult to achieve under a different structure. With this in mind, any future market design must also provide structures which facilitate appropriate levels of liquidity.

3.1.4 The Treatment of Wind

The key market attributes that have facilitated the development of RE thus far are noted below. BG Energy cautions against any negative change to the effect of these attributes in the new market design in light of the considerable investment that has been made in RE in SEM and in light of government targets:

- a. Facilitation and incentivisation of renewable generation to participate in the market. The current aggregation of all generation protects market participants from penal imbalance charges. This is particularly important for intermittent generation. Exposure to penal balancing prices would deter RE market entry and would be a retrograde step in SEM's progress on promoting RE and its resulting positive impact on competition. Such exposure has more detrimental consequences for intermittent generation as compared to conventional generation in light of difficulty in accurate forecasting and RE's lack of ability to react accurately to imbalances. This could result in a significant erosion of the value of renewable investments, a devaluation of supply contracts between REFIT participants and suppliers and as such it would fundamentally frustrate the SEMC's duty of promoting RE⁸ and is a factor to consider going forward;
- b. The price-taking provisions in the SEM allow for the effective and transparent application of Priority Dispatch provisions of the Renewable Energy Directive. This provision again incentivises participation in the SEM and provides certainty to renewable generators and counterparties entering into PPAs. Furthermore, Priority Dispatch is an obligation with as much legal applicability as the Target Model and must be incorporated into the new market design;
- c. The single ex-post SMP has provided an appropriate price reference for REFIT, PPA and PSO contracts. It also incentivises new market entry, increased competition and allows for price transparency with incidental project financing benefits. An appropriate reference price sourced from a liquid marketplace to underpin investments must continue to be discernible;
- d. Regulatory Construct: Investment decisions were made primarily on the basis of the regulatory construct of the market. The effects of such initiatives, e.g. facilitation of renewable energy and capacity payments, must not be undermined in the market re-design and/ or negatively impact the investment decisions already made. This applies equally across all generation investments.

3.1.5 Market Transparency

Pricing transparency incentivises new market entry while also contributing to competition and market power mitigation to the benefit of the consumer. Efficient pricing and price signals are powerful

⁸ Section 9(5)(b) Electricity (Single Wholesale Market) (Northern Ireland) Order 2007, Section 9BC(5)(b) Electricity Regulation (Amendment) (Single Electricity Market) Act 2007

factors in market entry and exit decisions and the recovery of uplift and capacity payment revenues assist in this regard. Notwithstanding that the current SMP is quite unpredictable, the new market design should take into account (and factor in) the benefits of transparent market results with active market monitoring.

3.2 Conclusion on SEM performance and Design Attributes to Retain

In conclusion, the fundamental attributes of the SEM as outlined above have been and continue to be instrumental in facilitating the key objectives of the SEM and its HLD.

BG Energy does not believe that there has been any significant change to these objectives since the SEM was established in 2007, or that the obligations of the Target Model oblige their reversal. In summary, BG Energy believes that any new market design of the SEM must include:

- i. Efficient pricing mechanisms, such that participants can recover their costs in light of diminishing energy revenues, increasing RE capacity and continuing competition and security of supply objectives;
- ii. Market Power Mitigation must continue in the absence of a structural solution and the role of BCOP, the MMU and Directed Contracts is central here;
- iii. Liquidity arrangements will necessarily have to continue being implemented in light of the limited scope for liquidity to emerge from the European market given the real level of interconnection;
- iv. An aggregate approach to balancing to accommodate the fluctuating nature of wind generation. Ultimately, it would be more efficient, both in terms of system operation and costs, for balancing to be conducted at a macro level by the TSO, that would work for the ultimate benefit of consumers;
- v. An appropriate single price reference must be ascertainable in the new market design for REFIT, PPA, PSO pricing and hedging purposes – it is interesting to note that Ofgem and its relevant participants are struggling to identify a relevant market price for the purposes of its market reforms.

4. Assessment Criteria for the New Market Design

The original SEM HLD assessment criteria were derived from the SEM principles and objectives as discussed above. BG Energy notes that the Consultation's proposed assessment criteria is the same as that adopted for the original SEM HLD save for four additional criteria, to which this response now turns. BG Energy however considers that it would not be appropriate to decide the weighting or priority to apply to these criteria without first finalising the principles and objectives of the new market design. Notwithstanding that, BG Energy has a number of comments with respect to the criteria as presented in the consultation paper.

4.1 The Four New Additional Criteria

4.1.1 Protection of Consumers

BG Energy concurs with the primary importance attached to this objective pursuant to the relevant SEM establishment Acts.⁹ An understanding of the meaning 'Protection of Consumers' is important to ensure that market participants take appropriate steps to achieve the objective.

⁹ Electricity (Single Wholesale Market) (Northern Ireland) Order 2007, Electricity Regulation (Amendment) (Single Electricity Market) Act 2007

In this context, BG Energy believes this primary objective reflects that of the overarching SEM objective to ensure delivery of “an efficient level of sustainable prices to all customers, for a supply that is reliable and secure in both the short and long run on an all-island basis.”¹⁰ The achievement of such an objective requires assurance of efficient short term supply and prices as well as long term signals for investment. The SEM Committee (SEMC) has and should continue to achieve these objectives by providing for the regulation and monitoring of efficient short-term prices while also providing for efficient investment signals in the long-term. This will facilitate the achievement of an enduring, efficient, safe, diverse, sustainable and economic supply of electricity to meet all reasonable demands.

4.1.2 Internal Market

BG Energy opines that this is not a criterion but a fundamental objective over which the RAs have no control. Adopting a new HLD that takes into account the legal parameters discussed in section 2, will ensure this objective is achieved.

4.1.3 Environment/ Renewables

Acknowledging that a market cannot be designed around RE, it is necessary to recognise that since 2005 the promotion of RE has gained importance on Irish policy agendas. In fact, Ireland is ahead of its European counterparts in assessing and reviewing market arrangements and operational parameters which optimally facilitate renewable generation. BG Energy does not believe that there is any flexibility with this objective and any market design must give significant regard to being conducive to electricity generated from RE as well as supporting flexible thermal generation, CHP and demand side management.

4.1.4 Adaptability and Stability

Adaptability requires the new market design to take into consideration a future market with high RE penetration and *potentially* greater interconnection, within the legal parameters highlighted in Section 2. However, it must foster a stable environment in which investments can be made. These somewhat conflicting objectives must be recognised in any assessment.

4.2 Conclusion on the Assessment Criteria

The above discussion has focused on the new assessment criteria introduced as part of this Consultation. In summary, it would be useful if the RAs could provide more detail around the meaning and intentions of all of the criteria to avoid any confusion at the assessment stage of the project. Once clarified with relevance to the core principles and objectives of the project, it will provide a useful and transparent framework from which parties can progress.

5. Additional Concerns for Consideration in a New Market

Following numerous workshops and bi-laterals, it would not be unreasonable at this stage to say that there are considerable gaps in the detail of the options presented in the Consultation. Coupled with the points made in the previous sections and our view that the project should start with an agreed, transparent and robust framework before considering design detail, BG Energy cannot comment on the viability of the market design options presented in the Consultation at this stage. On that basis, the comments in this section only relate to issues (additional to the above discussion) that must be

¹⁰ AIP/SEM/06/05 The Single Electricity Market (SEM), Proposed High Level Design, 31 March 2005

further considered, assessed and clarified before reasonable consideration can be given to a possible market design option.

5.1 The Additional Concerns

5.1.1 Complex Bidding

To ensure continued competition, security of supply, transparency and minimisation of consumer prices BG Energy believes that complex bidding must be incorporated in the new market design. While the European timeframes do not provide for complex bidding, there may be scope to consider incorporation of such bidding on a SEM level, for SEM's unilateral requirements and the benefits noted at the start of this paragraph. Complex bidding also provides scope for recovery of production costs which if ignored contravenes the SEM HLD principle of determining prices that fairly reflect the costs of production and runs counter to the SEM legal duty of securing that electricity licence holders are able to finance their activities.¹¹

5.1.2 Central versus Self Dispatch

The majority of the (evolutionary) options presented in the Consultation are predicated on the basis that central dispatch will be maintained by the TSOs. While central dispatch has functioned well in the SEM and would seem appropriate for markets with high RE levels, BG Energy recognises that further examination of the viability of a centrally dispatched market within the Target Model is required. It is noted that the RAs' ongoing work is examining this issue which will inform the extent to which market positions can be respected. BG Energy looks forward to further consultation on this specific issue in the near future.

On a related issue, clarification on the criteria and process that will be applied for determining feasibility of bids is also required for transparency and predictability purposes.

5.1.3 Ancillary Services

The incentivising or reward of flexibility in the new market design is not directly addressed in the Consultation. The requirement for ancillary services will inevitably vary according to the final market design, but will play a central role in minimising security of supply risks and facilitating the renewable policy objective. The attractiveness of a market as an investment location will be heavily influenced by how ancillary services are encouraged and rewarded. The concurrent work of the DS3 project should be incorporated within this Project given the timelines around each or them.

5.1.4 Demand

From a retail perspective, further detail and assessment is needed as to how demand will interact in the market. Certain of the proposals could expose suppliers and therefore customers to significant risks and ultimately costs. The impact of this on the SEMC's primary objective to protect consumers implies that this warrants much greater attention.

5.1.5 Hedging Opportunity

BG Energy requests clarification as to whether it is anticipated that forwards trading as occurs presently via CfDs will apply in the new market design. Furthermore, interconnector capacity limits of 1,000MW implies that liquidity cannot expect to be significantly enhanced by virtue of cross-border

¹¹ AIP/SEM/06/05 The Single Electricity Market (SEM), Proposed High Level Design, 31 March 2005 and *Supra* fn. 7 respectively

trade in the medium term. On this account BG Energy believes that regulated CfDs are necessary in the new market design to ensure generators are in a position to hedge out spot prices providing price stability and predictability for consumers. The Network Code on forwards may require this issue to be revisited and BG Energy cautions against anything that may limit forward hedging opportunities in SEM.

5.1.6 Trading Day Alignment

There is confusion as to the alignment of gate closure time (GCT) and trading days across the integrated markets. The RAs have indicated that the SEM trading day (06.00-06.00) may be retained alongside a Target Model trading day of 23.00-23.00. It is unclear at this stage how this will practically work from a commercial perspective. Further detail on this issue would be welcomed.

5.1.7 Long Term Capacity Rights

BG Energy commends the RAs acknowledgement that the value of long term explicit capacity rights must be protected and welcomes the incorporation of consideration of this issue in the Project going forward.

5.1.8 Cost-Benefit Analysis

The CACM Framework Guidelines, section 1.2 derogation, requires that a Cost Benefit Analysis (CBA) be undertaken. BG Energy submits that even minor tweaks in a market can have significant costs implications, both systems and operations, for participants for limited benefit. It is only a re-statement of the principles and objectives of a new market design that will ultimately reveal the extent of change required to the current SEM to comply with the Target Model. Part of the assessment of the new market design should include a CBA for the market as a whole as well as participant and consumer impacts.

5.2 Conclusion on Additional Concerns for Consideration in a New Market

The above noted concerns are in addition to the discussion on the “Performance of SEM to Date” in Section 3. BG Energy submits that combined, these are the issues that should be at the forefront of the RAs approach to considering a new market design appropriate for SEM while being cognisant of Target Model requirements.

6. Projects outside the New Market Design Process

In relation to the work on the projects referenced in the Consultation which are outside the regional market integration process, BG Energy believes that no significant change to the current market structure should occur before January 2017.

However all of the projects, particularly those on market power mitigation, capacity payments, the DS3 project and the treatment of renewables must progress holistically in light of changes required by virtue of the ultimate market design chosen. The RAs are also encouraged to take into consideration the legal requirement of harmonising locational signals across the EC,¹² the prevalent European method of recovering such through TUoS charges, and the potential for cross-border barriers to trade introduced by the application of compressed TLAFs on the Irish side of the island’s interconnectors, when determining the appropriate next steps on the project.

¹² Regulation (EC) 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity, stipulates that locational signals must be harmonised across the Community in Articles 6(8)(k), 18(2)

It is crucial that significant liaison with industry occurs on each of these projects.

7. Appropriate Next Steps

BG Energy understands that the RAs are under pressure to comply with ACER requirements related to the Section 1.2 CACM Framework Guidelines derogation from the 2014 deadline. However in light of the fact that the network codes on balancing and futures markets are not expected to be finalised until H2 2012 and H2 2013 respectively, and the fact that the BETTA market only recently commenced its determination of how to comply with the Target Model, BG Energy would caution against any urgency in deciding on the final market design before the end of 2012. To reiterate, it is BG Energy's view that it would be more appropriate if a detailed project plan with segmented objectives and deadlines was adopted by year end with work on a number of the objectives commenced.

In the meantime, the RAs have indicated that work on the extent to which RE can be protected in the new market, how a CPM will be incorporated in to the design, whether self or central dispatch is possible in a new design and the level of complexity in bidding that can be adopted in new trading arrangements is being undertaken. BG Energy is of the view that industry should play a role in informing the scope of these projects and significant dialogue thereon between the RAs and industry is encouraged before any potential decision on any of these aspects is taken.

In essence the immediate next steps should be to decide on an appropriate project plan and timeline with segmented objectives, the first objective which should be to review the SEM HLD of 2005 in light of the current market conditions. Once the appropriate HLD principles and related objectives are chosen, the appropriate assessment criteria to apply to the new design will be easily distilled as will the apposite weighting to apply to each. Workshops and bilateral meetings with industry should continue to form a key part of the process the RAs will adopt.

8. Summary and Conclusions

In summary, BG Energy believes that the Target Model only partially informs the structure of the new market design as legislation explicitly anticipates that within Member States, subjective measures can be taken to respect a State's respective system and market requirements. Local policy requirements must not be negatively compromised in favour of the Target Model.

This response has highlighted that a review of the current SEM HLD and the continued applicability of its principles, objectives and assessment criteria and how it would perform in light of increased RE, interconnection and Target Model obligations is required. Only then can a decision on the change, and the extent of change, required to SEM be made.

BG Energy believes that the performance of SEM to date in facilitating the key policy objectives is a result of the market's high level structures and core market attributes. These attributes should not be lost as part of this process. On that basis and at this early stage of the project, BG Energy urges the RAs and SEMC to give strong consideration to the following core market attributes in any market redesign:

- i. Efficient pricing mechanisms: participants must be in a position to recover their costs in light of diminishing energy revenues, increasing RE capacity and continuing competition and security of supply objectives;
- ii. Market Power Mitigation: this must continue in the absence of a structural solution. The role of BCOP, the MMU and Directed Contracts is central here;

- iii. Liquidity: arrangements will necessarily have to continue being implemented in light of the limited scope for liquidity to emerge from the European market given the real level of interconnection;
- iv. An aggregate approach to balancing: wind generation intermittency must be accommodated;
- v. An appropriate single price reference: such must be ascertainable in the new market design for REFIT, PPA, PSO pricing and hedging purposes. Notably, BETTA participants are currently struggling to identify a relevant market price for the purposes of its market reforms.

Furthermore, additional analysis and consultation are required in at least the following areas:

- vi. Complex bidding: its importance from a market power mitigation perspective and price transparency for example is noted. The potential to continue its applicability in SEM for SEM's unilateral policy and market reasons must be examined;
- vii. The operation of central or self-dispatch in each timeframe, on which issue significant liaison with industry is required;
- viii. Appropriate encouragement and reward of ancillary services in any new market design in light of RE targets;
- ix. A cost benefits analysis illustrating impacts on market participants and consumers alike.

BG Energy agrees that Consumer Protection should be one of the paramount criterion for a new market design and understands that this requires provision for efficient short-term prices as well as long-term investment signals through capacity payments, ancillary services and regulatory certainty. Further details around the meaning and intention of the criteria particularly that of Consumer Protection would be welcome, as it will provide a useful and transparent framework from which parties can progress.

BG Energy considers that the appropriate next steps are to re-assess/re-confirm SEM's HLD principles from which appropriate objectives and assessment criteria can be distilled. An appropriate project plan with realistic timelines in light of pending developments on a European and Great Britain level should be communicated to industry in Q4 2012. In the interim, any side-projects which the RAs undertake (e.g. bidding principles, capacity payments) should involve interaction with industry.

BG Energy is thankful for the opportunity to respond to this Consultation and looks forward to a continued high level of engagement with the RAs as they embark on the next steps of this Project. I hope that you find the above comments and suggestions useful and if you have any queries, please do not hesitate to contact me.

Yours sincerely,

Julie-Anne Hannon
Regulatory Affairs – Commercial
Bord Gáis Energy

{By email}