Joint Response by Forfás/ IDA Ireland/ Enterprise Ireland to the SEM Committee's Consultation on the Proposals for Implementation of the European Target Model for the Single Electricity Market

April 2012

The development agencies, Forfás, IDA Ireland and Enterprise Ireland, represent the interests of the internationally trading business sector in Ireland. Over three quarters of Ireland's exports of goods and services in 2010 were by development agency client companies. Agency-assisted companies operating in Ireland provide almost 300,000 direct jobs, a similar number of indirect jobs; 40 per cent of national GVA; €33 billion through payroll, materials and services purchases (which represents about 25 per cent of GNP); and three-quarters of all corporation tax.

The enterprise development agencies (Forfás, IDA Ireland and Enterprise Ireland) welcome the opportunity to input to the Single Electricity Market (SEM) Committee's Consultation on the Proposals for Implementation of the European Target Model for the Single Electricity Market.

Energy competitiveness remains an important issue for enterprise development. Ireland's recovery and future economic growth depends on the ability of businesses to trade successfully in increasingly competitive global markets. A reliable, sustainable and competitively priced supply of electricity is essential to maintain and grow our existing export base, to continue attracting high levels of foreign direct investment and support job creation. The way in which the target model is implemented in the all island electricity market is a very important issue for the development agencies as it will have significant implications for Ireland's future energy competitiveness.

Key issues for enterprise

The development agencies agree with the SEM Committee that the establishment of the SEM in 2007 has been a very positive development. It has brought many benefits from a competitiveness perspective. Most notably, it has led to increased efficiencies in generation and greater transparency in the electricity market as well as incentivising investment in new generation capacity and increasing competition. As a result, we have seen significant improvements in security of supply as evidenced in the large margin of spare supply (we do acknowledge that some of the improvement is due to reduced demand) and more transparent and competitive prices for enterprise. In addition, our environmental sustainability performance has improved as much of the old, inefficient, dirty generation plant has had to make way for more renewables and cleaner, more efficient gas plants.

The development agencies are strongly of the view that we must take all possible measures to ensure that we retain the positive aspects (e.g. transparency, cost reflective wholesale prices) of the SEM while ensuring compliance with our EU obligations to implement the target model. We agree with the SEM Committee that this will be very challenging. But we welcome the strong emphasis in the consultation paper on protecting the interests of consumers, which from an enterprise perspective means ensuring a reliable electricity supply at least cost to the customer.

From an enterprise development perspective, the main principles that should underpin the implementation of the European target model for the single electricity market are:

- ensuring a transparent wholesale market – one of the key advantages of the SEM for enterprise, particularly large, sophisticated users, is the transparency it provides on wholesale price trends, allowing them to negotiate more effectively with their suppliers and giving them a choice of electricity products, e.g. pool-price-pass-through tariff;
- ensuring the price of electricity is cost reflective and that measures to mitigate market dominance are in place and rigorously enforced;
- promoting competition in the generation and supply markets, in particular, it should continue to facilitate new entry by small players that may not be active in both generation and supply;
- continuing to support investment in cost effective renewable capacity to meet our EU commitments;
- incentivising investment in new, efficient plant, especially flexible plant (to complement the increasingly large amounts of wind capacity on the system) while also encouraging the closure/upgrading of any remaining old, inefficient plant; and
- ensuring that the rules deliver efficient use of the interconnectors and do not result in unnecessarily higher costs for consumers.

Enterprise views on consultation proposals

This section will highlight the development agencies' views on the consultation proposals of most relevance to enterprise.

Assessment criteria/objectives

We strongly agree with the SEM Committee that the objectives identified in 2005 when developing the SEM remain as valid today and should also underpin the future all island market design.

On the proposed assessment criteria, we fully support the SEM Committee's proposal to make protection of consumers, which from an enterprise perspective means ensuring a reliable electricity supply at least cost to the customer, the primary objective of the future all island market design.

We agree with the other objectives set out in section 6.6 but question if there are too many secondary objectives, particularly given the potential tensions between them in delivering on the primary objective to protect customers. From an enterprise perspective, the critical ones are security of supply and competition[1].

Evolutionary versus revolutionary

As previously stated, the development agencies' preference would be to retain the many benefits that the SEM has delivered. However, we understand the challenges for the SEM Committee in developing a market that complies with EU requirements but without it becoming overly complicated and opaque. Designing a new market may be a better approach but it is also likely to be more expensive (e.g. high software costs), which would mean higher prices for energy customers. Regardless of which approach is selected in the end, all necessary steps need to be taken to minimise the cost of designing and operating the new market so as to minimise the costs passed through to electricity customers.

The development agencies are not in a position to independently review the four evolutionary options – our comments are based on the initial evaluation of the proposed options outlined in Table 5, which we have examined against the key issues for enterprise outlined in the previous section of this submission.

Of the criteria listed, transparency is a particularly important criterion for enterprise, especially for large users. We are aware that a bilateral market will not be able to offer the transparency that has been so central to the success of SEM. However, we would urge the SEM Committee to give a strong weighting to this criterion in its assessment of the different options and their capacity to deliver on the SEM Committee's primary objective to protect consumers.

Other important considerations from an enterprise perspective are the impact on new entrants and price formation/ liquidity. On the issue of new entrants, we favour options that do not require pre-

1 We assume competition will be as defined in the original objectives for SEM design as set out on page 29 of the consultation document, i.e. *competition amongst profit maximising market participants incentivises participants to increase output, reduce costs, increase availability and invest in new capacity. The market design should not create barriers to entry /exit and should promote transparency.*

existing contracts with buyers/suppliers and that promote competition and investment and that can deliver cost efficient electricity to end users.

While the SEM ensures a highly liquid market for wholesale prices in each half-hour, in its recent energy report, Forfás highlighted the need to address potential challenges for smaller players in the context of the transitional arrangements to be put in place to implement the target model[2]. Due to the volatility of half hourly prices it is crucial for suppliers to hedge their demand against price movements; the easiest way to do this is through contracts with generators. The dominance of a small number of generators and suppliers means that it can be difficult for smaller players to obtain appropriate contracts and reduce the market dominance of the bigger companies.

Central dispatch

The decision on whether to retain a central dispatch system or to move to a self-scheduling model is a complex one. From an enterprise perspective, the reliability of the electricity supply is absolutely paramount. However, we would encourage the SEM Committee to fully consider the merits of both models in an island of Ireland context when it undertakes its in-depth assessment of the preferred options. The fact that Ireland has always operated a central dispatch model is not a sufficient reason in itself not to explore the benefits, as well as the risks, of operating a self scheduling model over a central dispatch system.

Capacity payment mechanism

The capacity payment mechanism has played a key role in incentivising new investment in generation capacity when needed, particularly in the past when Ireland had a very tight generation capacity margin, a lot of old, inefficient plant and a growing demand. In addition, as highlighted in the consultation paper, other countries across Europe, including Great Britain, are considering introducing such a measure to promote investment in timely replacement plant over the next decade.

The development agencies ask that the SEM Committee considers keeping the concept of the capacity payment mechanism in place in the future all island market. However, we recommend reviewing its design to ensure that it incentivises investment in the type of generation capacity required to ensure security of supply in the longer term while minimising the impact on costs for energy users. We acknowledge that the SEM Committee may have to await developments at European level before making a firm decision on how to proceed. Policy certainty is critical to the effectiveness of the capacity mechanism as a signal to investors. We need to avoid making multiple changes to its design and implementation.

Interconnection

Interconnection capacity and its efficient use is critical to enable Ireland to exploit the full benefits offered by the development of the single EU electricity market in the longer term. A recent ESRI study maintains that to participate fully in the single EU market that electricity interconnection capacity will have to at least double[3]. The study concluded that additional interconnector capacity

2 Review of Energy Competitiveness Issues sand Priorities for Enterprise, Forfás, December 2011. http://www.forfas.ie/media/forfas201211-review_of_energy_competitiveness_issues_and_priorities_for%20_enterprise-Publication.pdf

3 The Internal EU Electricity Market: Implications for Ireland, Paul K. Gorecki, ESRI Research Series Number 23, October 2011.

of between 1,000 MW and 3,000 MW (in addition to the 500 MW East-West interconnector) lowers the price of electricity in Ireland as the difference with Great Britain narrows. However, the ESRI cautions that the benefit, measured in terms of lower electricity prices in Ireland, of additional interconnector capacity, is likely to decline as more capacity is built.

Without interconnection to mainland Europe, Ireland is likely to become increasingly exposed to increases in UK electricity prices, which could impact negatively on retail electricity prices here. Although prices are currently lower in the UK than in Ireland, there is an expectation that UK prices will rise in the future as it has to replace at least a quarter of its electricity generation in the next decade.

While building new interconnection is vital to allow Irish enterprise reap the full benefits of a single European electricity market, the question of who pays for it needs to be addressed at EU and national level. The potential to use the recently announced EU fund to support energy infrastructure investment needs to be explored. In October 2011, the European Commission announced plans to fund a €50 billion investment – the Connecting Europe Facility (CEF) - to improve Europe's transport, energy and digital networks. It proposes a €9.1 billion fund between 2014 and 2020 to support investment in trans-European infrastructure to help meet the EU 2020 energy targets. It is proposed that the investment fund would be used to finance cross-border projects (involving at least two member states) that are not deemed commercially viable[4].

The SEM Committee needs to ensure that it puts in place market rules to use the interconnectors as efficiently as possible. The more the interconnectors are used, the lower the transmission charge passed through to electricity customers. This is particularly important to support SMEs as the network charges make up a larger proportion of their electricity bills than those of larger users.

The significant challenges facing the UK to ensure sufficient electricity generation capacity in the future and to meet its 2020 renewable targets may offer export opportunities for Ireland given our favourable wind and wave energy resources. If generation capacity is exported directly to Britain without passing through the Irish electricity grid, and no subsidy is paid by Irish taxpayers or consumers (either directly or indirectly, including through the tax system), then it should not adversely affect the Irish consumers or Ireland's cost competitiveness. However, if any of the exported electricity was to pass through the Irish electricity network, it could lead to higher prices for Irish consumers by increasing congestion or necessitating additional grid investment. Given that energy is an important input to the entire enterprise base, we need to find a way to realise the potential export opportunities without adversely affecting the cost competitiveness of the wider enterprise base and Ireland's attractiveness as a location to do business[5].

Conclusion

Energy competitiveness remains an important issue for enterprise development. Ireland needs to ensure that the changes to the all island market design required to implement the target model deliver efficiencies and least cost electricity to consumers.

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4 For more details, see: http://ec.europa.eu/energy/infrastructure/strategy/2020_en.htm

5 For policy actions to realise the enterprise opportunities, see section 3.4 of the 2011 Forfás report, Review of Energy Competitiveness Issues sand Priorities for Enterprise.

We welcome the strong emphasis in the consultation paper on protecting the interests of consumers, which from an enterprise perspective means ensuring a reliable electricity cost at least cost to the customer. The establishment of the SEM has been a very positive development. Balancing compliance with the target model with retaining the benefits of the SEM but without making the market very complicated and opaque will be very challenging but is vital for Ireland's future energy competitiveness.