



**Response by Energia to the SEM
Committee consultation SEM-12-105a**

***Implementation of the European Target Model for the
Single Electricity Market***

Next Steps Proposed Decision Paper

21 December 2012

1. Introduction

Energia welcomes this opportunity to respond to the SEM Committee's Next Steps Proposed Decision on Implementation of the European Target Model for the Single Electricity Market (SEM-12-105a). By necessity, given the limited time afforded to respond and the distinct lack of engagement with industry since the closure of the January 2012 consultation¹, this brief submission is limited to high level comments and important points of principle and process. We draw heavily from our response to the initial consultation on implementing the Target Model published in January 2012 (SEM-12-04) because this is very relevant to where we now find ourselves. We furthermore share and strongly echo the concerns raised, and recommendations made, by the Electricity Association of Ireland (EAI) in its response to SEM-12-105a.

2. Discussion

Implementing the European Target Model in the SEM by 31 December 2016 represents the most significant and challenging projects to be undertaken in the all-island market. Energia recognises the mandatory obligation to comply with Target Model requirements as will be reflected in binding network codes. Energia is firmly committed to engaging constructively and proactively in this process to achieve an effective market design in the context of Target Model requirements. We look forward to working with the RA's Project Team going forward, as we have done to date when given the opportunity.

It is now clear that significant re-design of the all-island market will be required and it is fundamentally important to approach this project in an open-minded manner, receptive to consider all feasible options for compliance. We suggest this will require assistance from independent consultants with proven expertise in market design (working closely with the RA's) and a cost benefit analysis. This should be complemented by intensive industry engagement to choose which option to progress (giving bilateral and pool-type arrangements equal consideration) in the detailed design phase of the project. We understand that the proposed 'working assumption' of central dispatch is to rule out a bilateral market arrangement like BETTA. We consider that this fundamental proposed decision is premature and has been taken without full consideration and consultation.

¹ We acknowledge and welcome the short extension granted on 27 November moving the response deadline from 5 December (giving 3.5 weeks to respond) to 21 December (giving 6 weeks to respond in total). However we should stress that 6 weeks is insufficient for an issue of this importance and complexity, especially given the distinct lack of communication and engagement with market participants over the preceding 7 month period during which time developments in thinking have advanced considerably following: (1) analysis regarding compatibility of SEM bids into the price coupling algorithm; (2) further TSO analysis on the issue of self/central dispatch; and (3) a review of the TSO analysis by an independent consultant. We should also stress that the value of what eventually became a 6 week consultation is diminished considerably because that 6 week period was not known from the outset – i.e. for planning purposes (required for in-house modelling, analysis or engagement of external expertise) market participants were effectively given just 3.5 weeks.

As previously stressed in response to SEM-12-04 it is important to recognise strengths and weaknesses of existing SEM design and for these to be reflected (or addressed) in a new high level design. Particular care needs to be taken however not to extrapolate from positive affirmations of SEM success that it is consequently desirable to retain core elements of SEM design when implementing the Target Model and to simply “bolt-on” what is considered necessary to achieve compliance. This would dangerously pre-suppose that the internal consistency and effectiveness of SEM design in meeting its objectives remains unchanged when modified and combined with the requirements of the Target Model. It should also be stressed that any perceived cost savings associated with this approach could be easily misconceived.

Successful design and implementation of this complex undertaking will require good process and design principles, skilled independent expertise, resources and well-designed project governance with extensive and structured stakeholder engagement. Systems and implementation costs are an important consideration but should be considered secondary to the goal of achieving an internally consistent and efficient market design capable of fostering competition and delivering the required mix of generation plant over a long time horizon. In response to consultation SEM-12-04 we made the following recommendations:

*“The next steps of this project should seek to address the shortcomings of the approach to date, including the **need to adopt high level market design principles** to guide progress along a **planned project path** to full compliance for a market that can deliver benefits to customers and does not undermine significant investments made by market participants. The RAs should be **assisted in this by independent experts with proven experience of market design**. **Undue reliance on the assumed impartiality of the TSOs/MO should cease**, with the TSOs/MO called on to contribute their technical expertise when required and afforded the same opportunity as market participants to respond to public consultations and engage in future public forums. As a starting point, **Energia considers there to be two general but distinct approaches which deserve equal consideration, namely a bilateral market approach and a pool-based market approach**. **By adhering to the proposed design principles contained in this response, either approach is considered capable of delivering an internally consistent, compliant and efficient market design** that will ensure the interest of customers are upheld and significant investments made in the all-island market by participants are not undermined”* (Executive Summary, page ii, emphasis added).

Subsequent developments, and proposed decisions around central dispatch in SEM-12-105a, have only served to accentuate many of our key concerns expressed in response to SEM-12-04. Indeed a significant retrograde step was taken in the area of industry engagement. Previously, industry engagement was relatively frequent albeit somewhat limited by excessive influence being given to the TSOs/MO in developing Target Model compliance options. Since closure of SEM-12-04 in April 2012 there has been virtually no industry engagement other than with the TSOs.

This is despite previous indications that the examination of the dispatch issue, renewable integration, capacity payments and uplift would be communicated with stakeholders in advance of the publication of a proposed decision. We are understandably concerned that the TSOs have been the only market participants with whom the RAs have engaged during this period, it should not be forgotten that as well as being a TSO, EirGrid is a significant asset owner. Full consideration must be given not only to system related issues but also commercial implications. We do not consider that this has been the case to date and would stress that the TSOs will always have control over the system irrespective of market design. There is a real risk that such narrow engagement distorts the whole process to its detriment. A prime example is the proposed decision that ‘there will be a working assumption that changes to the SEM high level design will be based on central dispatch’. This follows bilateral discussions between the RAs and the TSOs, with the recommendations of the TSOs sanctioned by an external consultant appointed by the RAs. Our reasonable expectation is that such an important issue would have included engagement and consultation with market participants in the detailed design phase of the project. We also consider that choosing the dispatch model is an unhelpful and unnecessary constraint at this stage of the process, as further discussed below.

We therefore call for the ‘working assumption’ of central dispatch (regardless of how this is defined) to be withdrawn and strongly recommend a wide-ranging, inclusive, independently informed, and unbounded assessment of the options going forward developed in line with good process and market design principles. We maintain that this will produce the most efficient outcome – i.e. a final market design that functions both consistently and efficiently from a commercial perspective (independent of dispatch decisions) for all industry participants on a non-discriminatory basis.

It is worth re-iterating at this juncture key design principles previously advocated by Energia in response to SEM-12-04 for the further development of the all-island market in implementing the European Target Model.

- Distinct and deliberate separation of the market from the physical system.
- Equal treatment of technology types in the market, there should be no discrimination or preferential treatment of specific technology types or market participants.
- Generators must be able to update prices, and where relevant positions, from the submissions made to the TSO day-ahead, pursuant to the objectives of the Target Model.
- TSOs should have the flexibility to act prior to gate closure and in close to real time, thus preserving absolute control of the system and system planning and security. However the matter of generator flexibility to submit market positions, referred to vaguely as central/self-commitment in discussions to date, should remain open and not be confused with a loss of control of system security.

- Where relevant, financial compensation must be provided in instances where generators are dispatched away from their market position.
- Generators must continue to recover all relevant short run costs from the energy market with prices continuing to reflect SRMC and Uplift.
- A Capacity Payments Mechanism is a necessary and central feature of any redesigned market. This should complement a further objective of ensuring the commercial basis for investments made to date are not undermined.
- There is an enduring need to retain regulatory provisions to address market power which will remain a feature of the market unless there is substantial targeted divestment undertaken by ESB.
- Retention of liquidity provisions will be necessary. In the event that a pool-based market is to be implemented, participation should be mandatory to ensure potentially significant liquidity issues are avoided. Similar provisions would be required around the balancing market.
- Locational signals should be retained to ensure appropriate signals are provided to the market on preferred location for new investments.

Energia considers that commitment to these principles as part of a process to design a market that is compliant with the requirements of the Target Model will provide for an outcome that is in the best interests of customers, while also respecting the investments made by market participants to date and the absolute role of the TSO in managing and maintaining system security. In the light of these principles, developments since the closure of consultation SEM-12-04 (on 20 April 2012), and proposed decisions in SEM-12-105a, our key concerns, recommendations and observations are detailed further below.

2.1 Key concerns, recommendations and observations

2.1.1 An expert, independent, inclusive, and open minded assessment of market design options is required, guided by good market design principles

We concur with the decision to drop the previous “evolutionary” versus “revolutionary” dichotomy and welcome the decision not to progress the so-called evolutionary options proposed by the TSOs/MO which were based upon a presumption of minimal change and the strictures of current market design and dispatch. We submit that the lack of clarity and coherency of these options acknowledged by the SEM Committee in SEM-12-105a, and the discrimination in favour of interconnectors over other market participants, was largely symptomatic of the process followed. There was an over-reliance on the assumed impartiality of the TSOs/MO and a failure to engage independent experts with proven experience of market design which led to unnecessary self-imposed (market design and dispatch)

constraints within which the options were conceived and developed. Energia favours a wide-ranging, inclusive, independently informed, and unbounded assessment of the options going forward in line with the process and principles previously advocated in response to SEM-12-04. We maintain that this will produce the most efficient outcome.

Given lessons learned to date it is highly surprising and disappointing to see a proposed decision that ‘there will be a working assumption that changes to the SEM high level design will be based on central dispatch’. It is unclear what this means or achieves and we consider it an unhelpful and unnecessary decision at this stage of the process. As a ‘working assumption’ we note that it could be subject to change should circumstances necessitate it anyway. And the manner in which this ‘working assumption’ has been derived is entirely unsatisfactory; following bilateral discussions between the RAs and the TSOs, subsequently corroborated by an external consultant, and presented to industry as a fait accompli. It is also relevant that the SEM Committee intends to procure market design consultancy and other relevant expertise for the next phase of the project. It is further worth noting the SEM Committee’s intention (detailed in page 6 of the proposed decision) is to re-design the SEM in the following order:

- I. Agreement on principles and objectives
- II. Project scoping and set up phase
- III. Consultation and decision on design changes required to SEM, within the framework of agreed principles and objectives
- IV. Development of detailed market rules and accompanying systems in an inclusive manner

The RAs acknowledge that under a centrally dispatched market, continuous intraday trading “poses problems of timing” which “could be difficult to implement in a centralised market”. It is clear that this area of the market design needs significant analysis and Energia expects significant engagement and consultation on this issue as part of the “design changes required to SEM” phase of the project. We would strongly caution against a working assumption on dispatch while only at the “agreement on principles and objectives” stage of the project. We would further caution that, as with the MAE project, implementation difficulties can arise² and that making this assumption in advance of detailed design or substantive analysis could unduly increase project risk and cost, compressing the timeline for a solution that works. It is also unclear, particularly at this stage in the process, what the advantages are of a self-imposed constraint on dispatch or a presumption that a bilateral type market is not desirable.

² <http://www.dcenr.gov.ie/Energy/North-South+Co-operation+in+the+Energy+Sector/North-South+Co-operation+in+Energy.htm> (page 8, Option 2)

Good process, which importantly maximises the likelihood of achieving the most effective outcome, calls for withholding any presumption of the dispatch or market model at this stage (and we note the TSOs believe either is workable) and for consideration of all feasible options in the market design stage of the process with the support of independent market design expertise and through consultation with market participants, with the TSOs responding to the consultation like other parties.

We therefore call for the 'working assumption' of central dispatch (whatever this means) to be withdrawn and strongly recommend a wide-ranging, inclusive, independently informed, and unbounded assessment of the options going forward developed in line with good process and market design principles.

2.1.2 Governance and project management

In relation to governance and project management Energia agrees with the comments submitted by EAI in its response to SEM-12-105a and supports its recommendations as re-produced below for ease of reference.

To provide for robust assessments it is imperative that the project engages with and includes the perspectives of industry participants. The forum proposed in relation to European issues such as network codes is welcomed. There are useful elements in the governance structures proposed, however we would make the following recommendations, which we believe will greatly enhance the utility and progress of the Forum, namely:

- *The Forum should be inclusive of the entire internal market development process - dealing appropriately with Framework Guidelines, Network Codes and Comitology;*
- *A fluid or joint chair arrangement should be adopted whereby the chair is linked directly to specific item(s) under discussion (i.e. chaired by RAs when discussing Framework Guidelines, TSOs for the Network Codes, and Government Departments for the Comitology stage) with attendance by a representative of the RAs, TSOs, Departments, at each meeting;*

Furthermore at the time of Network Codes consultation we would propose that the forum meet to go through technical or commercial details and drafting on a line by line basis where appropriate - this is necessary for stakeholders to gain a proper understanding of the issues at hand as well as to provide effective input to the process.

- *Engagement should be on a regular as well as timely basis particularly in advance of key development points in the process (i.e. Draft FG publication, Draft code publication and pre-comitology stages). We note that the level of engagement from ENTSO-E at a European level with regard to some of the network codes has been far from adequate, and we would not like to see such a practice mirror itself in an Irish context.*

Industry Governance Group

The Paper does not appear to give the same focus to the SEM integration project as to European developments. In fact we note that no explicit provision for industry engagement with the SEM integration project itself has been outlined in the Paper. While we do not doubt that engagement will be a key part of the RAs endeavours, given our opinions expressed above we would welcome concrete proposals at this time.

On that basis, the EAI recommends:

- *The addition of a 'SEM Integration' specific stakeholder group to the project governance arrangements to incorporate:*
 - o *A 'project' stakeholder forum, inclusive of government departments, regulatory authorities, industry participants and system operators, to meet monthly or more often as necessary, to receive reports on the progress of the project;*
 - o *A 'design' stakeholder forum to discuss the various and specific topics under consideration **both before and during** the formal consultation process;*
- *A project work programme detailing timelines, milestones, key activities, consultation periods along with the appointment of an experienced and dedicated programme manager.*

We believe such a grouping would allow market participants to pro-actively contribute in advance of public consultations being issued as well as during the consultation process and should allow for more robust and timely decisions.

It is also possible that some of the industry structures employed in the original SEM Design could be re-established and applied for the 'Integration Project' - this could be incorporated under the auspices of the proposed Project Office. While this could be beneficial, improvements can always be made. It is incumbent on the RAs to ensure that sufficient time is given for participants to formulate opinions on topics and that their views are considered in advance of key decisions. The RAs must also ensure fair and balanced engagement with industry whereby commercial impacts of design decisions are given equal status with system issues. This is critical for the achievement of an efficient and timely outcome.

2.1.3 Cost Benefit Analysis

Energia welcomes the SEM Committee's commitment to regulatory impact assessments. It will also be important that the impacts of any proposed market design be fully assessed against viable alternatives and that a detailed and

comprehensive Cost Benefit Analysis (CBA) is concluded to provide confidence and positive reassurance for all stakeholders that the effort will provide tangible benefits. This analysis must take into account the impact on market participants, including their risks and costs.

2.1.4 SEM design stability

Energia welcomes the commitment to maintain the design stability of the SEM to 2016 without material market changes in the interim. It would be helpful to clarify for the avoidance of doubt that this commitment extends to the start of the new market and will consequently result in the continuation of the existing capacity payments mechanism until at least that date, notwithstanding the current European Commission consultation on capacity payments. This would provide much needed investor confidence at this time of heightened uncertainty.

2.1.5 Capacity payments mechanism

Energia strongly supports the retention of a Capacity Payments Mechanism in the market and while we note that it will need to comply with any future EU rules, we consider there are very valid reasons why such a mechanism is appropriate in a small, largely islanded market with finite interconnection to the GB market. We also suggest that a major area of concern regarding distortion between member state markets could be addressed through removal of payments and receipts from interconnector flows (effectively treating interconnectors like other transmission wires).

We welcome the SEM Committee's statement that "It is important that the total remuneration from energy payments, capacity payments and ancillary services is sufficient to ensure security of supply" and we look forward to further detailed consultation on this issue. A broader statement of intent to ensure an efficient, competitive and liquid market would also be helpful as commercial risk management from both generation and supply perspectives has been given little or no consideration in the process to date.

2.1.6 Treatment of renewables

Energia welcomes the SEM Committee's proposed decision that changes to the SEM High Level Design should promote the use of energy from renewable energy sources, however like IWEA we have concerns over the use of the wording 'where appropriate' in the SEM Committee's statement. We would share IWEA's view that this is a very broad statement and would reference the information session in Belfast on 27 November 2012 where it was clarified by the RAs that there would be no situation outside of legislation where it would not be appropriate to promote renewable power. Therefore Energia requests that the wording 'where appropriate' be removed as this creates unnecessary uncertainty.

Our other views on the treatment of renewables mirror those made by IWEA in its response to SEM-12-105a as re-produced below for ease of reference. We should stress that, if implemented with due consideration, RES integration strategies can be equally effective in bilateral markets as in pool type markets.

Imbalance Settlement

IWEA welcomes the recognition of the difficulties of how to manage the treatment of an exposure of wind generators to imbalances between firm day ahead and intraday physical positions and metered generation. Further consideration will need to be given to this issue and IWEA welcomes the intention to consult further on this in the next phase of the process.

Priority Dispatch

IWEA welcomes the SEM Committee's decision to adhere to an "absolute" interpretation of priority dispatch whereby economic factors are taken into account only in exceptional situations and only where this can be done in a manner that does not threaten the delivery of renewables targets, and that this decision will also apply in a re-designed SEM. This is in line with the meaning and intent of the Renewables Directive and should be a primary principle of any new market design. IWEA believes it is appropriate that this principle should be included as a high level principle of the market design. The next phase of detailed design should explicitly outline how priority dispatch for renewable generation will be facilitated.

Curtailement

IWEA notes the statement in the Proposed Decision paper that "The SEM Committee has decided that that its decision on the Treatment of Curtailement in Tie Break Situations will also apply in a re-designed SEM and this will be taken into account in its decision". In our response to that consultation IWEA noted that it is inappropriate to decide on one element of the redesign of the EU Target Model in advance of the market design project itself and in the absence of any holistic analysis required. IWEA believes that the proposal to remove compensation for curtailement as has been put forward is a detailed design issue and should be considered along with the other components of detailed design which will be considered after the HLD stage. It is also important to note that it is too early at this stage to know what levels of curtailement are to be expected under the new market rules. It is essential that this market integration process is carried out in such a way that reduction of curtailement is promoted and incentivised. Deciding to remove compensation for curtailed wind permanently at this stage is premature and potentially limits the SEM Committee's legislative duty to promote renewable energy and the scope to meet this objective with the new market design. The decision on the treatment of curtailement in the new market design should be addressed as part of the design process.

Recommendations

As outlined in our submission to the previous Market Integration consultation in April, IWEA would like to reiterate the point that, given the significant and vital role that renewables will play in the future of the all-island electricity system, it is important that careful recognition is given to the nature of renewable energy assets as part of any market redesign process. Key issues in this regard include:

- **Imbalance Pricing** – IWEA believes that any attempt to reintroduce penal imbalance pricing as part of this redesign process would be significantly detrimental for the renewable sector and an unnecessary step for the market as a whole.
- **Efficient Market Signals for Import and Export** – Any new market design should enable the efficient import and export of electricity in a manner that will reduce the overall level of renewable generation curtailed.
- **Reference Price** - Any redesigned market must provide a clear market reference price which renewable generation can access in a systematic way and which can be referenced by support schemes such as REFIT.
- **Priority Dispatch** - Any suggested market redesign options should explicitly outline how priority dispatch for renewable generation will be facilitated. Additionally, any new market should ensure ease of access for independent and unsupported renewable projects.

2.1.7 Market power & liquidity

Energia welcomes the SEM Committee's proposed decision that there will continue to be market power mitigation measures in the SEM.

As previously stated in response to SEM-12-04, Energia considers the continued presence of a market power mitigation strategy to be a necessary control on market power in the all-island market, irrespective of the final market design implemented. Arguments that increased interconnection and market coupling will reduce the relevant market share of all participants in the all-island market below any reasonable level of concern with regard to competition policy are overly simplistic. For the foreseeable future, absent significant divestment of ESB generation assets, Energia considers the retention of a market power mitigation strategy of as central to the protection of the market, participants and customers from anti-competitive effects arising from the effective local market dominance of one player in a relatively small market.

The design of a market power mitigation strategy should be tailored to the preferred market design. But the need for market power mitigation should not preclude a bilateral market. Important features that can and should be retained under any market design include; price/bid transparency, price/bidding rules, market share mitigation mechanisms, and vertical separation of the incumbent.

Similar to the approach outlined with respect to market power mitigation, the preservation of liquidity provisions, although not necessarily a replication in their current form, is considered to be another central feature of any future market design.

As a secondary benefit of the proposed market power mitigation strategy, market share mitigation mechanisms will ensure a level of liquidity is preserved, however, further auctions, to be determined in accordance with the new market design and regulatory objectives, similar to those currently provided are likely to remain important for generators, suppliers, competition and customers post-2016.

If implemented with due consideration, both market power mitigation and liquidity strategies can be equally effective in bilateral markets as in pool type markets.

2.1.8 Locational signals

The proposed decision is silent on locational signals. Energia would like to point out that locational signals should remain an integral feature of any re-designed SEM. The desirability of locational signals from the SEM Committee's perspective has been clearly established following a prolonged locational signals workstream and it would be helpful and appropriate to clarify this early in the context of market re-design, albeit noting a need to address concerns around the stability and predictability of locational signals.

2.1.9 Review of bidding zones

We note the SEM Committee's proposed decision to conduct a review of the bidding zones in the SEM as part of the Target Model implementation. Energia believes that for liquidity and investor confidence reasons, zones should only be delimited where absolutely necessary and in consideration of investments already made in the market. We also note that the North-South constraint is temporary pending completion of the second North-South tie line.

2.1.10 High Level Principles for the market

Energia welcomes the decision to re-affirm the High Level Design Principles and supports the SEMC's recommendations. We would note however that the existing SEM market does not satisfy all of the current HLD principles; for example, in relation to Efficiency/Equity/Competition where interconnector users are treated more favourably than generators (i.e. interconnector units achieve firm ex-ante positions compared to generator units whose commercial position is determined ex-post). This differential treatment may have evolved during practical implementation of SEM but equity of trading and risk management opportunities for generators and suppliers in the new market must be a fundamental principle.