



Response to
Proposed Decision of the SEM Committee
On
Next Steps to Implementation of the European Target Model for
the Single Electricity Market
(SEM-12-105a)

21st December 2012

Executive Summary

Regulatory Process to Date

In opening our response to the SEM Committee's Proposed Decision on SEM Market Integration Next Steps, we wish to highlight a number of key concerns we have with the process to date. These are:

1. The length of time between the close of the initial consultation in April 2012 and the publication of the proposed decision in November 2012, an elapsed period of 7 months;
2. The lack of any meaningful engagement with market participants during that period; and
3. The seeming lack of sufficient and requisite resources available to the project, particularly in the areas of electricity economics and project management.

These concerns we believe are general to the industry and were voiced at the information session organised late in November to communicate the contents of the Proposed Decision and the supporting documents. We have also communicated these concerns in our recent bilateral discussions with the Project Team.

However while we are in no way enamoured with the process to date, the matter at hand now is how to proceed with the enormous challenge yet facing the industry – achieving a wholesale market design and implementation that suits the particular context of the Irish electricity system within the constraints of the European Target Model. This is the new urgency.

Essentials for the Next Steps

To address that urgency two things are now essential.

- A. The first is the development and publication of a roadmap to account for the various elements and stages of the project – including the analysis, consultative, design, implementation, testing and transition phases.
- B. Second, it is crucial that the structures and mechanisms for engaging the industry, particularly SEM market participants, are developed, communicated and put into effect.

We cannot emphasise the second element enough. The success of the Market Integration project will to a very great extent reflect the effective participation of market participants, who in a very real sense 'own' the SEM trading experience and will continue to do so post-2016, under the redesigned market.

We will say more on this matter of industry engagement within the body of our substantive response.

On the Recommendations to Government

1. High Level Principles for the Market

a. Security of Supply, Stability, Efficiency, Practicality/Cost, Equity, Competition, Environmental, Adaptive

b. New Principle –The Internal Electricity Market

SSE welcomes the reaffirmation of the high level principles for the market, both the pre-existing ones and the addition of the principle of the Internal Electricity Market. In doing so however, we would have looked for a more incisive exploration of these principles; examining how they have performed over the life of the SEM till date, where challenges from that experience have been most acute, and how the addition of the principle of the Internal Electricity Market interacts with each of the pre-existing principles.

'Pre-existing' Principles

However while we welcome this reaffirmation, we would like to point out that the interpretations and value judgement given to the reaffirmed principles differ, often significantly, from those of the original SEM design High Level Design (HLD). For example, the idea of **the principle of Security of Supply under the original SEM HLD, as espoused in AIP/SEM/06/05 is to encourage sustainable prices and efficient investment. Under the current Market Integration programme, there has been a shift in emphasis to imply that Security of Supply is about system operation.**

Furthermore many of the principles were not discussed at length in the SEM HLD decision (e.g. Efficiency, Stability and Equity) so interpretations given in SEM/12/105 are not necessarily self-evident nor reflective of the original intent. Again, the 'Adaptive' principle seems to be a new addition, although it is not presented as such in SEM/12/105.

This goes to suggest that if the market changes are to be coherent and evaluated by means of objective and comprehensive criteria which are understood by all, further discussion is required.

Hence what is clear is that the reaffirmation addresses the labels of the principles, not their core meanings. With these evident inconsistencies, we request clarification on what the reaffirmation means for each principle. This may require a closer re-examination of each of the principles.

New Principle

Regarding the new principle of The Internal Electricity Market, we wish to recall to the RAs their oft-stated view that “the task is not merely compliance with a European Regulation but to implement

the Target Model in a manner that best serves the interests of consumers and is best coordinated with other strategic goals of national and European Energy Policy – i.e. integration of renewable, promotion of competition and security of supply”. In fact this view can be buttressed by this excerpt:

“Organic Market Integration

“This paper on the design of the SEM sets out the next stage in what is clearly an organic growth in market integration. The single wholesale market is not a construct being imposed on either customers or the electricity industry on the island. It is simply the logical next step in removing the next set of barriers to competitive prices and quality service for customers. It will do so by establishing a trading mechanism that enables us to share more efficiently the opportunities we have to produce and supply electricity to customers wherever they are on the island. As we face common problems we can solve them at lower cost by sharing the solutions.”¹

This statement could well have been made for the current phase of market integration.

We share these views and hold also that indeed, the current Market Integration project represents “the logical next step in removing the next set of barriers to competitive prices and quality service for customers”.

However we contend that in order to actualise those objectives, it will be essential to demonstrate how all decisions within the project fit within this framework. To demonstrate that it will be essential to support all decisions by conducting, at each juncture, CBAs that cover the full costs of the project, not just central project costs.

2. Governance and Project Arrangements

a. DCENR –DETI JSG Sub Committee on TM implementation

b. UK Ireland Steering Committee

c. Regulatory Authority Project Office

d. Joint Regulatory Arrangements with Ofgem

e. A Stakeholder Forum on the European Internal Market

SSE is pleased to finally see a proposed shape on the project arrangements, together with the governance components. However it is disappointing that involvement of industry has been reduced to mere participation in a forum to discuss Network Codes and other EU policy developments. The proposed structure disregards the parties who have been, and will remain the primary participants

¹ SEM Proposed High Level Design document (AIP/SEM/06/05)

and users of the electricity market on the island of Ireland. The omission risks the exclusion of actual operational experience gained in the SEM to date from consideration in the project.

Once again we recall from the original SEM HLD document this excerpt:

“This is not a final step. It would be logical to have other steps, which will follow in due course to deliver yet further benefits to customers...**Customers and the market players themselves will have a major impact on that evolution** both by what they say and what they do. It is after all market players which have by their behaviour produced the remarkable transformation of the island’s energy scene over the very few years which have elapsed since the Internal Market Directive took effect in Ireland in 2000. **It is they who will be the drivers in the future.**”²

It will be hard to point to any evidence of the statement above, either throughout this process to date or in the proposed governance and project arrangements.

While not discarding the structure outlined above, we would call for a significant improvement, particularly with reference to the RA Project Office sub-group. Our recommendations are:

1. Setup industry expert group (s). The group(s)’s role(s) would be primarily to shadow the RA Project Office, receiving documents from the Project Office and reviewing with view to input industry perspectives.
2. Commit to a regular workshop schedule (perhaps monthly), not information sessions, to work through the knotty issues of market integration.
3. Employ an economic consultant with broad and deep electricity market design experience. The RA Project Office should employ such consultant to advise on commercial aspects of electricity market design.

Regarding expert groups, we would like to bring your attention to a format in operation in GB. For the ongoing Electricity Market Reform (EMR) DECC has established three Expert Groups which will play an important role in testing and improving policy proposals. These groups are:

- Capacity Market Expert Group
- Contracts for Difference Expert Group
- Institutional Framework Expert Group

The Expert Groups are comprised of industry experts as well as DECC policy team members and complement other forms of stakeholder engagement. The Terms of Reference and memberships of each group are available on DECC’s website³.

It is important to point out the structure of the memberships which are generally chaired by DECC and include DECC’s economic consultant, the TSO and industry participants selected on expertise.

² Ibid

³ http://www.decc.gov.uk/en/content/cms/meeting_energy/markets/electricity/emr_expert/emr_expert.aspx

Without explicitly recommending DECC's EMR expert groups structure, we would urge the RAs to develop a structure for industry engagement to be adapted into the Market Integration project.

On SEMC Proposed Decisions

1. European Target Model will be implemented in the SEM by 2016 in a coherent and stable manner

The Five Pillars of the Target Model

SSE agrees with the identification of the five elements that form pillars of the Target Model. However we wish to point out that **these elements have all been put forward to form a coherent whole that fundamentally is about facilitating increased and efficient cross-border trades in electricity. We urge that this overarching imperative is not lost sight of through the market integration process.**

On the specific elements, we wish to point out some of the challenges posed to the current structure of the SEM as an all-island union.

Capacity calculation and zones delimitation

The first element on capacity calculation and zones delimitation perhaps poses the most danger in this regard to the continued existence of a market with a single price zone. With the significant constraint between the North and South, very detailed analysis needs to be conducted on this issue to evaluate the various options that are feasible from interpretations of the legal requirements as a precursor to determining the most appropriate course of action. A priori, we would regard market price splitting as an undesirable outcome. With the context of a small, relatively isolated electricity island system, having significant liquidity and market power issues, we do not see how market splitting will contribute to any objectives of Market Integration.

Cross border forward hedging and harmonisation of allocation rules

On cross border forward hedging and harmonisation of allocation rules, we wish to point out the efforts of EWIC and Moyle in seeking harmonisations across their operations, as well as with the other FUI-region interconnectors – IFA and BritNed. Of note is the recent consultation reviewing auction and curtailment approaches across the SEM interconnectors. SSE strongly supports these efforts, as such harmonies can only drive transaction efficiencies by market participants. However while harmonisation efforts are to be aimed for where possible, it is also important that underlying them is a commitment to seek the most efficient rules in the first place.

Day Ahead market coupling & Intra-day continuous trading

The day-ahead and intra-day elements of the Target Model are two elements that pose the most challenges to the SEM's long lead times to gate closure, as well as the ex-post pricing nature. This challenge of long lead times to gate closure was acutely evident during the recent implementation of

the current intra-day trading element of the SEM, and this for the addition of just two extra gate closures within the Trading Day. As the requirement of the Target Model is for continuous trading up to one hour prior to real-time, it is imperative that the constraining factors that feed into those long lead times are identified through rigorous analysis and suitably addressed. While some of these may relate to the operational logistics of the market operator, our understanding, based on previous evidence from the TSO, is that this lead time is to allow sufficient time to bring certain thermal plants from cold states to minimum generation levels. This situation has to be addressed, but in our view will pose an immense challenge for a centrally committed market.

Cross border balancing

On cross-border balancing, we acknowledge that so far the Irish TSOs have been taking opportunities to work with National Grid in GB on matters of mutual interest. These interactions we believe have been on informal bases. Proceeding, it may be necessary to procure for some of these working relationships on more formal and visible bases.

However we are dismayed that after repeatedly calling for participant involvement in this area of TSO-TSO trades, it appears that the TSOs have now obtained permission from the RAs to export power across the interconnectors, presumably in effort to reduce constraints on wind. While we welcome and applaud the efforts to provide for more wind on the system, we would argue that these trades are not being conducted via market-based mechanisms, a fundamental tenet of the European cross-border trade programme.

At the most recent EirGrid Conference, the TSOs presented that “[t]he control rooms now try to trade priority dispatch plant with NGC rather than constrain”⁴. From our recollection this power can be traded for any price above €0, implying that such power can be significant discounts to prevailing market price levels. If this contention is true, we wish to ask how revenue shortfalls are being bridged. Presumably they will form part of UoS charges.

We wish to call for a full review of this mechanism, and as an all-island issue, it must needs be consulted upon.

SEM Design Stability to 2016

On the subject of SEM design stability till 2016, again with the experience of implementing intra-day trading within the SEM, SSE agrees with the intention to place a hold on material changes to the current SEM design.

Impact Assessment and CBA

SSE welcomes the commitment to an IA of the market redesign, as well as a CBA. However we wish to point out that CBAs ought to required for all major decision points and should not be

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<http://www.eirgrid.com/media/Alex%20Baird%20SONI%20All%20Island%20Power%20System%20Review.pdf>

discretionary as seems to be suggested in the Proposed Decision. As discussed above, any CBA must also include costs to be incurred by participants.

2. Market Design

a. 'evolutionary options' described in the consultation paper should not be pursued further.

b. SEM RAs will work jointly with Ofgem on efficiently implementing target model together both in SEM and BETTA

c. There will continue to be market power mitigation measures in the SEM.

SSE welcomes the proposed decision to drop usage of the terms 'evolutionary' and 'revolutionary'. The use of those descriptive labels has not been helpful to the discussion thus far and it is imperative that proper project conventions are followed going forward, including general agreement on labelling and usage of terms.

Another term that needs clarification is 'dispatch', which appears to be conflated with unit commitment. This now needs to be clarified to forestall the potential for confusion.

On market power mitigation, it is SSE's view that this is necessary and should be robust and well-designed. However we would point out that this has nothing to do with the centralisation or otherwise of the market. A more pertinent issue remains the adequate skilling and resourcing of the MMU.

3. Central Dispatch

There will be a working assumption that changes to the SEM high level design will be based on central dispatch.

SSE has a distrust of the use of the term 'working assumption', borne out of previous SEM market developments. As far as we can interpret it, we regard it that the SEMC has decided on a market that employs centralised bids from market participants.

At this juncture we wish to point out that all electricity systems, if they wish to remain stable and secure, have to be centrally dispatched. This is not in dispute; this is a role that only the TSOs can perform. Hence we regard the issue under reference here to be 'unit commitment', not 'dispatch'. Thus under this definition, we view the SEMC decision to be 'central commitment', as against 'self commitment'.

If our redefinition is correct, the issue centres on whether unit commitment decisions be left to participants or be based on mathematical optimization. We strongly believe that debate is still

required on this issue and should not be foreclosed. While benefits such as transparency of price formation are obtainable under the mathematical optimization approach, there remain the issues of how centralized unit commitment can be accommodated within a continuous trading mechanism.

In addition, unless a decision is also made as well as to continue the effective non-participation of demand in the market, the centrally committed market will be further challenged in that respect.

4. Promotion of Renewable Energy Sources

Changes to the SEM High Level Design should promote, where appropriate, the use of energy from renewable energy source, as set out in legislation

As the largest renewable energy generator on the island SSE welcomes a dedicated position to promote the use of energy from renewable energy sources. This has been a tenet under the current SEM and should be taken forward into the market redesign.

However we wish to point out that the phrase “promote, where appropriate” is nebulous. In view of the work being carried out under the DS3 programme, we prefer more precise language to the effect that “use of energy from renewable energy sources is to be promoted where technically feasible”.

5. Capacity Mechanisms

It is important that the total remuneration from energy payments, capacity payments and ancillary services is sufficient to ensure security of supply

The capacity payments mechanism will need to avoid distortions in the internal market and comply with relevant EU rules

SSE welcomes a restatement of the support for a capacity mechanism for the redesigned SEM. The present Capacity Payments mechanism has been instrumental in maintaining appropriate generation capacity margins in the SEM and would be one of the primary factors for the success of the SEM. Furthermore we agree with the view that it will need to serve within the full complement of other payments – energy and ancillary services – to ensure generator revenue adequacy.

At this juncture we wish to point out that capacity mechanisms do not of themselves cause distortions. As any other market element such as system services, if appropriately designed, capacity mechanisms exist to play a supportive role to the core energy market. Given the transition to an increasingly variable renewable generation future, capacity mechanisms are essential requirements to ensure security of supply.