SSE Response to

SEM-12-089

Treatment of Gas Transportation Capacity Costs

Re: SEM-12-089 - Treatment of Gas Transportation Capacity Costs in the SEM

SSE welcomes the opportunity to respond to the SEM Committee's consultation on the Treatment of Gas Capacity Costs in the SEM. We consider that this is a very important issue for the market as it is not currently possible for generators to recover the costs of gas transportation capacity. At the same time the structure of any marginal gas transport costs should not result in either over-remuneration of the infrastructure owner or undue impact on electricity consumers.

We believe that gas transport capacity costs do constitute a Short Run Marginal Cost and further consider that it can be inferred from the RAs' discussion of Opportunity Costs that they also consider gas capacity costs to be a Short Run Marginal Cost. If this is the case, generators are obliged to include these costs in their offers to the market and there is no room for discretion on the part of generators or the RAs.

SSE is concerned about the impact that inclusion of these costs may have on suppliers and consumers and would ask the RAs to look carefully at the weightings attributed to the transmission asset owner's recovery of costs in the gas transport tariff. There may be other ways of allocating the cost recovery to minimise any impact on electricity prices, such as a relative reduction of the costs of short term capacity or a specific tariff for gas-powered electricity generators. We believe that a review of gas transmission capacity costs should be carried out in parallel with this consultation to ensure that the structure of these tariffs does not result in an over-remuneration of gas transmission asset owners at the expense of customers. Mapping between gas transport costs and the required set of monotonically increasing PQ pairs in the bid is also key in terms of ensuring compliance with the BCOP.

Given the open nature of the consultation paper we consider that the RAs should publish a proposed decision as the next step in order to provide clarity and opportunity for engagement to market participants and customers. It is essential that no short-term decision is taken on inclusion of gas transportation costs in generator bids without simultaneously addressing both the structure of these costs and the potentially material financial exposure of suppliers to Pool price movements; SEM hedging arrangements are inadequate to address the impact of these additional costs on SMP.

Q1 – Has there been sufficient development of the gas transportation capacity market since the publication of the Bidding Code of Practice to allow the cost of such to be included in Commercial Offer Data? If so, why? Is this situation different between Northern Ireland and Ireland?

SSE considers that gas transportation capacity costs constitute a Short Run Marginal Cost as defined in the SEM Licence to Generate and as such, in accordance with the judgment of Hardiman J, in *Viridian Power v CER*[1] generators are **obliged** to include it in their bids. So long as daily capacity is available, irrespective of whether there has been sufficient development of the market, these costs should be considered Opportunity Costs as set out in the Bidding Code of Practice.

Q2 – Should the cost of gas transportation capacity be included in the Commercial Offer Data of units in Northern Ireland?

[1] Supreme Court Reference 285/11; Judgment of 23/2/2012

We believe that the Opportunity Cost of gas transportation capacity must be the regulated daily price for Ireland and Northern Ireland, as appropriate.

We note that the daily gas transportation capacity in Northern Ireland must be purchased at least 12 days in advance of when it is expected to be needed. We do not consider the question of when the product was offered for sale is the essential consideration; rather the fact the fact that a daily product exists which constitutes a cost of generation requires that it be included in Commercial Offer Data.

We consider that this product should be developed, whether or not CAG proceeds, in order to allow short term capacity to be purchased day ahead as the current product is not as useful or flexible as it could be; this development would be in keeping with the spirit of EU Regulation 1775/2005. We do not consider that shortcomings in the product can be taken as a bar to inclusion of its costs in bids; its basic structure is that of a short-term product. The daily price constitutes a Short Run Marginal Cost as defined in the SEM Licence to Generate and so must be included in Commercial Offer Data.

Q3 – Should the cost of gas transportation capacity be included in the Commercial Offer Data of units in Ireland? Is there any good cause why the principles within paragraphs 8(i) and 8(ii) of the Bidding Code of Practice should not be applied?

As set out above we believe that the Licence to Generate obliges generators to include gas transport capacity costs in bids if they constitute Short Run Marginal Costs.

We do not consider that a ‘good cause not to‘ apply the principles set out in paragraph 8 of the Bidding Code of Practice exists in this case. The ‘benefit foregone’ can readily be ascertained under the principles set out in paragraph 8(i) and (ii) and there is therefore no justification for disapplying them.

As regards the section of this paper that discusses risks associated with choice of capacity products, SSE does not accept that there is a ‘perverse incentive’ on generators to purchase a daily product so that it can be included in Commercial Offer Data. As stated above, we note that it is within the realm of generators’ commercial strategy to decide which way capacity is to be purchased, in the same way that a generator can decide how it is to purchase fuel, but is obliged to bid in the daily spot value of that fuel. Further, we do not recognise that there is a perverse incentive as to how capacity is purchased, the capacity is designed by the RAs in a certain way to incentivise certain buying patterns, if generators react to this price signal then this cannot be said to be ‘perverse’. It is within the ambit of the RAs to revise these tariffs.

That said, SSE considers that the RAs ought now to look to review gas transport capacity tariffs to minimise any undue impact on electricity costs for suppliers and customers. This might include restructuring the tariffs so as to reduce the premium associated with short term capacity or to provide a specific tariff for gas-powered electricity generators. Put simply, our view is that generators must recover the costs of gas transport capacity but that customers should not over-pay for this due to the design of those regulated gas tariffs. Similarly, asset owners should not over-recover costs. Therefore we believe that the gas transport capacity tariffs should be reviewed in parallel with this consultation.

Q4 – If the cost of gas transportation capacity is to be included in the Commercial Offer Data (of units in Ireland) is there a recognised and generally accessible trading market in short-term gas transportation capacity? Is this recognised and generally accessible trading market in secondary capacity or regulated daily capacity?

The tariff represents an accessible market for accessing the daily product.

Q5 – If the cost of gas transportation capacity is to be included in the Commercial Offer Data (of units in Ireland) and there is no recognised and generally accessible trading market in short-term gas transportation capacity, what is the replacement cost?

As outlined above, SSE considers that, within the current market framework, gas transportation capacity costs constitute a Short Run Marginal Cost and they must therefore be included in generators' Commercial Offer Data under the terms of the SEM Licence to Generate.

At the outset we would highlight that we do not consider it appropriate for the RAs to draw a distinction between baseload and mid-merit units and to second guess whether each will buy long or short term capacity. We consider that it is up to generators to decide what commercial strategies to employ and that there must be room for competition. We agree with the RAs logic in section 3.2, that a generator may purchase daily capacity in which case the 'benefit foregone' is the price of that capacity.

Further, we agree with the RAs that whether a recognised and generally accessible trading market exists or not, the relevant price for Primary Capacity under paragraph 8(i) or 8(ii) of the BCOP is the daily regulated price of daily capacity. Thus the argument as to whether there is a recognised and generally accessible trading market is moot.

We do not consider that the cost of Secondary Capacity can be used for inclusion in bids. Secondary Capacity cannot be viewed as a substitute for Primary Capacity given that it is interruptible; this would constitute a risk to security of supply. In addition, given the lack of transparency and liquidity in the Secondary Capacity market, we do not consider that there is a recognised and generally accessible market. On this basis, we consider that Secondary Capacity falls within paragraph 8(ii) of the BCOP and the replacement cost is the relevant figure to be used in bids, which leads us again to the primary capacity regulated daily price.

We note the comment in the RAs' paper that if the actual price of secondary capacity were to be used in bids, that it would be difficult for the Market Monitoring Unit to assess bids for compliance with the BCOP and SEM Licence to Generate. As stated above, we do not advocate the use of the price of secondary capacity and appreciate that this would be more complex than using the regulated daily price, but we also consider that limitations of the MMU should not influence or determine market rules. The MMU's role is to support the market so it should not be a consideration in decisions on how the market is to operate.

Given the rationale outlined above, we do not consider that it is open to generators to bid in different costs for gas transportation capacity, all are obliged to include the primary capacity regulated daily price.

Q6 – If the cost of gas transportation capacity is included in the Commercial Offer Data (of units in Ireland) should the price of the BNE be recalculated?

We note that even if gas transportation costs had been excluded from the calculation of the BNE, that the distillate plant would still have been chosen as the BNE. On this basis, it is not necessary to re-calculate the BNE if it is decided that the cost of short-term gas transportation capacity is to be included in Commercial Offer Data.

We note that AIP/SEM/12/078 , after substantial consultation and discussion, decided that the BNE Peaker for 2013 is to be fixed for three years in order to provide a level of certainty to generators. To make an adjustment in these circumstances would undermine confidence in the capacity mechanism which would in turn undermine its aim of providing a level of certainty to generators.

As the Market Integration Project required by EU rules may have determined far-reaching changes to the SEM by the time three years has elapsed, we consider that questions as to how the capacity payment is to be calculated for 2017 should be considered holistically as part of the market integration project. We agree as a matter of principle that there must not be double recovery for gas transportation capacity costs and our view is that this will not happen if gas transport capacity costs are accepted as a Short Run Marginal Cost.

Q7 – Which of the methods outlined in Section 3 is the most appropriate for accounting for the cost of short term gas transportation capacity?

Based on the rationale of our arguments above, we consider that the regulated price of daily gas transportation capacity must be included in generators' Commercial Offer Data under the terms of the SEM Licence to Generate and the Bidding Code of Practice. This is in accordance with Method 1 or Method 2, depending on the determination regarding the existence or otherwise of a recognised and generally accessible trading market. We do not believe that Method 3, whereby generators would determine the method by which they would calculate and include costs, is in accordance with the SEM Licence to Generate.

Q8 – Are there any other methods for valuing gas transportation capacity which have not been included in Section 3?

SSE does not consider that there are other methods of valuing gas transportation capacity that merit consideration in the context of this consultation given the existence of a daily capacity product and the requirement under the SEM Licence to Generate to include Short Run Marginal Costs in COD.