

Elaine Gallagher
Commission for Energy Regulation
The Exchange
Tallaght
Dublin 24
egallagher@cer.ie

3rd September 2013

RE: Trading and Settlement Code Policy Parameters 2014, SEM-13-053

Dear Elaine,

Bord Gáis Energy (“BG Energy”) welcomes the opportunity to respond to the Trading and Settlement Code, Policy Parameters 2014 Consultation (“the Consultation”). BG Energy has a number of concerns, particularly with regard to the proposed review of the PCAP value as well as the proposed revision of the Uplift parameters. The concerns centre principally on the rationale and analysis behind such proposals especially in light of their stated objectives as well as the Regulatory Authorities’ (“RAs”) stated desire to maintain stability and implement minimal change in the market while market re-design is ongoing. BG Energy urges caution against implementing change in these areas without explicit supporting analysis and rationale as to do otherwise would result in regulatory uncertainty and reduce investor confidence in the market at a time when ongoing market re-design is already undermining market certainty.

1. PCAP

BG Energy believes that one occurrence of the need to apply PCAP does not indicate that the PCAP value is distorting the market and is insufficient justification for its review upwards. BG Energy considers that proceeding with a review in such circumstances amounts to direct regulatory interference triggering significant uncertainty and undermining investor confidence in the market.

The PCAP was set at €1,000¹ by the RAs as a conservative approach in the absence of sufficient liquidity in the contracts markets for risk hedging or certainty that the SEM software would not “frequently” drive prices to PCAP at times when all load is actually being served. PCAP was thus set at a number reasonably in excess of the highest expected short run marginal cost of the most expensive plant on the system to allow for SMP variations while ensuring no generator would generate at a loss if its marginal costs exceeded PCAP. The latter is ensured through the application of make-whole-payments.

BG Energy believes that there is still inadequate liquidity in the contracts market and that one incidence of PCAP over six years should not trigger a change of its value. That there has been only one incidence of PCAP since SEM Go-Live indicates that it is set at an appropriate level and its value should remain unchanged. Furthermore the fact that the plant which triggered PCAP in that sole incidence received make-whole-payments confirms that the generator did not operate at a loss and was not negatively impacted by the €1,000 PCAP value.

An increase in PCAP values would have a direct impact on the capacity payments revenue stream in SEM, however, with consequential impacts on participant revenues and risk profiles. This is because the capacity revenue stream is calculated with reference to the revenues of a peaking plant at PCAP and increasing those revenues by increasing PCAP would decrease the amount of the capacity pot. Given the complementary roles

¹ AIP-SEM-07-484, page 9

of the bidding rules and capacity payments in SEM to prevent price spikes, it is important that a change in one does not have a disproportionate and detrimental impact on the other. Furthermore, the proposed change and related impact on capacity payments undermines the SEM Committee's commitment to fix the BNE peaker costs until at least 2015 leading to regulatory uncertainty. BG Energy believes that, in the absence of evidence from the market suggesting a need to revise PCAP, the only rationale to do so at present is to suppress the value of capacity payments to generators. A reconsideration of the PCAP value, as proposed would at this point amount to regulatory interference, increasing investor risk in a time when ongoing market re-design is already undermining investor confidence with consumer price impacts.

2. Proposed Revision of Uplift Parameters

In relation to the proposed revision of the Uplift parameters, BG Energy is concerned that the proposal would introduce considerable price uncertainty in the SEM and distort the objectives of the uplift parameters eroding any arguable benefits. This view is formed on the basis: that the underlying rationale for the current parameters given in the 2006-7 consultation process remain valid today; that the market data presented is too narrow in scope to capture the full impact of the proposed changes on the market and its various participants; that the RAs' study of the role of and interaction between the Cost and Profile Objectives in the 2006-7 consultation process is insightful and discourages the RAs' proposed re-weighting of these Objectives, and; that the practical impacts of such a revision would cast doubt on SEM revenue stability and predictability with resultant knock on effects on risk profiles and end consumer prices. These issues are discussed below in turn.

2.1 The 2007 Decision on Uplift Parameters and Recent Market Data

BG Energy believes that the primary reasons given for the RAs' 2007 choice of parameters (which parameters have since remained unchanged) remain valid today. These reasons were founded on analysis carried out at the time which is instructive in light of the RAs' proposals in this Consultation. Furthermore the RAs stipulated in 2007 that ongoing monitoring of the appropriate parameter values would occur in the context of: a) achievement of the desired Uplift Objectives; b) the stability of SEM prices.² BG Energy is of the view that the initial analysis provided in the Consultation paper is not sufficient to fully assess these criteria. Furthermore, internal analysis undertaken by BG Energy³ would suggest that changing the parameter values as proposed in the Consultation paper would actually be contrary to the criteria.

The RAs' chose the current Uplift parameters and their weighting⁴ on the basis that, compared to other parameter values, they would:

- i. Lead to a small increase in overall projected SMP revenue and a rather more stable set of price profiles with lower incidences of price spikes;
- ii. Increase the degree to which the Profile Objective⁵ can be met, with little negative impact on the degree to which the Cost Objective⁶ can be met;
- iii. See an anticipated reduction in the incidence of price spikes and would better meet the Global Objective.⁷

BG Energy asserts that the Consultation does not present data that could reasonably be used as a driver for reviewing Uplift parameters. On the contrary, previous RA analysis as well as company analysis demonstrates that, the RAs' proposal of, placing more emphasis on the Cost Objective over the Profile Objective will: result in outcomes that run directly contrary to the reasoning outlined above; hinder the balanced achievement of the Uplift Objectives, and; impact SEM price stability.

Notwithstanding that in 2007, the RAs left open the possibility to review the Cost Objective in light of "market data,"⁸ BG Energy considers that rather than providing grounds for a review of the Uplift

² AIP/SEM/07/51, pages 18-19

³ Further discussed in section 2.3 below

⁴ AIP/SEM/07/51, page 18. The weighting is Alpha=0; beta=1; delta=5

⁵ Minimisation of the deviation from Shadow Prices

⁶ Minimisation of uplift payments

⁷ The cost of energy should reflect the marginal cost

parameters, the market data presented for the latest compared datasets⁹ underscores the fact that a change of parameters is not justified at this time.

For example, in this year's Consultation the stated:

- i. Increased correlation between the SMP and Shadow Price implies that Shadow Price is forming a larger portion of SMP than previously. This is in line with the Profile Objective;
- ii. No change in the correlation between the SMP and Uplift – together with the 'standard deviation' of Uplift and SMP decreasing, and of Shadow Price increasing - implies that Uplift was not responsible for the increase in the SMP. The increase can rather be attributed to increased Shadow Prices rather than uplift. These results are compatible with the Cost Objective.¹⁰

The RAs' proposal appears to be driven by a desire to reduce overall SMP by targeting uplift minimisation without any real market data validation. BG Energy urges the RAs not to instigate a review on this basis as such subjective rationale will have negative repercussions for SEM on foot of such regulatory interference and uncertainty, increasing market risk, eroding investor confidence and impacting end consumer prices.

2.2 The Cost versus Profile Objectives

BG Energy notes that the RAs propose to put less weighting on the Profile Objective in favour of the Cost Objective, contrary to the current Profile weighting preference. BG Energy considers that the studies undertaken by the RAs in the 2006-7 consultation process demonstrate the negative impacts such a proposal may have particularly on the Profile Objective whereby price spikes will counteract any perceived benefit.

It appears the key driver for this proposal is a belief that SMP may be reduced by 1% (favouring the Cost Objective) with little impact on price volatility (i.e. on the Profile Objective). It is however instructive to recap briefly on the 2006-2007 consultation process which has already taken into account the possible "trade-off" between the Cost and Profile Objectives.¹¹ In that analysis, the Composite Uplift Weighting ("CUW")¹² was used to assess the performance of different parameter values against the Cost/Profile Objectives. The final chosen CUW, which still applies, was '0' which is reflected in the current alpha value of '0'. However, this Consultation effectively proposes an increase in CUW to 0.1¹³. The 2006-7 analysis illustrated that such an increase results in reduced Uplift costs but to the severe detriment of Profile. Prices become significantly more 'spiky' and the performance of the Profile Objective,¹⁴ on a scale 0-1 (poor-good), reduces from '1' to '0.6'.

In addition to the above discussed analysis, the RAs were also originally influenced¹⁵ to place more emphasis on the Profile over the Cost Objective, on the basis that algebraically this had the effect of removing the first term of uplift optimisation¹⁶ in favour of relying entirely on the second term of uplift optimisation.¹⁷ Allowing for this to occur algebraically favoured uplift values that were (i) flat and not spiky across any given day, and were (ii) low. It also ensured that uplift optimisation contributed to meeting both the Cost and Profile Objectives.

On the basis of the above, BG Energy submits that the RAs' revision down of the Profile value risks spikier, higher prices and endangers the continued joint achievement of both the Cost and Profile Objectives. Furthermore, it would run contrary to the original rationale for choosing the current parameters as enumerated above in section 2.1. BG Energy would welcome further insight to the driver for this proposal as

⁸ AIP/SEM/07/51, page 19

⁹ May 2012- April 2013 and May 2011- April 2012

¹⁰ Revenue paid through Uplift revenues should be minimised

¹¹ AIP/SEM/07/51, page 15, Figure 2

¹² I.e. as alpha and beta are merely 'relative magnitudes' so the composite of alpha and beta together was assessed

¹³ Under the CUW equation, an alpha of 0.1 and beta of 0.9 (as $a+b=1$), results in a CUW of 0.1 (i.e. $0.1/0.1+0.9=0.1$)

¹⁴ Measured in terms of "goodness of fit" using 5 composite measures to assess how well various values perform

¹⁵ AIP/SEM/07/51, page 17

¹⁶ Which sought to minimise SMP revenue

¹⁷ Which sought to minimise the sum of the square of uplift

the reasoning put forward for the review is unsubstantiated and does not provide the context for which a review is warranted – the two Objectives would not be better met, nor would price stability be improved. In fact the opposite is true, and a proposed change at this time would reflect direct unwarranted regulatory interference in the market which would lead to increased market risk and related consumer price impacts. The RAs are encouraged to exercise caution in the possible review of such parameters.

2.3 Practical Impacts of the Proposed Review of Parameters

In addition to the above-mentioned negative impacts demonstrated by previous RA analysis, company analysis has also revealed that, while SMP will slightly decrease, not only will price spikes greatly increase when alpha values increase over 'o', but such spikes will occur in unintuitive trading periods, for example during periods of low load in the market. BG Energy believes that this will have negative impacts on interconnector flows, risk premiums, market entry and wind payments for example. The results also run contrary to the Uplift Objectives.

Increased uplift in periods of low load as compared to peak periods will result in increasingly volatile prices. Price volatility is inefficient in a market and increasing costs into low load periods is counterintuitive. It would distort the Cost Objective with the result that higher prices in one period will be perceived as preferable to greater volatility across a trading day as it will be considered more cost reflective and should give rise to less volatility. Moreover, historical prices will be an unreliable guide as to price recovery in SEM which increases market risk. Heightened market risks results in risk averse behaviour in markets, a side effect of which is increased risk premiums (for example in SEM CfD and interconnector auctions). In addition, difficulties in price predictability will act as a barrier to entry for new SEM suppliers to the ultimate detriment of consumers. The emphasis on uplift in low demand periods will also have unintended consequences on interconnector flows. In order to capture the possible uplift available in times of low demand, contrary to what occurs presently, suppliers will seek more baseload generation imports in the overnight period, when high uplift periods could very well occur.¹⁸ Distributing uplift in times of low demand will result in unnatural responses, for example, putting pressure on wind assets. Overall SMP reduction will also impact wind payments under REFIT.

In addition to the above practical implications, the RAs' proposal runs contrary to the three key Uplift Objectives. For example:

- i. Distributing Uplift payments during times of lowest demand breaches the Global Objective of setting the cost of energy in SEM to reflect the marginal costs of producing or consuming electricity during the optimisation time horizon. Applying uplift recovery to low demand periods risks generators not recovering their costs of generation and is an inefficient economic signal;
- ii. The application of Uplift in times of low demand is also counterintuitive, running contrary to the part of the Profile Objective that SMP should not deviate significantly from the Shadow Price. This proposition is supported by the "basic example" of the importance of prices reflecting underlying market dynamics given in the 2006 consultation process on Uplift Objectives.¹⁹ This example was that "prices at times of highest demand should be higher than periods of low demand assuming that no other factors... change";
- iii. In terms of the Cost Objective, the 2006 consultation process on Uplift Objectives recognised that while generation should be scheduled at the lowest cost of production to meet demand, results have shown that recovery of submitted costs during periods of operation is threatened if they are only recoverable in times of lower demand.

The benefit of the proposed increased weighting in favour of the Cost Objective is thus questionable considering the real market impacts it will have as well as the conflict with Uplift Objectives outlined above.

¹⁸ Otherwise participants may risk not recovering their marginal costs of generation

¹⁹ AIP-SEM-92-06 Consultation, section 4

3. Conclusion

In summary, BG Energy submits that:

- i. The fact that PCAP was applied once in the last year does not warrant an increase in PCAP value. Such an outcome would also significantly undermine the SEM Committee's 2012 Decision to leave the BNE costs static until at least 2015. Unnecessary regulatory interference increases investor and market risks;
- ii. The proposed revision of the Uplift parameters are unwarranted as:
 - a. the primary reasons given for the RAs' 2007 choice of parameters remain valid today and the Consultation's market data demonstrates that compared to recent years, Uplift is performing well against its objectives. Placing more emphasis on the Cost Objective over the Profile Objective will: result in outcomes that are contrary to the original rationale for the Cost-Profile weighting outlined in section 2.1; hinder the balanced achievement of Uplift Objectives and; impact SEM price stability;
 - b. The analysis done during the initial consultation on parameters in 2007 illustrates that placing more weight on the Cost/ alpha value will significantly increase price volatility impacting the Profile Objective with knock on impacts on investor certainty, market risk and consumer prices;
 - c. Additional company analysis indicates that any slight increase in SMP will be offset by increased price spikes if alpha increases over 'o' and such spikes will also occur in unintuitive trading periods such as low load periods. This will have knock on negative impacts on market risk premium, market entry, interconnector flows, wind and consumer prices.

BG Energy therefore urges caution against proceeding with a change in uplift parameters at this time. If however the review progresses, it should be subject to a full public consultation process with a wider analysis of the market, including the impact of changes on price stability, interconnector flows, CfD prices and REFIT supports. BG Energy believes that a time period of three months for this analysis is too short and that at least one year of historical and forecast data should be reviewed. A more robust analysis would be provided through the use of Monte Carlo simulations on wind and prices for example. Importantly, BG Energy requests clarification as to what the RAs consider would be an acceptable increase in volatility in giving greater weight to the Cost Profile as any level of deviation/ volatility in SMP increases suppliers' risks the mitigation of which in turn has knock-on impacts. If after further and more detailed analysis the RAs consider that changes are warranted, this should not be implemented until 2015 at the earliest. Changes to the parameters for 2014 would undermine CfD and interconnector auctions that have already taken place.

Any interference at all with PCAP or Uplift Parameters is considered inopportune in light of the market re-design process the Go-Live which is expected at the end of 2016. The proposed changes have huge potential negative impacts in terms of reflecting arbitrary unwarranted regulatory interference which undermines investor certainty, increases market risks and causes regulatory instability with consequences for end consumer prices.

I hope that you find the above comments helpful. Should you have any queries, please do not hesitate to contact me.

Yours sincerely,

Julie-Anne Hannon
Regulatory Affairs – Commercial
Bord Gáis Energy

{By email}