Response by Energia to the Regulatory Authorities Consultation Paper SEM-13-053

Trading and Settlement Code Policy Parameters 2014

3 September 2013

1. Introduction

Energia welcomes this opportunity to respond to the Regulatory Authorities (RAs) Consultation Paper SEM-13-053 on the Trading and Settlement Code (T&SC) Policy Parameters for Calendar Year 2014. Energia is an active member of the Irish Wind Energy Association (IWEA) and the Electricity Association of Ireland (EAI) and we fully endorse their respective submissions to this consultation paper.

Energia would echo the concerns raised by IWEA and EAI regarding the questionable and arbitrary changes proposed to the T&SC policy parameters for 2014 and the damaging and unjustified departure from due process suggested by the RAs. At this time of unprecedented uncertainty, given the need for market reform by 2016 driven by Target Model requirements, market stability is needed more than ever. It is therefore surprising that unnecessary changes are now being proposed to the T&SC policy parameters for the first time since inception of the SEM.

Consistent with IWEA and EAI (and for reasons elucidated in their submissions) we strongly recommend the following:

i. PCAP to remain unchanged at €1,000/MWh for 2014

ii. PLOOR to remain unchanged at minus €100 for 2014

iii. Uplift parameters to remain unchanged for 2014 – i.e.

   - $\alpha = 0$
   - $\beta = 1$
   - $\delta = 5$

In the interests of expediency the remainder of this response will focus on our key concerns with the proposed, highly questionable and unclear changes to the PCAP and Uplift parameters. We would reference the IWEA and EAI responses as supplementary to this submission and we would of course welcome further discussion on any of the points raised herein if that would be helpful.

2. PCAP

It is proposed in the consultation paper that PCAP be increased from €1,000/MWh to €1,200/MWh for 2014. This follows an evaluation of the existing PCAP's effectiveness which states, inter alia, the following:

a) "If SMP is *frequently* being set at PCAP, for reasons other than Insufficient Capacity Events in the MSP software or an inability of the software to reach a feasible solution, then it could be argued that PCAP was set at too low a level and was preventing the proper functioning of the price-setting algorithms in the market software" (p. 7 emphasis added).

b) "However, the PCAP was set at a level in excess of the SRMC of the most expensive unit on the system for all Trading Periods to allow prices to be set as intended by the MSP software without constraint. *PCAP was therefore effective* *in achieving its objectives* – i.e. allowing for variations in SRMC during the year to be reflected in SMP without constraint and ensuring that no generator would be expected to generate at a loss if its SRMC was higher than PCAP" (p. 7, emphasis added).

c) "In the instance where the PCAP was reached…the unit received corresponding Make Whole Payments in that Trading Period to make up for the remaining amount to recover" (p. 7)

d) "In the setting of the parameter values in the SEM, the RAs are cognisant of the need for as much certainty as possible for participants operating in the market." (p.7)

e) "The data presented for the year May 2012 to April 2013 [shows]…*fewer instances* (50 instances) of very high SMP (defined here as more than €300/MWh) as opposed to 71 instances in the 2011-212 period" (p. 7, emphasis added)

f) "The period from January 2013 saw a significant decrease in the price of carbon…Both end-of-year prices and year-ahead prices are considerably lower [70% and almost 69% respectively] than the same period from April 2011 to April 2012" (p. 7).

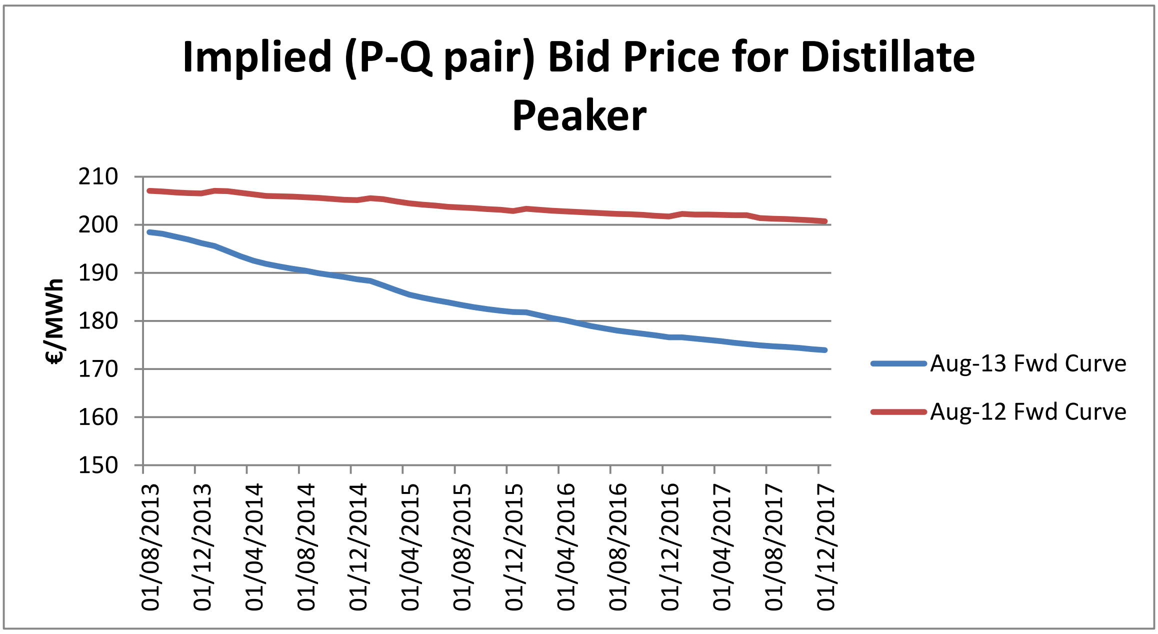
g) "Forward fuel prices for the 2013/14 tariff period (Q4 2013 to Q3 2014) suggest an increase of approximately 6% in day-ahead gas prices when compared to the average gas price over the period May 2012 to April 2013. Coal prices are forecast to be 14% lower during the 2013/14 tariff period as completed with period May 2012 to April 2013. Gas oil and fuel oil forward prices for the 2013/14 tariff year are approximately 4% lower than their average price over the period May 2012 to April 2013" (p. 8).

h) However, while an increase in gas prices is expected over the next 12 months, the RAs would emphasise that when fuel and carbon prices reached record highs in mid-2008, the level of PCAP was maintained at €1,000/MWh (p. 8).

With reference to above it is worth noting the following:

The €1,000/MWh PCAP for 2013 has effectively achieved its objectives. SMP was not frequently set at PCAP and PCAP exceeded the SRMC of the most expensive unit on the system for all Trading Periods to allow prices to be set as intended by the MSP software without constraint. On the one occasion when PCAP was reached (under highly unusual circumstances it should be stressed as discussed further below) the unit in question received corresponding Make Whole Payments and therefore did not generate at a loss as a result of PCAP. Fewer instances of very high SMP have been observed compared to previous years and the forward price of fuel for *the most expensive unit on the system* (oil) has fallen and this has been accompanied by a significant decrease in the price of carbon. Whilst the forward price of gas has increased this is far less relevant to oil and carbon in the context of PCAP. And in any event, it is acknowledged that PCAP was maintained at €1,000/MWh when fuel and carbon prices reached record highs in mid-2008.

It is also instructive to consider the forecast average cost (implied P-Q pair bid price) for a benchmark distillate peaker in the SEM which has been calculated with reference to forward fuel and carbon prices as of 5 August 2013 and 5 August 2012 respectively. This clearly illustrates (on a like-for-like basis) that there is no foundation for increasing PCAP in 2014 based on underlying fuel and carbon prices.



Based on the evidence it would seem reasonable to conclude that a reduction in PCAP is warranted for 2014. It is therefore quite incredible, not to mention arbitrary and inconsistent with a desire to provide certainty to market participants, that a so-called (but anything but) 'modest increase' in PCAP to €1,200/MWh is proposed for 2014.

Apart from its distinct lack of justification the materiality of this proposed change should be recognized in the context of the interaction between PCAP and the capacity mechanism, which the RAs should be aware of. Increasing PCAP to €1,200/MWh potentially reduces the capacity pot by over €10.5m in future years. Given this interaction any potential increase in PCAP should be carefully considered to avoid a disproportionate effect on the market. Viewed in this context, an ill-justified increase in PCAP could also undermine confidence in the regulatory process.

The justification for the proposed increase in PCAP to €1,200 for 2014 is entirely predicated upon one rare and isolated event in February 2013, when a unit was available for only one minute in the trading period where it was committed on. This occurrence is not symptomatic of a wider trend and does not in any way increase the probability of PCAP being reached again or more frequently in 2014. It is not even worthy of further analysis and therefore it cannot reasonably justify an increase in PCAP to €1,200/MWh for 2014. We therefore recommend that PCAP remain unchanged at €1,000/MWh for 2014 and consideration should be given to reducing it based on the evidence.

3. Uplift Parameters

In the absence of the results of suitably robust analysis of the uplift parameters and further consultation on same Energia would consider it highly inappropriate to consider changing these parameters. This combined with the need to respect to stipulated T&SC timelines would preclude any change to the uplift parameters for 2014.

Further required analysis should cover at least a 12 month timeline, and should consider, inter alia, seasonal effects; forced and planned outages; interconnector activity (including EWIC operation); increased penetration of wind; the coal/gas price flip; and new generation. Clearly a forward looking view taking into account the above is required as well as historical analysis. A 3 month timeline as proposed in the consultation paper is not sufficiently robust to inform any decision to change such fundamental parameters given the potential consequences for supplier risk, hedging, and efficient interconnector flows.

The four month notice period as provided for under the T&SC should be adhered to. The proposal to potentially change the existing parameters for 2014, and without compelling reason, before the end of 2013 arguably undermines the legitimacy of the T&SC and certainly disregards the purpose and intent of its stipulations as further detailed below. Sufficient notice of change is required so that market participants can budget for the year ahead and take hedging positions from a supply and generation perspective. Market participants have already concluded significant volumes of CfDs for 2014 and modifying the uplift parameters after those hedges have been executed could expose the parties to material commercial losses/gains that would have accounted for in the strike prices for the various CfD products had they forewarning of a revised basis for SEM price formation.

It is also critical in the interests of transparency, robustness and identifying unintended consequences that all stakeholders are given the opportunity to fully consider the analysis and respond to any proposed changes to the Uplift parameters. The consequences of potentially changing the Uplift parameters need to be very carefully considered, recognising that the damaging effect of increasing the volatility of SMP (increasing supplier risk, reducing liquidity and reducing the efficiency of interconnector trades) could more than outweigh any potential benefits of reducing the overall cost of Uplift.

With reference to above, as further detailed in the IWEA and EAI submissions, Energia recommends the following:

1. No change to the Uplift parameters for 2014
2. The completion of further detailed and rigorous analysis by the RAs and SEMO covering at least a 12 month dataset, which should be forward looking as well as historical.
3. Further consultation on the Uplift parameters for 2015 following publication of the required analysis.