Response by Energia to Single Electricity Market Committee Consultation Paper SEM/13/051

Gas Transportation Capacity Costs Consultation on BCoP Modification Directions

26 September 2013

1. Introduction

Energia welcomes the opportunity to respond to this Single Electricity Market (SEM) Committee consultation (SEM/13/051) on Bidding Code of Practice (BCoP) modification directions in respect of the treatment of gas capacity costs in the SEM. We also acknowledge the opportunity to respond to the SEM Committee Guidance Note and Provisional Good Cause Determination paper (SEM/13/039) contained within the current consultation paper.

The approach adopted by the SEM Committee has been unusual and piecemeal. It would be an unwelcome development if future SEMC consultation consisted in the issuing of provisional guidance following consultation, without a formal decision or consultation on the principles advanced in the guidance, and subsequently looking to consult on the implementation of these principles. This approach cannot be considered good regulatory practice. Our response is structured so as to address the pertinent issues in a consistent and accessible manner, we therefore provide no delineation between the papers in this response but rather assess the consistency and legitimacy of the ultimate position the SEM Committee are seeking to implement in respect of the treatment of gas capacity costs in the SEM.

In summary, this response highlights a number of fundamental errors that are fatal to the legitimacy of the both the SEM Committee's guidance and the proposed modifications to the BCoP. Principal among these points are the following;

- The SEM Committee's interpretation of "costs" and the required treatment of GTC costs in the calculation of SRMC is flawed and is compromised by the inclusion of irrelevant considerations and erroneous arguments.
- The ability to purchase GTC in respect of a trading day, not necessarily on the day, is sufficient to allow for the full cost of GTC to be recovered by the generator, in compliance with the cost-reflective principle contained in Condition 15.1.
- There is no longer a demonstrable "good cause" argument to be made in satisfaction of the approach outlined in the consultation paper for the inclusion of paragraph 12 (Gas Transportation Capacity Costs) in the BCoP.
- The SEM Committee cannot, through the BCoP or any amendment thereof, derogate from the principal requirement of cost-reflectivity in Condition 15 in the Licence.
- The process undertaken by the SEM Committee in respect of this issue has been a significant departure from normal regulatory practice for consultations. They have also displayed a concerning misunderstanding of the bidding principles, despite the clarity provided by the Irish Supreme Court[1].

[1] *Viridian Power Limited & Anor v. The Commission for Energy Regulation & Anor* [2012] IESC 13.

Given the fundamental and fatal errors underlying the SEM Committee's understanding of the relevant Licence and BCoP provisions that form the basis for the Guidance Paper and the present consultation, we request, on the basis of the legitimacy of this guidance and subsequent proposals for enduring change to the BCoP, that the SEMC withdraw both their guidance and this consultation. If the SEM Committee continues to proceed to a decision aligned with this consultation, the SEM Committee will put themselves in the invidious position of being in direct conflict with a relevant judgment of the Supreme Court.

This response, acknowledging the primacy of the Licence, first addresses the requirements of Condition 15 of the Generator Licence, including Short Run Marginal Cost (SRMC) and the principle of cost-reflectivity. The response then considers the BCoP requirements, particularly in relation to paragraph 8. In respect of both the Licence and BCoP we present a summary of the correct legal construction and interpretation of the documents. Section 4 of the response considers the basis for and legitimacy of the BCoP amendments. Section 5 addresses the regulatory uncertainty brought about by the SEM Committee's approach and reasoning, as applied to the treatment of gas capacity costs in the SEM. Finally, section 6 presents a brief summary of the response and offers some conclusions.

2. Short Run Marginal Cost

Within this section we provide; a brief summary of the correct legal interpretation of the Generator Licence and specifically Condition 15; consideration of fundamental flaws in the interpretation by the SEM Committee of Condition 15, and; reiterate Energia's longstanding position in respect of the proper treatment of GTC costs in the SEM which is that all gas-fired generators in the SEM are obliged, under their Licence, to include GTC costs in their bids.

2.1 Review of Licence Condition 15

For a number of reasons outlined elsewhere by the SEM Committee, the SEM is a highly regulated market wherein generators are effectively required to submit bids on a stand-alone basis that reflect the prevailing market price, or replacement cost, of all items used for the purpose of electricity generation, that otherwise would not be incurred. The Generator Licence (Condition 15[2]) is the primary document that regulates generators' bids in the SEM. Largely arising from the majority Supreme Court judgment of Hardiman J in *Viridian Power Limited & Anor v. The Commission for Energy Regulation & Anor*[3], the correct legal construction, interpretation and requirements arising from the Licence are clear and unambiguous. In the context of this response, it is helpful to revise Energia's more detailed submission previously made in respect of SEM/12/089 and to restate the summary points made in relation to the correct legal view of the Licence.

[2] This response refers throughout to Condition 15 of the Generator Licence issued by CER. We note the equivalent provision is contained in Condition 17 of the Generator Licence issued by the Utility Regulator (UR).
[3] [2012] IESC 13.

Licence (Condition 15)

1. The term "total costs" is to be interpreted with recourse to its ordinary and natural meaning and is to could equally be considered to be "all costs", of the same kind.[4]
2. "*[I]t is not lawful for an operator in this market to engage in below cost selling, or to exclude any actual costs from the category of "total costs*".[5]
3. The definition of "total costs" is to refer to all cost items incurred by the generator in generating electricity with respect to a trading day, as determined by Condition 15.3. This condition is separate and distinct from the method of valuing these costs.
4. There is no reference in the relevant licence condition (Condition 15) to a day-ahead requirement or any temporal restrictions on costs considered to be within the "total costs" of generating, as outlined in Condition 15.3.
5. Condition 15.4 requires the value of such costs to reflect the "Opportunity Cost" of the cost item on the relevant trading day. The methodology for determining the "Opportunity Cost" is provided for in Condition 15.5 and determined in the BCoP. The implication of this provision is *inter alia* to allow for actual accounting costs incurred by the generator to differ from the costs submitted in bids.
6. "*[T]here is nothing in the language of Condition15.7 which suggests that the Commission is given any power of interpretation of the licence…There is nothing in the terms of the licence, in my view, which confers on the Commission any powers of interpretation over the terms of the licence itself*."[6]

2.2 Gas Capacity, SRMC & the SEM Committee

Underpinning this consultation is the SEM Committee Guidance Note to market participants (SEM/13/039) within which the SEM Committee provide their understanding of Condition 15 of the Licence. It is Energia's view, consistent with that of advice received, that this stated interpretation is defective and as such fundamentally impairs the conclusions of the Guidance note and subsequently the premise for the BCoP amendment.

In SEM-13-039 the SEM Committee accepts that the costs associated with Gas Transportation Capacity (GTC) are 'costs' for the purposes of paragraphs 1 to 3 of Condition 15[7]. This is consistent with the Supreme Court findings[8]. However, the SEM Committee's understanding of paragraph 1 of Condition 15 appears to be clearly defective and inconsistent with that of the Supreme Court. The SEM Committee state that they consider; "that paragraph 1 of Condition 15/17 operates such that, in formulating and submitting its COD, a generator is required to form an expectation as to the costs (including those associated with GTC) which its plant

[4] [2012] IESC 13 at 40.
[5] [2012] IESC 13 at 49.
[6] *Viridian Power Limited & Ors v. Commission for Energy Regulation & Anor* [2011] IEHC 266 at 38.
[7] SEM/13/039 at para 4.4.
[8] [2012] IESC 13.

would, in fact, incur were it called upon to generate or not"[9] (emphasis added). The costs a plant would "in fact" incur is immaterial to the construction and proper interpretation of the Licence and BCoP provisions. Generators are required to identify all cost items associated with the ownership, operation and maintenance of a plant that are unique to that plant generating. This is the stated scope of Condition 15(1-3) in identifying "all costs" and the valuation of these costs is a separate exercise undertaken in the BCoP (Condition 15.5).

The SEM Committee's misunderstanding on paragraph 1 of Condition 15 is central to the flawed interpretation of the treatment of GTC costs in generators bids and from it stems a number of other false interpretations that cannot be supported by the requirements contained in relevant provisions of Condition 15 or the BCoP. **Given the clearly incorrect understanding of the SEMC of this vital element of the licence, we request that the SEMC withdraw their guidance note and this consultation**.

A related issue with the SEM Committee's interpretation is the role they seek to prescribe to trading strategies or contractual positions. The SEM Committee place considerable reliance on generators' expectations in order to justify their stated approach but the costs a generator would expect to "in fact" incur is immaterial. To the extent that expectations play a part, it should be limited to the submission of Commercial Offer Data (COD), something divorced from actual costs by the Licence through the calculation of SRMC (Condition 15.3). However, it is accepted that, within the permitted confines of Condition 15, expectations play a part in identifying relevant cost items unique to generation. For present purposes, this point is easily explained by reference to a generator's expectation of incurring gas transportation capacity costs.

By not generating, a generator does not expect to incur any GTC costs. It is only in generating that a generator would expect to incur such costs. GTC is not a cost associated with the ownership, operation or maintenance of a plant that is not generating on a Trading Day, as GTC is not required for any purposes other than electricity generation. It therefore must fall squarely within the definition of "total costs" as outlined in Condition 15.3(a) only and for COD to comply with Condition 15.1, this cost, valued in accordance with the BCoP, should be included. Quite apart from accommodating a generator's trading strategy or contractual positions, the requirements of Condition 15 and the BCoP are to remove potential differences attributable to these strategies/positions and to create a level playing field based on a cost-reflectivity principle that obliges generators to include "all costs" associated with generation on each distinct trading day, that they would not otherwise incur. It is clear that in respect of a trading day, no generator would willingly incur GTC costs to not generate. The fact that a generator may hold a long term gas capacity booking is no more material, for the purposes of generators bids, than are the terms of a long term commodity contract (e.g. take-or-pay) for the purchase of gas.

[9] SEM/13/039 at para 4.4.

Arising from this erroneous inclusion of trading strategies into the proper interpretation of SRMC under Condition 15, the SEM Committee propose three fundamentally flawed categories of generators. Simply put, to satisfy the cost-reflectivity principle of Condition 15, "all costs" attributable to generation must be identified and these form the basis of a generator's SRMC; it is not possible to generate without incurring some GTC cost and GTC costs are not required to be incurred when not generating, therefore, irrespective of trading strategies or contractual positions, Condition 15 obliges the inclusion of GTC costs in all SEM gas fired generators' COD.

Analogously, the treatment of a generator's fuel costs (e.g. gas) incurred to generate electricity is not considered to be dependent on whether the gas is purchased within-day or is delivered under a long term contract. Applying the GTC cost argument advanced by the SEM Committee to fuel costs would suggest that fuel supplied under a long term contract are both a "cost" of generating (Condition 15.3(a)) and of a "cost" of not generating (Condition 15.3(b)), as it is the generators ability to dispose of the commodity that subsequently adjusts the "cost" of not generating, such that this cost is netted off. Any suggestion that this scenario reflects the correct interpretation and operation of Condition 15 would be fanciful and absurd. For the purposes of Condition 15, a generator incurs fuel costs attributable to the generation of electricity only when they generate. There is no "cost" for the purposes of Condition 15 associated with fuel costs (or GTC costs) where a unit is not generating. Furthermore, the methodology contained in Condition 15.3 makes no reference to the resale or disposal of cost items and an interpretation dependent on such approach would appear to be unsupported by the plain and authoritative words of the Licence.

2.3 Conclusions

In summary, the SEM Committee's interpretation of how GTC costs are to be included as SRMC is flawed. Through the inclusion of irrelevant considerations and erroneous arguments, the SEM Committee interpret the plain words of the Licence and BCoP in a manner unsupported by the text and as such are proposing to act contrary to the unambiguous findings of the Supreme Court and in a way that is *ultra vires*.

GTC costs on a trading day are not required to be incurred by a non-generating gas-fired generator in respect of the ownership, operation and maintenance of a plant. While these costs may be incurred by such a generator in practice, this is the result of a commercial decision of the generator to enter into a forward contract, the terms of that contract are immaterial to the exercise to be undertaken under Condition 15. Were a generator prevented from recovering the costs of GTC associated with generation when they generate, due to their GTC contractual position, this situation would not be consistent with the cost-reflectivity principle outlined in Condition 15.1.

Having dealt exclusively with SRMC, it is now pertinent and in accordance with the proper construction of the Licence and BCoP, to now move to consider the valuation of this identified cost.

3. Valuation & Good Cause Determination

Similar to the previous section, the structure of this section first considers the correct legal interpretation of the BCoP before moving to a critique the SEM Committee's flawed understanding of paragraphs 7 and particularly paragraph 8 of the BCoP. Included within this critique is an analysis of the legitimacy of the provisional "good cause" determination which now appears unfounded following the CER decision to remove secondary capacity in CER/13/191.

3.1 Review of BCoP

In light of the review and discussion in the preceding section, it is useful to summarise the Supreme Court's findings in relation to the interaction between the relevant provisions of the Licence and BCoP, in particular any requirements that must be respected by both generators and the SEM Committee, before considering the BCoP further.

Interaction between Licence & BCoP

1. *"[I]n relation to the terms of the licence and the BCoP one must first note the primacy of the licence….The BCoP, therefore, is a document derivative from the licence and whose scope is defined by the licence."*[10]
2. *"The licence first establishes the obligation of cost reflectiveness and the obligation to quantify one short-run marginal cost in terms of "total costs""*[11], the judgement goes on to affirm, *"[I]t will be noted that BCoP is not permitted to derogate from the requirements of cost reflectiveness, or the requirement to calculate short-run marginal cost by reference to "total costs"."*[12]

As with the previous section, a summary of the points made in response to SEM/12/089 are restated herein, contained the correct legal view of the BCoP.

Bidding Code of Practice

1. "*It will be noted that BCOP is not permitted to derogate from the requirements of cost reflectiveness, or the requirement to calculate short-run marginal cost by reference to "total costs"*."[13]
2. "*Paragraph 6ff of the Bidding Code of Practice appears to me to be concerned with matters of calculation and not of the exclusion of any item from the category of "total costs"*."[14]
3. "*Paragraph 7 says that the opportunity cost shall comprise the value "of the benefit foregone" by a generator in employing that cost item for the purpose of electricity generation. This is to be done "by reference to the most valuable realisable alternative use of that cost item for purposes other than electricity generation".*

[10] [2012] IESC 13 at 46.
[11] *ibid*.
[12] [2012] IESC 13 at 47.
[13] [2012] IESC 13 at 47.
[14] *ibid.*

This paragraph, again, does not appear to me to exclude any item from the category of "total costs"."[15]

4. "*Paragraph 8 of the BCOP provides method of calculating the value of a benefit foregone, and talks in terms of market price, where there is a market in the item in question, or the costs of replacing it where there is not.*"[16]
5. The BCoP is entirely related to the methodology to be applied in valuing costs and it is this methodology that is to apply, unless there is "good cause not" to employ it (Para. 8). Importantly, where the methodology (Para. 8(i) or 8(ii)) is not to be followed, an alternative method of valuation must be provided which ensures compliance with the licence requirement for "total costs", determined as SRMC, to be fully recovered. Previously, in the case of a cash levy, the computation of which was statutorily provided for, the "good cause" clause was found to be redundant.[17]
6. "*It therefore appears that the appellants are not merely entitled but are obliged to make sure that the offer price which they make to the Regulator is equal to their short-run marginal costs of generation.*"[18]

3.2 Gas Capacity, BCoP & the SEM Committee

Energia has previously argued that the value for GTC, with reference to paragraph 8 of the BCoP, is the price of primary daily gas capacity from the Transporter. In the first instance, we have contended that the sale of daily gas capacity by the transporter represents a RAGATM and as such can be valued at the prevailing regulated price in the market (paragraph 8(i)). Despite the SEM Committee's "doubts" that primary gas capacity does not constitute a RAGATM, it is unclear that the reasons given (a regulated market with only one seller) sufficiently support this "doubt" upon which they are unwilling to recognise the primary market as a RAGATM. Nevertheless, we have also contended in the alternative that in the event that there is deemed not to be a RAGATM in gas capacity, the presence of the daily product itself provides a clear "replacement cost" (paragraph 8(ii)) for daily GTC.

Importantly, **on a correct reading of the construction and requirements contained in the relevant sections of the Licence and BCoP, it is the mere presence of a daily capacity product that allows such a product to be valued**. It is therefore irrelevant whether any generator actually uses the product or whether the product itself is available for use by any one particular generator. As a cost item within SRMC, the BCoP is obliged to value the cost to ensure compliance with the cost-reflectivity principle of Condition 15.1 and it can do nothing to remove costs that have been identified therein[19]. The methodology by which the generator is obliged to value the cost items of the COD is laid out in paragraph 8 of the BCoP and is to be with reference to;

i. the market price in a RAGATM; or,

[15] [2012] IESC 13 at 48.
[16] *ibid*.
[17] *ibid.*
[18] [2012] IESC 13 at 49.
[19] [2012] IESC 13 at 47.

ii. the replacement cost (if no RAGATM); or

iii. by some other method if the SEM Committee is satisfied that there is good cause not to apply either of the preceding methods.

It is the SEM Committee's view in this instance that (iii) applies but in light of the recent CER decision on financing the gas transmission network (CER/13/191), it is appropriate to review the "good cause" argument relied upon by the SEM Committee in both SEM/13/039 and SEM/13/051, particularly in respect of the replacement cost approach.

CER/13/191 sanctioned the removal of both the secondary market for gas capacity products (01 October 2013) and within-day gas capacity products (as soon as practicably possible). While this decision may do little to resolve the "doubts" expressed by the SEM Committee in relation to primary daily capacity market as a RAGATM, it has significant bearing on the rationale forwarded for relying on a "good cause" approach, as opposed to the replacement cost provision contained in paragraph 8(ii). The SEM Committee's decision to apply a "good cause" determination is based on the following conclusions;

a. the extent of dubiety around whether either primary or secondary capacity arrangements can properly be characterised as RAGATM;

b. the lack of substitutability, for replacement purposes, between primary and secondary capacity and the complexity and uncertainty which that creates, and;

c. the problems associated with applying the replacement cost principle in paragraph 8(ii) of the BCoP.[20]

These problems are detailed as being;

i. an inability to identify whether the generator would avail of primary or secondary capacity[21]

ii. a difficulty in reconciling paragraph 7 with paragraph 8(ii)[22]

iii. it may not fully reflect the scope to realise value from the sale of GTC

iv. it may be prone to manipulation or misstatement.

Having already addressed (a), the issues raised in (b) are no longer an issue (from 01 October 2013) with the removal of the secondary market. In respect of (c), a number of comments are warranted. First, (c(i)) is no longer an issue (from 01 October 2013). Secondly (c(ii)), it is the observance of the methodology contained in paragraph 8 of the BCoP that compliance with the general principle of paragraph 7 is satisfied. It would be an absurd suggestion for the SEM Committee to make, that adherence to paragraph 8 (methodology for calculating opportunity cost) violated the general principle of opportunity cost set out in paragraph 7. It is important to note that the exercise contained in paragraph 8 is in no way dependent on the actual

[20] SEM/13/039 at para 4.28.
[21] SEM/13/039 at para 4.22 & 4.24.
[22] SEM/13/039 at para 4.23.

actions of the generator buying or selling any cost items or the actual costs incurred or the contractual position of the generator but rather merely an exercise in valuing cost items already utilised in the generation of electricity[23]. As paragraph 8 is applied in respect of all other comparable cost items to determine the appropriate "opportunity cost", there is no rationale forwarded or any apparent distinction between GTC and other "costs" (e.g. fuel costs) which would prevent the same approach being applied; namely, use paragraph 8(i) or 8(ii) to calculate the "value of the benefit foregone in employing a cost item for the purposes of electricity generation"[24]. In fact, generators are obliged to apply paragraph 8 in satisfaction of paragraph 7 under the wording or paragraph 8 and in the absence of "good cause". Thirdly (c(iii)), the ability of the generator to sell capacity is irrelevant and **the ability to purchase GTC in respect <u>of</u> a trading day, not necessarily <u>on</u> the day, is sufficient to allow for the full cost of GTC to be recovered by the generator in adherence to the cost-reflective principle**. Finally (c(iv)), it is unclear in the simplified scenario of only primary capacity being available, where manipulation or misstatement can arise by reference to a regulated tariff.

On the basis of this assessment, there no longer appears to be a legitimate basis for the SEM Committee to continue with the provisional "good cause" determination, as it can no longer be demonstrated, on the basis of the arguments already advanced, that there is "good cause" to disapply the provisions of paragraph 8, particularly paragraph 8(ii).

Furthermore, it should be noted that many of the issues raised by the SEM Committee in respect of the application of paragraph 8 are considered to be of their own construction, arising from erroneous conclusions and incorrect interpretation of the relevant Licence and BCoP requirements. The absolute and unequivocal requirement of the BCoP is to ensure compliance with the cost-reflective principle of Condition 15 through valuation of cost items at their opportunity cost, as defined in paragraph 8 (or elsewhere in limited circumstance), and it cannot derogate from this requirement. **Consistent with the treatment of other costs, GTC costs can clearly be valued under the existing provisions of paragraph 8(i) or 8(ii)**, particularly following the decision of the CER to restrict the availability of products in CER/13/191. **Condition 8(ii) of the BCOP has been drafted specifically for the purpose of valuing cost items in circumstances where a recognised and generally accessible trading market does not exist**.

3.3 Conclusions

In respect of the current consultation, therefore, it is Energia's firm view that there is no longer a demonstrable "good cause" argument to be made in satisfaction of the approach outlined in the consultation paper for the inclusion of paragraph 12 (Gas Transportation Capacity Costs) in the BCoP.

[23] Where a generator is to receive any payment from the market, with the exception of constrained (down) operations, it is necessary for the generator to have expended the cost items for which full cost-reflective recovery is being sought in accordance with SRMC. It is not that the generator faced any choice as to what to do with the cost items required for the purposes of electricity generation.
[24] AIP, *The Bidding Code of Practice – A Response and Decision Paper*, AIP/SEM/07/430 at 10.

4. Modifying the BCoP

A central conclusion of the analysis undertaken in the previous section on the SEM Committee's rationale for the provisional "good cause" determination, is that there is little or no valid remaining reason by which the SEM Committee could seek to rely on "good cause" to determine an alternative valuation methodology for GTC costs within the BCoP. This section considers further restrictions on such an approach, as well as the proposals to include new principles of "good market behaviour" in the BCoP, specifically with respect to GTC costs (proposed paragraph 12).

Summarising points already made elsewhere in this response, including the findings of the Supreme Court, it is Energia's view that;

1. It is not open to the SEM Committee to amend the BCoP to require generators to exclude an actual cost item (which forms part of "total costs" attributable to generation on a trading day) from their COD.
2. It is not permissible for generators to engage in below cost selling and therefore any attempt to restrict or prohibit the full recovery, valued in accordance with the BCoP, of any cost item risks breaching this principle.
3. "Total cost" has been held to refer to "all costs" and therefore, it would not be permissible for the SEM Committee to prohibit a generator from recovering a cost incurred and attributable to generation.

Under the provisions of paragraph 5(c) of Condition 15 of the Licence the SEM Committee has the power to "set out such other principles of good market behaviour as, in the opinion of the [Commission/Authority] should be observed by the Licencee and other generators in carrying out the activity to which paragraph 1 refers". It is important to recognise that this provision is not an absolute power to set out, in the view of the Committee, principles of "good market behaviour" but rather "good market behaviour" principles can only be implemented in furtherance of the cost-reflectivity principles contained Condition 15.1.

Relating this somewhat restricted power of the SEM Committee to the two new proposed principles of "good market behaviour" (12(c) and 12(d)), the following represent the views of Energia and reflect advice received.

1. Proposed paragraph 12(c) is unnecessary in the context of a market regulated and monitored by the Regulatory Authorities (RAs) and the Market Monitoring Unit (MMU). No similar requirement is contained in paragraph 8 of the BCoP and this new provision provides no added benefit to the already existing requirements contained in the Licence and BCoP. Nevertheless, as a principle of reasonableness is already considered to be inherent in the bidding requirements, this not considered to be a material change to the BCoP.
2. Proposed paragraph 12(d) is more problematic and there are serious reservations in relation to the legitimacy of the inclusion of this principle in the BCoP. The pertinent issues that would appear to be insurmountable for the legitimacy of this proposed new paragraph are as follows;

a. As already outlined herein, the Supreme Court ruling clarified that the BCoP cannot be used to exclude a cost from the "total costs" of a generator. To the extent that an overrun or uninstructed flow charge is a cost attributable to the generation of electricity, the BCoP is required to value the cost item and cannot expressly exclude it as to do so would be *ultra vires* the primacy of the Licence and its requirement for cost-reflectivity.

b. Furthermore, it is not possible for the SEM Committee to include a principle of "good market behaviour" for the purpose of requiring generators to include a cost item in a manner which does not adhere to the cost-reflectivity principle of Condition 15.1. As with the Carbon Revenue Levy, any such charge levied in respect of overrun or uninstructed flows is considered to be a cost attributable to generation and with an opportunity cost equivalent to the cash cost used to pay the charge. Consistent with the Supreme Court ruling, generators would be obliged to include the cash cost of such a charge in their COD.

c. It is not open to the SEM Committee to include principles of "good market behaviour" in relation to general generator behaviour, it is restricted by the text of Condition 15.5(c) to Condition 15.1. Therefore, no principle of "good market behaviour" the SEM Committee may seek to implement could oblige generators to purchase specific capacity products, or indeed to purchase gas capacity. While the SEM Committee may consider such behaviour to be "good market behaviour", it is *ultra vires* the discretion explicitly afforded to them in Condition 15.5(c).

In addition, it is worth noting a number of further points in relation to the proposed new principles of "good market behaviour". The proposed "penalties principle" (paragraph 12(d)) and the SEM Committee view that penalty charges are not necessarily "costs" for the purposes of Condition 15 or would fall within a generator's SRMC[25], gives rise to two principal issues. First, it is a long established principle of the common law that penalty clauses in contracts are unenforceable.[26] The Code of Operations is both a regulatory and a contractual document and to the extent that it is contractual, penalties are unenforceable. It is noted that there is a well-established principle that fines and penalties can only be imposed by regulatory bodies if they are expressly authorised by legislation. We are unaware of any such legislation in regard to this matter. Furthermore, to the extent that overrun charges and unauthorised flow charges are imposed as penalties to incentivise particular behaviour(s), they would appear to be penalties at law and so be unenforceable.

Secondly, to the extent that such charges are not penal but rather reflect the cost of the Transporter in managing flows without a concomitant capacity booking, such costs are deemed to be enforceable. However, such costs would represent a "cost" (Condition 15) attributable to generation on a trading day and as such a generator would be obliged to include such a cost in their COD.

[25] SEM/13/051 at para 4.10.
[26] *Dunlop Pneumatic Tyre Company Limited v. New Garage and Motor Company* [1915] AC 79.

In conclusion to this section it is Energia's view, in accordance with that of our advisors, that the SEM Committee cannot, through the BCoP or any amendment thereof, derogate from the principal requirement of cost-reflectivity in Condition 15 in the Licence. In fact, amendments to the BCoP and "principles of good market behaviour" are only permissible to the extent that they act in furtherance of Condition 15.1. It is not a discretion of general application but rather it is a specific and restricted discretionary power conferred on the SEM Committee to ensure compliance with the Licence. The proposed new principle of "reasonableness of assessments" seems to be somewhat superfluous given the operation of the existing bidding regime and, the continued regulation and monitoring of the market by the RAs and MMU. Finally, in respect of this proposed "penalties principle", the arguments relied upon by the SEM Committee are without merit, thus removing the legitimacy of the inclusion of this principle in the BCoP.

5. Regulatory Stability

In respect of the issue of the treatment of gas capacity costs in the SEM, the SEM Committee have been responsible for an unnecessarily long, piecemeal and deficient process of consultation. The deficiency in the process is not limited to the SEM Committee's sporadic and unclear communications but also extends to the papers that have been issued which contain inconsistencies with both established SEM bidding principles and the correct legal interpretation of the relevant Licence and BCoP provisions, provided primarily by the majority judgment of Hardiman J[27] in the Supreme Court.

With regard to the consultation process, the SEM Committee has taken an inordinate amount of time to deal with this issue from the point of first consideration following correspondence from Energia in February 2012. As an issue identified as being of highest importance to generators in the SEM, the SEM Committee's approach has, for the majority of this time, appeared to be one of general neglect with rare interactions with market participants which were typically followed by extended periods of inactivity. Regulatory authorities are tasked with dealing with difficult issues and making hard decisions, and all of this should be done in a timely fashion. In this instance the SEM Committee appear to have delayed dealing with this difficult issue and this must be seen to be to the detriment of the regulatory regime in the SEM and contrary to the statutory duties of both regulators. In the absence of discretion in relation to "costs", the SEM Committee should not seek to rely on delay and the erroneous implication that by doing so they are complying with their primary duty. Compliance with the plain and unambiguous words of the Licence is a legal requirement which extends beyond the objective and functions to be pursued by the SEM Committee.

Regulatory stability and certainty was further undermined by the unusual approach taken by the SEM Committee to publish a consultation, followed by a provisional but binding Guidance Paper (SEM/13/039) and followed by a consultation on the enduring implementation of the Guidance Paper principles which, until this

[27] [2012] IESC 13.

consultation, were decided upon without consultation with industry. While this approach is unusual, the uncertainty and instability is compounded by the presence of an existing decision prohibiting the inclusion of gas capacity costs in generators COD, which we are unaware of being explicitly repealed, and the legitimacy of attempting to implicitly do so in a Guidance Paper. Also, the CER consultation on gas capacity products (CER/13/122) that was commenced and concluded during the course of the SEM Committee's deliberations on this matter, created and continues to impose substantial uncertainty on generators, and has potential implications for compliance with the Guidance Paper. It is noteworthy that despite repeated assurances from the CER that CER/13/122 was separate and distinct from the SEM Committee's consideration of gas capacity costs, the CER decision (CER/13/191) is to implement proposals contained in the Poyry report to the SEM Committee on gas capacity costs identified as options for change in the gas market that would mitigate the impact of including GTC costs (primary and secondary products) in generators' bids.[28]

Furthermore, as discussed herein, there are a number of fundamental and fatal errors contained in the SEM Committee Guidance Paper which are reinforced and underpin the proposals in the present consultation (SEM/13/051). It is therefore clear that the present proposals cannot legitimately be implemented and it would therefore appear to be incumbent on the SEM Committee to withdraw the Guidance Paper and the current consultation.

In the context of this general discussion it is worth making two further brief points. First, the SEM Committee has a statutory duty to have regard to the need to ensure that undertakings are capable of financing their activities. There is no evidence from any of the SEM Committee papers on this issue that any regard has been given to investigate the implications of the Guidance Paper or the proposed BCoP modifications on generators.

Secondly, while the SEM Committee has the explicit power to amend both the Licence and BCoP, it would seem inconsistent and legally uncertain for any proposed amendment of the BCoP to alter compliance with the Licence, without subjecting the amendment to the same regulatory and statutory requirements applied to Licence amendments.

In summary, there appears to have been a significant departure from normal regulatory practice in respect of this consultation. The SEM Committee has displayed a concerning misunderstanding of both the relevant Generator Licence conditions (i.e. Condition 15) and the correct legal construction and interpretation of the Licence and BCoP provisions in respect of a generator's COD, despite the clarity provided by the Irish Supreme Court[29]. Regulatory stability is not a reference to no regulatory change but rather to a regime of predictable changes arising from certainty attributable to the legal documents governing the role of both generators and the SEM Committee in this market.

[28] Poyry, Treatment of Gas Transportation Capacity Costs in Commercial Offer Data, a report to the Utility Regulator and the Commission for Energy Regulation , May 2013.
[29] [2012] IESC 13.

6. Summary & Conclusions

In summary, this response highlights a number of fundamental errors that are fatal to the legitimacy of the both the SEM Committee's guidance and the proposed modifications to the BCoP. Principal among these points are the following;

- The SEM Committee's interpretation of "costs" and the required treatment of GTC costs in the calculation of SRMC is flawed. Through the inclusion of irrelevant considerations and erroneous arguments, the SEM Committee interpret the plain words of the Licence and BCoP in a manner unsupported by the text and as such are proposing to act contrary to the unambiguous findings of the Supreme Court and in a way that is *ultra vires*.
- The ability to purchase GTC in respect of a trading day, not necessarily on the day, is sufficient to allow for the full cost of GTC to be recovered by the generator, in compliance with the cost-reflective principle contained in Condition 15.1.
- There is no longer a demonstrable "good cause" argument to be made in satisfaction of the approach outlined in the consultation paper for the inclusion of paragraph 12 (Gas Transportation Capacity Costs) in the BCoP. Consistent with the treatment of other costs, GTC costs can clearly be valued under the existing provisions of paragraph 8(i) or 8(ii). Condition 8(ii) of the BCOP has been drafted specifically for the purpose of valuing cost items in circumstances where a recognised and generally accessible trading market does not exist. GTC costs are no different to other costs attributable to generation on a trading day.
- SEM Committee cannot, through the BCoP or any amendment thereof, derogate from the principal requirement of cost-reflectivity in Condition 15 in the Licence. In fact, amendments to the BCoP and "principles of good market behaviour" are only permissible to the extent that they act in furtherance of Condition 15.1. It is not a discretion of general application but rather it is a specific and restricted discretionary power conferred on the SEM Committee to ensure compliance with Licence Condition 15.1.
- The process undertaken by the SEM Committee in respect of this issue has been a significant departure from normal regulatory practice for consultations. The SEM Committee has displayed a concerning misunderstanding of both the Generator Licence (Condition 15) and the correct legal construction and interpretation of the Licence and BCoP provisions in respect of a generator's COD, despite the clarity provided by the Irish Supreme Court[30].

Given the fundamental and fatal errors underlying the SEM Committee's understanding of the relevant Licence and BCoP provisions that form the basis for the Guidance Paper and the present consultation, we request, on the basis of the legitimacy of this guidance and subsequent proposals for enduring change to the BCoP, that the SEMC withdraw both their guidance and this consultation. If the SEM

[30] *Viridian Power Limited & Anor v. The Commission for Energy Regulation & Anor* [2012] IESC 13.

Committee continues to proceed to a decision aligned with this consultation, the SEM Committee will put themselves in the invidious position of being in direct conflict with a relevant judgment of the Supreme Court.