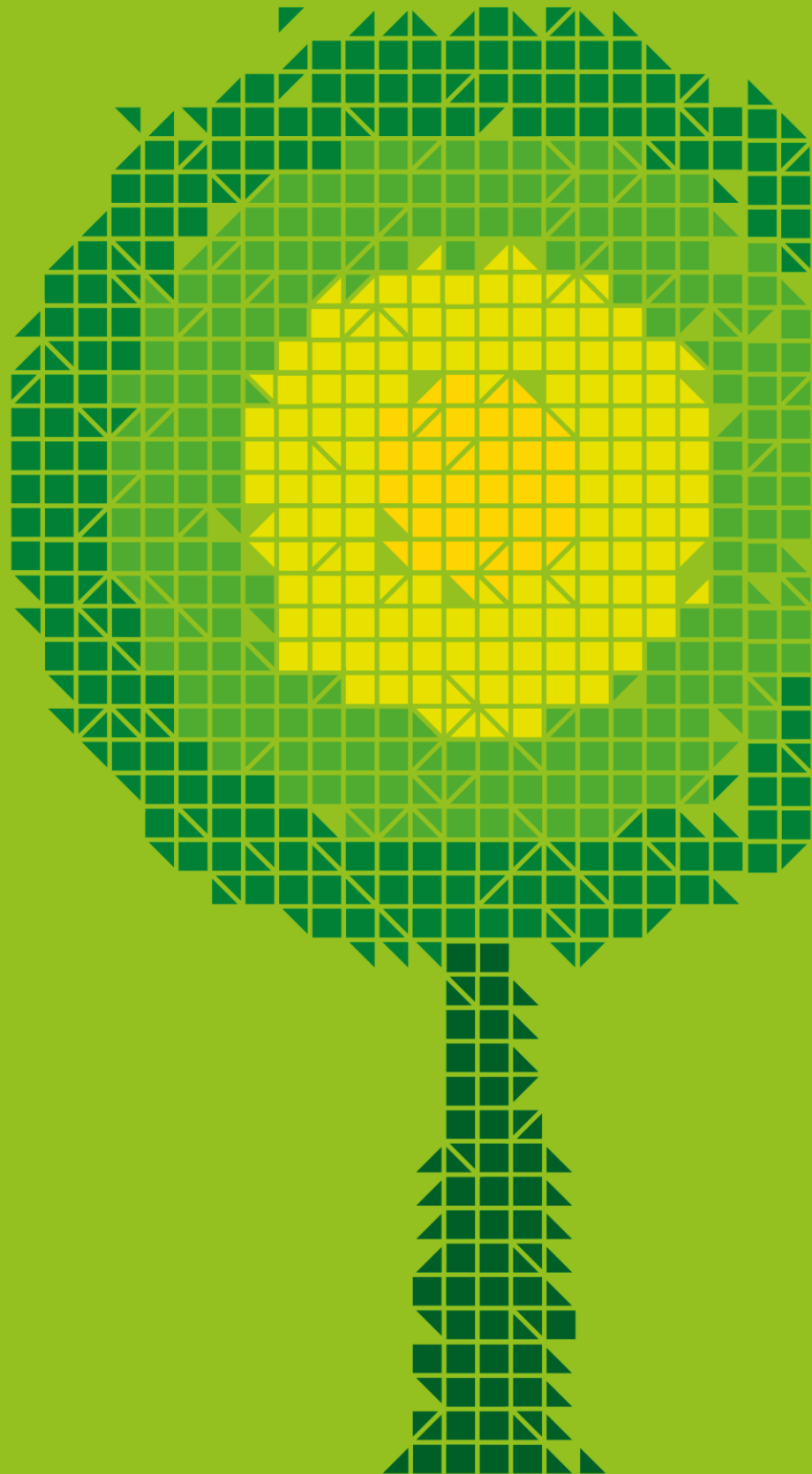


# Consultation on the Aggregator of Last Resort Framework

23 January 2015

Consultation Response



Gemserv



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**23rd January 2015**

Dear Warren and Kenny,

Gemserv welcomes the opportunity to respond to the Regulatory Authorities' consultation on the Aggregator of Last Resort Framework (SEM-14-106).

Gemserv specialises in putting government policy into practice. Gemserv is a specialist energy, utility and environmental service provider operating in the UK and Ireland. We have significant experience supporting the Regulatory Authorities on SEM and SEM-related matters and in utility market design in the UK. The proposed Aggregator of Last Resort (AOLR) mechanism may provide an innovative route to market participation for renewable generators within the context of I-SEM. As a potential AOLR service provider, we have a keen interest in the shape of the framework.

Our heritage as a central service provider to industry underpins much of our company ethos. Working predominantly at market level, in the best interests of the energy and environmental markets, our response is informed by three main beliefs:

- A commitment to making complex utility markets work for everyone. Gemserv is supportive of market oriented approaches but they must be underpinned by the correct rules, regulations and governance;
- Empowering the customer with choice and the promotion of energy efficiency and renewable generation in the widest sense at the user level. This belief manifests itself in work on smart energy, renewable generation and an interest in smart energy as a facilitator for customer empowerment;
- Regulators and agencies having an appropriate mandate and scope to discharge their functions under the legal and regulatory framework. Such bodies need to be funded and resourced in line with achieving that mandate.
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Given our heritage and close links with regulators and the importance of this consultation to the Irish energy sector, Gemserv would appreciate the opportunity to engage further with the Regulatory Authorities on this matter.

Yours sincerely,



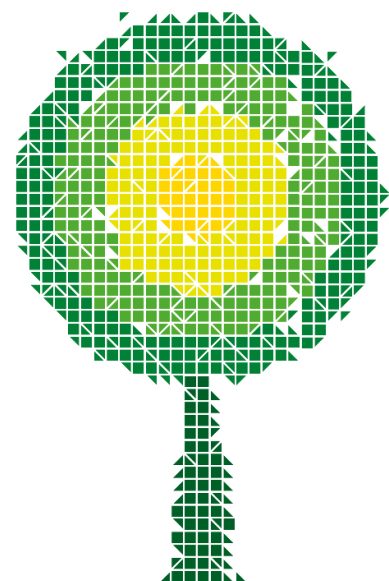
Conall Bolger  
Senior Consultant (Ireland)



# 1. INTRODUCTION

Gemserv welcomes the broad thrust of the approach proposed by the Regulatory Authorities (RA) in the consultation paper on the Aggregator of Last Resort (AOLR) Framework. Where this response has raised concerns or potential issues with implementation, these should be viewed within the context of support for an AOLR mechanism and for the operation of a competition to appoint an AOLR.

Gemserv wishes to commend the RAs on the quality of the consultation paper. The paper is very clear on the options presented and provides a concise discussion of the high level features involved in the development of what will be a significant innovation within the market.





## 2. RESPONSES TO QUESTIONS

In this section, Gemserv provides responses to the specific questions within the consultation paper.

### 2.1 POTENTIAL AGGREGATOR OF LAST RESORT MODELS (SECTION 4)

#### 1. Do you agree with the potential functions of the AOLR as outlined? Are there any additional functions that the AOLR could potentially perform in I-SEM?

The list of activities in the paper seems to be an appropriate set of functions for the role of the AOLR as envisaged within the I-SEM High Level Design (HLD) and this consultation paper. Some of the benefits of these functions include:

- Managing complexity – the functions “Undertaking trading in the DAM, IDM and BM on behalf of eligible generators” and “Submission of nominations to the TSO” would benefit generators participating in the AOLR by managing the complexity of market trading on their behalf.
- Management of risk – the function “Pooling of risks across the portfolio” helps manage the forecasting and balancing risk for users of the AOLR participants.
- Managing liability – the function of “Assuming market responsibilities (e.g. Signing up to Trading and Settlement Code)” permits the management of potential liabilities for generators in the AOLR and ensures they do not take on undue responsibility within the market.

We believe there is a need for the RAs to build in a degree of flexibility to allow the role of AOLR to evolve in the future. One mechanism might be to permit a review of the functions after six months of operation to investigate if the functions are

appropriate for the needs of participating generators and not creating any unforeseen market distortions. If, as discussed in the response to question 11, the RAs are minded to permit smaller non-wind generators to use the AOLR, the Pooling of Risks Across the Portfolio function may need redrafting to reflect the different portfolios under the management of the AOLR.

#### 2. Which of the three models proposed in this paper do you think should be implemented? If none, are there alternative models to the ones proposed that should be considered?

Gemserv considers an amalgam of Options 1 and 2 as conducive to encouraging participating within the AOLR. Generators participating in the AOLR can select the option appropriate for their organisation’s scale and expertise. Option 3 is a model that limits the functions of the AOLR, and it mitigates much of the benefit of the AOLR model. By the AOLR not undertaking the management of market liability, it could create greater risk for the market participant that is likely to be availing of the services of the AOLR and provide them with sub-optimal income.

The types of organisation participating in the AOLR may vary significantly in terms of scale, complexity and ability. They could range from more traditional utility-style organisations to small-scale independent power producers with minimal staff. Various organisations will possess different appetites for risk and different levels of capability for engaging with the market systems.

Gemserv is proposing that the AOLR should consist of two portfolios of wind farm participants. One portfolio would be managed in a manner consistent with Option 1 and the other portfolio would be managed consistent with Option 2. For example, a smaller independent wind farmer could have their



output managed in a fashion consistent with Option 1, while a larger organisation with greater resources could be more active and be managed in a fashion consistent with Option 2. Participants could opt in to the portfolio appropriate for their organisation, capabilities and appetite for risk. This degree of optionality could be valuable in encouraging take up by potential AOLR participants.

## 2.2 GOVERNANCE OF THE AGGREGATOR OF LAST RESORT ENTITY (SECTION 5)

### 3. Would you consider providing aggregation services in the new market? If so, would you consider being the AOLR service provider?

Gemserv would consider being the AOLR service provider as the role is consistent with the three principles identified in the cover letter to this response. The AOLR, at its heart, is a mechanism to facilitate wind generators participating within the I-SEM. It should help to promote participating wind generators. The proposals to outsource the AOLR are consistent with ensuring that the TSOs and RAs have the appropriate mandate in the new wholesale market (as discussed in our responses to question 4 and 5).

### 4. Should the RAs, or alternatively the TSOs, be responsible for establishing the AOLR framework and the subsequent procurement of the AOLR service provider? Outline reasons for your preferred option and if there are any further issues that merit consideration.

In effect, the AOLR is a market participant through its trading activities. In order to ensure that the nascent AOLR framework is credible, it will need to demonstrate impartiality with no conflicts of interest in the market. If the RAs were responsible for establishing the AOLR framework and subsequent procurement of the service provider, it may undermine regulatory neutrality. The RAs operating a regime regulating the wholesale market, while maintaining a contractual relationship with a market

participant could find it challenging to maintain a sufficient division (real and perceived) between the two spheres so as not to affect the credibility of the regulatory regime. In order to regulate a market, the responsible regulators should sit outside the ongoing activities of the market. It may be more feasible for the TSOs to implement an arm's length relationship and effective business separation between the central market operation duties and the AOLR responsibilities.

### 5. If the TSOs are selected as the preferred agent for establishing the AOLR framework, should the TSOs carry out the function in house or outsource it to a third party through a competitive tendering process? Outline reasons for your preferred option and if there are any further issues that merit consideration.

The TSOs possess the market expertise and technical experience to significantly contribute to the development of the AOLR framework. If there is not a clear separation between central operation of the market and the activities of the AOLR, it may create potential for conflicts of interest. This point suggests the need for a clear division between the role of the TSOs and the provision of the AOLR service. If the TSOs are to be the preferred agent for establishing the AOLR framework, then the relationship should be at an arm's length basis, suggesting that the TSOs should outsource the AOLR service provision to a third party through a competitive tender process.

To maximise the level of separation within this arm's length model, the outsourcing could be augmented with some form of a governance panel that consists of more than just TSO staff. This panel could reinforce the separation by requiring the AOLR to have a degree of oversight by an entity/entities beyond the one procuring the AOLR. Gemserv suggests that the TSO licence may need modification to oblige them to procure the AOLR service but not to directly provide it. Given the importance of establishing a separation between



the market operations and the provision of the AOLR service, such a separation may need to be given force through a licence obligation. The licence should ensure that the (to be) specified AOLR high level obligations will be provided by an independent arm's length organisation, presumably via a competitive tender process. Furthermore the AOLR is likely to be obliged, by the TSO contract, to be a party to the I-SEM equivalent of the Trading and Settlement Code (TSC) in which more detailed obligations could be specified (and changed over time) to ensure the role could evolve to ensure a level playing field exists for all participants. If necessary this option could enable jurisdictional differences to coexist in I-SEM.

The TSOs would be qualified to lead the procurement and develop the framework contract management to support their licence obligations. They have substantial experience in procuring and managing services such as those mentioned in the paper (counter trading on the EWIC or wind forecasting in the SEM). The benefit of utilising an open procurement process is that the costs associated with the AOLR could be reasonably efficiently incurred.

**6. Do you believe the options for the AOLR proposed in this paper present a potential cross subsidisation of AOLR costs by others not involved with the AOLR?**

Outsourcing the AOLR functions from the TSO may assist in mitigating the potential risk of cross subsidisation. An AOLR operated external to the TSO would be likely funded through revenue streams such as revenues achieved in the market (if a profit sharing model is adopted), performance incentives that may be utilised, and any fees paid by participants in the AOLR mechanism. In this scenario, the AOLR's revenues are largely linked to its performance of its trading functions.

The establishment and operational costs of the AOLR will constitute a cross subsidy to the extent

that the funding model involves direct transfers from other participants not involved in the AOLR. A model in which the function is outsourced, and the costs are netted against the revenues achieved by the AOLR in its trading activities, results in a model whereby provision of those costs is not a subsidy but more of an investment. The question for the RAs would be the funding source for the establishment costs and for the ongoing operating costs. The establishment costs may not necessarily be a subsidy either, as some element of these costs could be recovered via fees participating in the AOLR or through the revenues accrued once the AOLR is in operation.

**7. Do you agree with the transparency measures proposed and if there is other information that should be disseminated to participants?**

Gemserv agrees with the importance of transparency in the operation of the AOLR. It would grant participants the basis on which to choose to enter the market or encourage generators to choose whether to participate. We would favour the data being available in a readily analysable and user friendly format, ideally through an online portal. There could be value in reports at regular intervals (quarterly and annual) which can summarise developments usefully. From a commercial perspective, however, the ability to interpret data and model outcomes is particularly valuable, especially where considering participation within an AOLR or not. To put it simply, is it in a participant's interest to aggregate through the AOLR or not? A good example of a well-designed interface is the Smart Grid Dashboard on the Eirgrid website.

Data protection concerns and information security will have to be factored into the development of any live AOLR data interface. For example, decisions would be required on which data would be generally available and which data would be suitable only for different category of market participant. The release of any information that could be construed as commercially sensitive may disadvantage AOLR



users as other aggregators may not have to disclose the same information. Some information may need to be restricted to generators using the AOLR service who will inevitably have to sign some form of confidentiality agreement. Alternatively the I-SEM could publish appropriate data for all I-SEM aggregators to enable appropriate market-wide transparency.

Decisions on data flows surrounding the AOLR will also have to be consistent with the overall market design and the I-SEM data protection policy. The process of designing the AOLR may also need to consider freedom of information legislation and any obligations arising.

### **2.3 INCENTIVES & COST ALLOCATION (SECTION 6)**

#### **8. Do you agree that incentives are important for the AOLR? Are there other incentives that should be considered by the RAs?**

Yes, incentives will be important to promote the most appropriate AOLR behaviour, thereby ensuring there is operational effectiveness and efficiency for all users. Also, it is important that the AOLR is sufficiently attractive for commercial entities to bid for the role (assuming a third party service provider was to be used). In section 6.2.11 of the consultation, respondents are presented with two options: either a bidding AOLR assumes all the risks of low take up by AOLR users, or require the TSOs to underwrite some of the costs. Asking the successful bidder to take all the downside risk is unlikely to encourage enthusiasm from interested organisations, who would not bid without a reasonable expectation of profitability. If a party is to take that negative risk, they should be able to access upside benefits also. In the unlikely event one or more bidders are prepared to take the full participation risk, they would likely expect above average profits that may not be in the participants' (or customers') interests. Gemserv suggests that there should be a degree of risk sharing between

the TSO, the contracted AOLR, and – once in operation – the service users. If bidders are expected to take all the risk, there may be an inadequate number of organisations prepared to tender.

Gemserv proposes that the incentives applied to the AOLR should align with the outcomes desired. Beyond achieving a suitable price in the different trading arrangements, the AOLR would also be expected to deliver its services efficiently, to meet its obligations around service levels, and interface effectively with participants. Attaining these service levels could also be incentivised in addition to the price levels. Gemserv believes that the RAs should consider developing a blended incentive incorporating elements such as price and service provision.

One method of achieving some risk sharing and creating an incentive could be a profit sharing mechanism as discussed in point 6.3.11, but based not only on revenues but on meeting specified service levels and operating cost targets.

#### **9. Do you agree with the issues raised surrounding cost allocation and the potential stranding of assets? Are there other issues that merit consideration?**

Capital expenditure would normally be depreciated over the life-time of the asset. For information technology assets (IT) the depreciation period would usually be five years. As a substantive upfront investment in systems would be required, there will be stranded costs over any short/medium contract period that will need to be accounted for in the bidders' prices. The greater the level of participation within the AOLR, the greater will be the ability of the AOLR service to be provided at the most economic cost.





## 2.4 PARTICIPANT ELIGIBILITY (SECTION 7)

**10. Do you agree that no upper threshold limit for wind participation in the AOLR should apply? If not, please propose a limit and provide reasons for this position.**

Gemserv agrees that no upper threshold limit for wind participation should apply. A larger portfolio would help spread the costs of aggregation over a greater base of both generators and output.

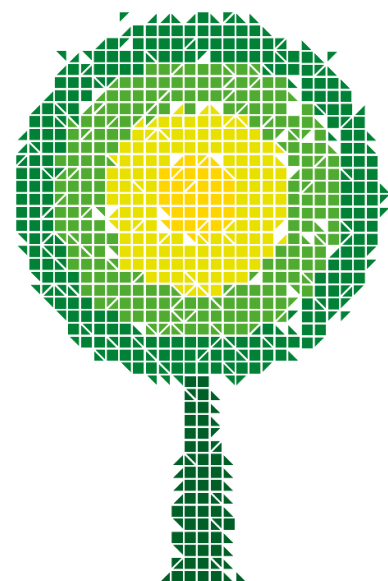
**11. Should smaller participants, other than wind, be considered eligible for participation to the AOLR? If you agree please outline the participants that merit consideration or if you don't agree please provide reasons.**

There may be merit in permitting generators below the de minimis level to participate in the AOLR as it may provide an alternative route to market, as discussed in the consultation paper. This alternative route to market may also provide small embedded generators with additional leverage in their strike price negotiations with suppliers. There is insufficient evidence at the moment to explicitly bar them for doing so, as there is not data supporting a supposition of harm that such a proposal may cause. Gemserv is recommending that the RAs permit this inclusion, subject to monitoring its effects on the market in initial live operation. One area worth considering is the potential impact upon

commercial aggregators operating within the wholesale market. Would this proposal in effect create competition between commercial aggregators and the AOLR? If so, would this situation stimulate or retard competition?

**12. If participants other than wind should be included in the AOLR, should these be grouped for the purposes of bidding into the ex-ante markets and settlement given their respective risks in the new market design?**

It is likely that the scale of these licence exempt (de minimis) participants, relative to the wind participants, will be small, but given their flexible nature they may have a significant effect on the balancing market in aggregate. It may not be equitable to socialise the benefits of this flexible plant across a portfolio of more variable generators. The inherent characteristics of the different types of plant may require different strategies in different circumstances, for example a CHP plant may provide base load but a standby diesel plant can bid in when the market is short and the prices are high. Having a group of standby generators operating in unison could be valuable for system operations. These points suggest that there may be justification in separating the different types of plant into groups within the overall AOLR portfolio.

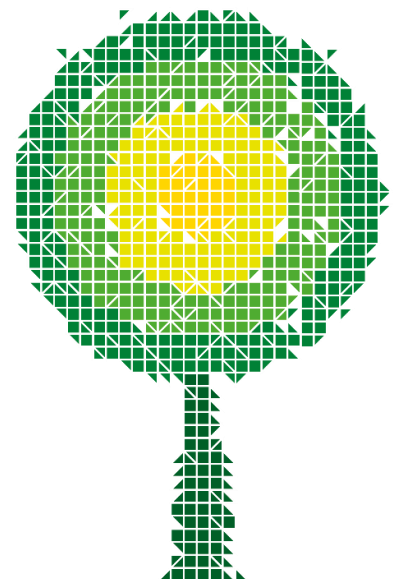


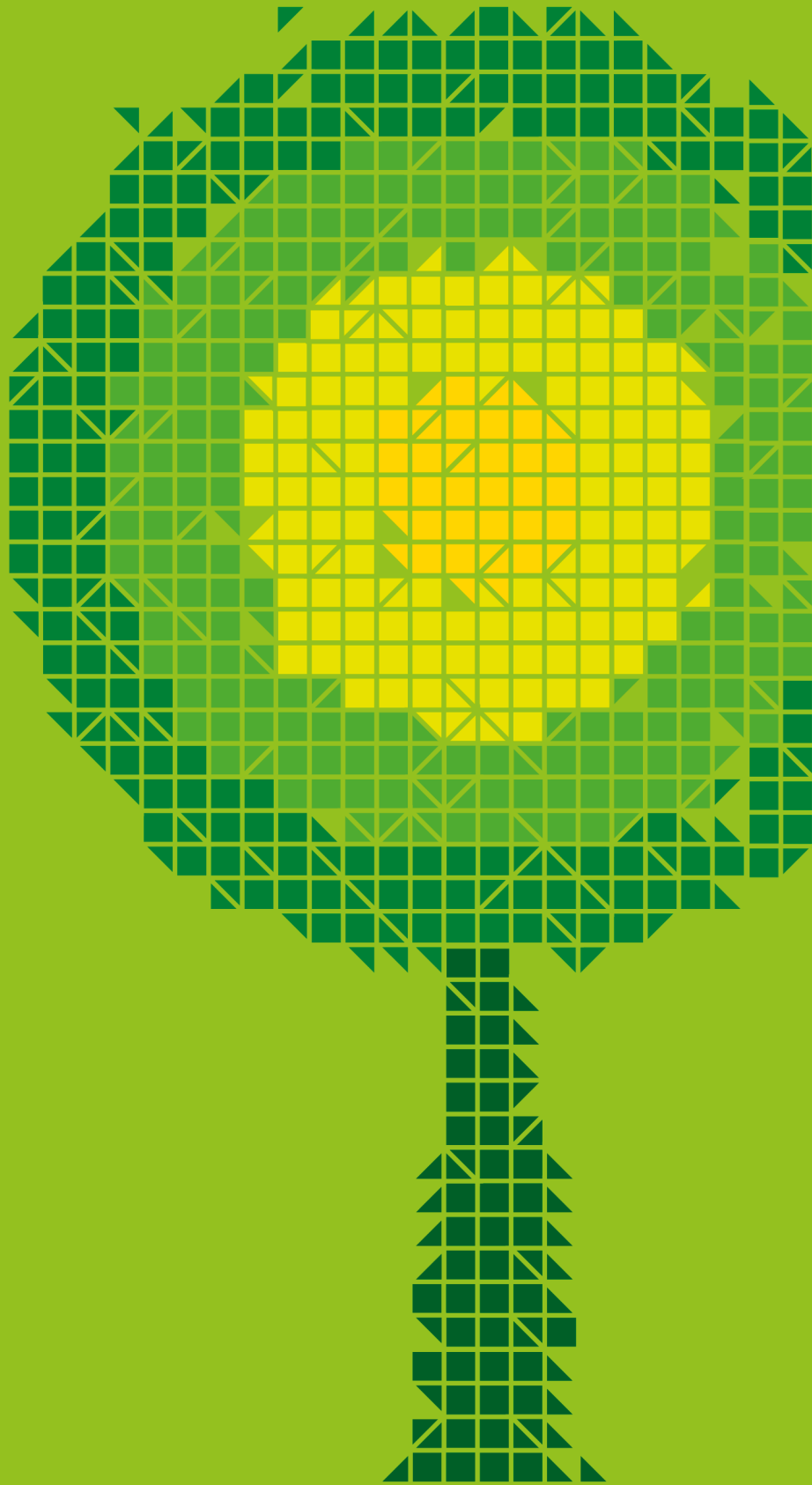


### 3. CONCLUSION

Gemserv supports the proposal for an AOLR within the I-SEM with that function being procured by the TSO through a competitive tender. This arrangement would require supporting governance arrangements. We consider that there should be a degree of flexibility within the AOLR; wind participants should be able to select Option 1 or

Option 2. Gemserv also propose the inclusion of smaller non-wind participants within the AOLR. Incentive structures should be considered in the development of the framework for the AOLR. If procuring the AOLR externally, then potential bidders should have a reasonable expectation of profit.





If you would like to discuss anything further with us, please contact:

**Conall Bolger**

Senior Consultant (Ireland)

M: +353 86 837 1511

E: [conall.bolger@gemserv.com](mailto:conall.bolger@gemserv.com)

W: [www.gemserv.com](http://www.gemserv.com)

Dublin Office:

Fitzwilliam Hall Business Centre

Fitzwilliam Place, Dublin 2

London Office:

8 Fenchurch Place

London

EC3M 4AJ

Company Reg. No: 4419878

