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Re: I-SEM Capacity Remuneration Mechanism -- Consultation Paper

Introduction

Veolia Alternative Energy (VAE) welcomes the opportunity to respond to the consultation document regarding the I-SEM Capacity Remuneration Mechanism -Consultation Paper

Demand Response (DR) and is an increasingly important element in the safe and secure operation of the grid. DR provides reliable distributed capacity to the system; reduces the need to invest in new peaking plant capacity, facilitates increasing levels of wind penetration and mitigates transmission and distribution network constraints. Effective integration of DR into the market structure will provide flexible, cost-effective capacity and in doing so complement thermal plant and renewable capacity.

VAE sees merit in the design approach taken by the Regulatory Authorities (RAs) to deliver the I-SEM CRM, however we encourage the RAs to be mindful of potential un-intended risks, and also that those risks that may occur are allocated in a fair and reasonable manner, and no larger than necessary to incentivise efficient operation. It is important that the market design does not present some or all participants with unmanageable risks, as these risks will result in costly risk premiums which will ultimately be passed through to end customers.

VAE would like to note that participation in a market that has an overly complex structure would require substantial resources, beyond the capabilities of some new market entrants, especially small aggregators. Failure to factor in demand-side participation in the initial I-SEM design may inadvertently force its exclusion due to the complexity of the proposed market structures.

Strike Price

Where the strike price is set is a concern to Demand Side Units (DSUs), as setting the strike price too low could unfairly impact upon capacity that has a high marginal cost to run. We would support indexing the strike price to the SRMC of the marginal capacity provider which is also the holder of the RO. This ensures that those capacity providers with high SRMC are dispatched at RO events, thereby avoiding the difference cost, provided of course that they respond to dispatch instruction from the TSO.

Market Reference Price (MRP)

It is crucial that the market reference price is accessible to capacity providers; otherwise some participants will not be able to hedge risk and the end customer will end up paying for any added cost of risk. The same principle should apply for DR as well as generators. It is also important that the MRP avoids distorting energy market bidding behaviour through exposing participants to risk when they do not actively engage in a particular market.

Load Following

We are of the view that a non-load-following obligation would have a detrimental impact upon the type and make up of customers that would be able to participate in DSUs. Loads that vary through the day would become less suitable for participation in DSUs. Restricting demand-side participation in this way would result in lower levels of DSUs capacity and also increase the cost of capacity in the auction. The load following obligation is the more appropriate solution. The potential for suppliers to benefit from windfall gains when a scarcity event occurs at a non-peak time is reduced.

Performance Incentives

VAE encourage caution in regards to performance incentives to ensure that a common performance incentive regime is not geared to the needs of a specific technology, as this will serve to increase risk for market participants using other technologies, and ultimately, the end customer will end up paying. We are supportive of the approach that capacity providers should be incentivised to make their capacity available whenever needed and to meet the dispatch quantity issued by the TSO. We therefore consider that if a workable technology-neutral performance incentive regime cannot be developed, then the development of separate schemes for different technologies may be required.

DSU Options

The consultation proposes three Options that may be applied to Demand Side Units. Of the three, Option 2 and 3 are both feasible and practical. Our preference is for Option 2 but we are also conscious that Option 3 is the most practical approach given the tight timeframe of the project. We are not in favour of Option 1 as it would have a detrimental impact on DSUs.

The challenges with Option 1 relates to the fact that the DSU will not receive an Energy Payment, but are still exposed to the RO. It does not provide an incentive for DR as it makes no difference whether DSU performs well or not at all. The view that the RO can be recovered because a DSU is avoiding the cost of electricity when dispatched is flawed because it does not take account of the cost incurred to reduce demand either by load reduction or back up generation, it also assumes that all sites have pass through tariff arrangements, which is not the case on the majority of sites.

Option 2 enables DSU providers to receive an Energy Payment when called that will cover the RO. The payments also ensure sufficient incentive for the DSU to deliver their full capacity.

Option 3 has the potential to provide a penalty/incentive scheme for DR, encouraging DSUs to respond to signals from the system operator by being available at times of system stress and also delivering according to the dispatch schedule.

Interaction with central dispatch is important and therefore in the case where DSUs do not receive an energy payment the guiding principle should be that capacity providers should not be exposed to Difference Payments under the reliability options, so long as they have made themselves available at the time of scarcity and have fully responded to dispatch instructions.

Reliability Options

The goal of the proposed RO design is to decrease price volatility. It does this by recovering spikes in the energy price from market participants who are successful in the RO auction. The RO auction process must have the flexibility to facilitate DSU participation, because at their core, DSUs provide capacity rather than energy. The costs of achieving demand reduction either through load reduction or running diesel generation is high and thus they have a high bid price, therefore DSUs will earn the majority of their revenue from the CRM rather than the energy, because they will be high in the merit order.

Terms and duration of ROs

Aggregators by their nature see their capacity vary up or down over time as IDs switch from one aggregator to another. This brings with it difficulties for DSUs in their efforts to make accurate predictions on the amount of available capacity they will have, unlike conventional generation. The net impact of this is that small aggregators may be forced into the high-risk secondary market. We feel that there should be flexibility with the duration of ROs.

De-rating

De-rating as it is described in the consultation is valid, and we recognise that historic forced outage rates for relevant technologies, is an effective method for determining that de-rating factor for conventional generators. However, DSUs do not have an inherent forced outage rate, since the performance of specific DSUs is a result of the specific programme rules. To ensure reliability of response, aggregators analyse their portfolio and calculate the requirement necessary to meet a stated capacity obligation. Aggregators are effectively imposing their own de-rating. For this reason DSUs should not be subject to further de-rating.