

**BGE Response to the SEMC's
DS3 System Services Auction
Design
Consultation Paper
SEM-15-105**

12th February 2016

1. Background and context

Since the inception of the DS3 project, BGE has maintained a preference for procuring System Services through a market-based approach as a means of encouraging market competition and ensuring that the trade-off between value and cost are appropriately balanced to deliver the required flexible generation for achieving 75% System Non-Synchronous Penetration (“SNSP”). While we still believe that a market-based solution is the optimal approach, we believe the SEM Committee’s (“SEMC”) consultation on Auction design is not an appropriate solution as the proposals are extremely complex and opaque and we feel it would create a high degree of uncertainty in the market should it proceed. At a high level, we are concerned over the following areas:

- *Long- vs short-term contracts*: we believe the proposal to separate long- and short-term contracts is unnecessary and the assumptions made around this would lead to discrimination against existing providers;
- *Bidding parameters*: the proposed parameters are extremely complex and the optimisation process is not transparent enough to allow market participants to replicate the market for their own business approval purposes;
- *Forecasting availability*: it is unreasonable at this time to expect market participants to accurately forecast their expected availability as we move into ISEM, which will retain to a large extent a central-dispatch market design; and
- *CRM and DS3 alignment*: at this point in time, we believe it is inappropriate to align the CRM and DS3 markets given the level of uncertainty relating to each and the divergence of the market designs.

Overall, we believe that the proposals outlined in this consultation are too opaque and uncertain leading to the feeling of a “too much too soon” situation. In our view this will lead to inefficient or unintuitive market outcomes as parties will not be able to properly value their risks and availabilities into the auction. We would suggest that instead of working on all areas of the market at once, the SEMC focuses firstly on fully developing the CRM auction design and allowing the Balancing Market (BM) and overall energy market in ISEM to bed down before delivering a competitive DS3 market.

That is not to say that DS3 should be delayed, we understand the need and urgency to provide the 14 services. We would instead advocate that Regulated Tariffs are applied on an interim basis, beyond the initial first year. If the Regulated Tariffs are designed appropriately, in line with the proposals being consulted on as part of the Regulated Tariff Workstream and set at an appropriate level, we believe this could incentivise the provision of services by both existing and new generators. We understand the concern of new investors seeking longer-term contracts and we believe this can be addressed in an efficient way (outlined in answer to question 4 below).

Once ISEM and CRM have been fully developed and implemented and parties become familiar with the market outcomes of each we believe it would then be appropriate to consider the design of DS3 auctions and the integration of this auction with the CRM auction on an enduring basis.

2. I-SEM & DS3 Interactions

Q1: What are your views on the proposals to try to ensure a level of consistency between CRM and DS3 System processes?

On an enduring basis, BGE does see merit in trying to ensure a level of consistency between the CRM and DS3 markets, but we believe that we should transition to this in time once the CRM auction and balancing market are implemented and parties understand the commercial and operational dynamics of the market and system respectively under the new market design.

Q2: Do you consider that the SEMC should consider facilitating a link (where participants require) to only proceed with participation in the DS3 System Services auction subject to a successful outcome in

the CRM auction or vice versa, i.e. create an interdependency that as much as possible mitigates the need for auction re-runs?

As outlined above, on an enduring basis, we do see merit in consistency between the CRM and DS3 auction processes, but at this stage we believe that it would be a step too far for the design of both auctions for them to be linked. In bidding into a DS3 auction, parties will want to understand their running under EUPHEMIA, the operation of the Intra-Day Market platform, and the pricing and scheduling outcomes of the balancing market as well as their potential risk exposure under the Reliability Option payback in the CRM. There are a number of dependent variables to consider before deciding on whether to bid, or what levels of bids to submit, and in the absence of certainty, parties will have to bid in higher risk premia either driving prices up or resulting in parties viewing this complexity as a barrier to entry and choosing not to invest. Either outcome will result in increase costs for consumers directly related to this complexity of design.

On that basis, we believe that the CRM auction should be held on a stand alone basis for a number of years before any DS3 auction is held in order to allow market participants to gain experience of the potential costs and revenues in the new ISEM market. In the meantime, we believe that Regulated Tariffs should be applied to System Services for a number of years (3 to 5 years).

We understand the view of new investors who would prefer to have both auctions run at the one time to give them investment certainty – be it positively or negatively – but in our view, this is a risky strategy that will not best meet the objectives of either market and will likely result in uneconomic market outcomes. A more cost reflective outcome is one that allows parties to bid with some level of reasonable certainty as to a) their scheduling in the market and therefore their availability, and b) the levels of revenues from other markets (capacity and energy). Furthermore, the risk of auction re-runs enhances the overall volatility of introducing DS3 without CRM or balancing market experience and further heightens the risk of the design process creating a barrier to entry for new build and consumers will likely pay for the costs of such risks.

Q3: What are your views on managing the interactions between the CRM and DS3 System Services auctions?

As per our response to Q1 and Q2, given the complexities of the DS3 market seen to date, we believe that the alignment of the DS3 and CRM auctions should be postponed for a number of years and that the procurement processes are carried out separately and independently until such a stage that experience in, and the interactions between DS3, the energy market and CRM are understood. Until such a time, we believe the SEMC should apply Regulated Tariffs to System Service products. This approach best serves the objective of incentivising efficient new entry (at optimal cost) in the interests of the consumer.

We also understand that new investors like the idea of both auctions being combined such that they get a binary outcome but in our view this creates 'boom bust' type outcomes. Which although suitable for those who have not yet invested, it would be detrimental for those who have already invested in the market. On that basis, we believe that a combined auction would drive too much uncertainty in the market at this time.

3. Long-term & short-term contracts

Q4: Do you agree with the proposals for separate DS3 System Service long-term and short-term auctions as set out in the DotEcon recommendation?

Based on the SEMC Decision on the high level DS3 design (SEM-14-108), we do not agree with DotEcon that there is a necessity to separate long- and short-term contracts for System Services. In our view, under the high level arrangements, new and existing plants are capable of bidding for the same volumes of System Services; the only difference is that new plants can take up a long-term contract (up to 15 years) and an existing plant must take one-year contracts but can and should be eligible to bid into auctions at some point in time in the future. Under the DotEcon assumptions, new plants would be

given preference in the long-term which would be discriminatory to existing plants. We therefore seek clarity and further discussion in this area.

Given that we believe Regulated Tariffs are a necessary interim step before moving to Auctions and understanding that Regulated Tariffs generally do not provide long-term investment signals, we believe that there are still opportunities for the design to facilitate long-term contracts. A possible solution would be to allow new plants to still be eligible to receive long-term contracts, but for a shorter time (say 5 years). Alternatively, new plants may take longer contracts (up to 15-years) but that a scalar is applied to their Regulated Tariff which would decrease the value of the tariff over time. A possible approach would be to apply a sliding scale-type mechanism whereby a long-term contract provider would receive the full Regulated Tariff in year one and that the value would linearly decrease throughout the contract relative to expected improvements in technology efficiency over the lifetime of the contract. This would satisfy the SEMC's alternative objective that long-term contracts provide good value, ensure investment in efficient technologies while also providing the required revenue certainty for investors.

Q5: Do you think the treatment of long-term contracting for System Services should be aligned with the proposed framework in the CRM?

The DS3 market design is still in its very early design phase and until it has the opportunity to be further developed, we believe that Regulated Tariffs should be applied to both long and short term DS3 contracts for a longer interim period, i.e. 3 to 5 years. This will allow the RAs to complete the I-SEM and CRM markets in time for Go-Live and then look to design a DS3 market which best enhances both the energy and capacity markets to ensure the most efficient investments are made in the ISEM on an enduring basis. We believe there are benefits to allowing an alignment of the treatment of long-term contracts for both DS3 and CRM but we feel the implementation of this alignment should not be progressed until a later date when both the operation of the energy market and the risks under the CRM are better understood by the market.

4. Volume considerations

Q6: What are your views on the proposals to calculate clearing volumes for the auction as set out by DotEcon?

We agree with DotEcon that clearing volumes should be calculated on an "additive" basis.

Q7: Do you agree with the proposals for introducing granularity for the purposes of calculating auction clearing volumes?

We understand the system constraints on the all-island system, however we are strongly of the view that a single clearing price should be set for each System Service product across the island. To the extent that the TSOs require a location specific service, this in our view can be adequately provided for through the proposed scarcity scalars, on which we expect a consultation imminently.

We do not agree with the proposal to apply a level of volume granularity for technology as it encourages discrimination between technologies. The level of volume contracted per technology should be controlled by the market given that market participants' availability will ultimately be determined by the markets' merit order.

Q8: What are your views on the proposal to introduce flexibility on the volumes to be procured?

We agree that a fixed volume requirement at any price would be inefficient practice and that a level of flexibility may be necessary. This flexibility should be clearly outlined and defined before the auction takes place to ensure complete transparency in DS3 contracts.

As per BGE's response to the Competition Metrics consultation, we believe a suitable approach for DS3 would be to apply a demand curve which sets a clearing price based relative to the amount of volume on the system. This relates directly to the second option outlined by DotEcon, a price dependent volume requirement.

5. Bidding Parameters

Q9: What are your views on the proposals for package based bidding?

Although a single “bid amount” is a seemingly more simple approach than bidding a price per System Service, the Auction process is still extremely difficult to interpret and understand. In particular, the derivation of the ‘clearing price’ is an opaque methodology that would be virtually impossible for participants to understand and replicate (for the purposes of verification and business planning).

Again, it is on that basis that BGE believes that a Regulated Tariff should be applied for a number of years until the complexities of DS3 such as the bidding process is fully developed and until the market reaches a stage that experience in, and the interactions between DS3, the energy market and CRM is understood.

If the SEMC is minded to proceed with the auction design as proposed by DotEcon (or an amendment thereof), we believe that further engagement is needed with industry to fully understand DS3 bidding processes and pricing methodologies. In addition to this, we encourage the SEMC to consider holding a working group similar to what is done with ISEM and CRM to discuss the intricacies of the bidding process and to facilitate a period of mock auctions before DS3 is fully implemented.

Q10: Do you consider that a provider will be able to predict its expected availability accurately on an annual basis?

It will be extremely difficult for a provider to predict its expected availability accurately on an annual basis given that the energy market is not a self-dispatch market. It is also unreasonable to expect plants to forecast their availability for up to 15 years, especially for new plants, who will have had no experience of running in the energy market and limited, if any experience of how the TSO will dispatch the Balancing Market.

Once again, BGE believes that the complexity around forecasting availability highlights the need for further consideration to be given to the DS3 market design and that Regulated Tariffs would be more beneficial at this time.

Q11: Do you agree with DotEcon’s proposals in relation to quantity units for the services outlined above?

We agree with the units of quantity measurements outlined in the consultation given that they have not changed since the decision paper defining the 14 products. BGE requests that numeric examples are provided for SIR and SSRP to provide greater transparency in the SEMC’s methods for calculating capability.

Q12: What are your views on a suggested cap or clawback on expected availability per plant to manage DS3 System Service expenditure?

It is unclear as to what this question relates to. If it relates to the concern highlighted above that parties will have difficulty in forecasting their availability, then rather than looking at caps and clawbacks, a ‘de-rating’ approach akin to that being applied in the CRM could be applied on an interim basis.

If the question relates to one of performance, we refer you to our answer to question 20 below where we suggest that the scalar system can be used as a mechanism to incentivise availability effectively.

In its report, DotEcon have suggested removing the Minimum Annual Revenue Requirement (MARR). There is no legitimate rationale for this approach and indeed the MARR will be a requirement given the uncertainty related to availability in the market. While we understand the need to manage DS3 expenditure, we believe that a MARR should be included in a participants’ contract to ensure an appropriate level of revenue certainty is given. On that basis, we cannot accept DotEcon’s proposal and urge the SEMC to preserve their initial decision on this point.

6. Definition of Availability

Q13: Do you consider the DotEcon Report to have accurately captured the considerations for availability the TSO should use for different DS3 products? If not, please explain your reasons why.

We agree with the DotEcon report that availability should be based on the higher of a market participant's MSQ and DQ positions.

7. Auction Winners & Losers

Q14: Do you agree with the proposals to ensure lower payments are received by SS providers who are not successful in the DS3 auctions but who are dispatched by the TSO to provide SS, than those who are successful in the auctions?

We do not agree with DotEcon's proposal for the treatment of Losers. By mandating Losers to take either the clearing price, or a lower payment than the clearing price, this would act as an incentive for the TSOs to under-procure System Service volumes in the auction and ultimately procure a greater amount of volume at a lower clearing price. Auction Losers would still be eligible to provide System Service volumes, as per the capabilities they provide in the Qualification phase, and they can do so through the Balancing Market offers (INCs and DECs). Parties that are not successful in the auction (i.e. 'Losers') will not be in receipt of a contract and therefore cannot legitimately be forced to offer services at an uneconomic price.

DotEcon refer to differentiating between 'Winners' and 'Losers' – this in our view is achieved through the contracts awarded to 'Winners' in the auction and the minimum revenue guarantee that accompany this contract.

8. Winner/price determination

Q15: Do you agree with the proposals for determining the winner/price as set out in the DotEcon recommendation?

The process for determining winners and DS3 prices as set out in the DotEcon report is extremely complex and difficult to interpret. While we understand the high level objective of trying to determine the least-cost solution to meet DS3 volume requirements, the optimisation process presented is a "black-box"-type solution that will be difficult if not impossible to validate and replicate, considering that market participants will be relying on these prices to make investment cases. We have experience with both TLAFs and GTUoS charges as to how opaque methodologies can erode trust and confidence in the algorithmic outcomes. Therefore we believe something more robust and transparent is needed if the market is to encourage investment and outturn efficient prices. Again, we do not believe the proposals are sufficiently developed and/or robust to enable implementation of the proposed auctions for Q1 2017 and therefore we advocate that the application of the Regulated Tariffs are extended for a number of years, to allow for more detailed analysis, worked examples and possibly mock auctions. This in our view would better allow all market participants to fully understand the mechanisms of DS3 and the interactions it has with the ISEM and CRM markets and in so doing provide for better market outcomes..

9. Treatment of interconnectors

Q16: Do you agree with the proposed treatment of interconnectors? Should this apply equally to all interconnectors?

We agree that interconnectors should be price takers in the DS3 market. The volume that they are eligible to provide should be based off the lower of either their maximum capability to provide System Services or the maximum volume the TSOs will procure from any single provider.

10. Auction Commitment Requirements

Q17: Do you agree with DotEcon's proposed preferred model of Contingent Commitment in DS3 System service Auction procurement?

Although DotEcon's commitment model addresses the issues associated with the "full commitment" and "no commitment" options, we do not agree that a DS3 contract should put an obligation on Generators to provide fixed Balancing Market offers as it disrupts competition and is potentially penal to Auction Winners.

In our view, the provision of System Services should not determine how a market participant should operate in the Energy market but rather the opposite; that a market participant should reflect its capability to provide System Services based on how they intend to run in the Energy market. Therefore we prefer a form of the SEMC's "Alternative Contingent Commitment" model which removes the obligation of fixed bids in the Energy market and instead uses a penalty/scalar system to ensure DS3 contract winners provide the System Service quantities that they contracted for. We discuss this further in Q20.

Q18: Do you agree with the position proposed by DotEcon that successful winners in the DS3 Auction should bid in the BM only at DEC prices set to a proxy of the energy price (section 7.2 above)?

Refer to our response to Q17.

Q19: Do you agree with the position proposed by DotEcon that successful winners in the DS3 Auction should bid in the BM only at INC prices set to a proxy of the energy price, or on a costs minus System Services income basis (section 7.2 above)?

Refer to our response to Q17.

Q20: Do you support the application of an alternative contingent commitment model that avoids direct commercial interaction and obligation within the Balancing Market (section 7.3 above)?

BGE supports the application of an alternative contingent commitment model which avoids direct interaction and obligation within the Balancing Market and instead of applying a financial penalty, we believe the SEMC could adapt the performance scalar system to ensure DS3 contract winners provide the System Service quantities that they contracted for.

At a high level, we believe the performance scalar could work in a way that penalises participants who have over-estimated or under-deliver on their availability and in return reward participants who have under-estimated or over-deliver on their availability. We believe the structure of the scalar system would need to be discussed in detail at a later working group in tandem with the anticipated Scalar Design consultation.

Q21: Do you agree with the proposed treatment of plant that does not require it to be in the schedule or on for provision of System Services?

It is imperative that a robust Qualification Process is established that puts in place a level of criteria that ensures participants are capable of providing the volumes of System Services that they will later contract for. If a technology is successfully able to demonstrate (through a robust testing regime) its

ability to provide any System Service whether it is dispatched or not, then it should be eligible to receive System Service payments if they successful in the Auction.

Q22: Do you believe that either the Full Commitment model or the No Commitment model offers a better option for DS3 System Service providers? Please explain your reasons for your view.

We do not believe that the “Full Commitment” model or the “No Commitment” model offer better options for DS3 System Service providers.

As stated in our response to Q20, we believe that there should be some form of commitment applied to DS3 contract winners in order to put some structure to the market. We believe this is best achieved through a performance scalar regime. This in our view minimises interference with the energy market but ensures that parties are incentivised to bid competitively into the energy markets to ensure they are competitively positioned and therefore ‘available’ to provide the services under contract.