Gaelectric Holdings Plc.

Response Paper to:

Capacity Remuneration Mechanism Consultation 3

Gaelectric Holdings Plc. Response

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Public

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1 GAELECTRIC BACKGROUND

Gaelectric Holdings Plc. ("Gaelectric") is an independent wind, energy storage, solar and biomass developer operating within the Republic of Ireland, Northern Ireland, United Kingdom and North America. To date Gaelectric holds approximately 175MW of generating assets across 9 projects in Northern Ireland and the Republic of Ireland, and a further 40MW of 'shovel ready' projects with grid connections and full planning approvals in place. Gaelectric's near term pipeline on the island of Ireland is circa 320MW with the expectation that the company will have 400MW of wind projects generating power by the end of 2017.

Through developing our portfolio of wind assets through early stage planning into construction and operation phases, we have become one of the largest independent developers and operators of wind energy on the island. Gaelectric are further involved in the development of bioenergy and solar projects in Ireland and the UK. Planning applications for 20MW of solar have been lodged in Northern Ireland, and the company has submitted over 20 applications to ESB Networks for solar grid capacity in Ireland.

In addition to our renewable portfolio, Gaelectric are developing Project CAES NI. This project has an agreed connection offer in place with SONI and its planning application has been submitted Planning NI. Project CAES NI is designated as a Project of Common Interest (PCI) by the European Commission and has been recommended for grant funding of up to €6.5million under the Connecting Europe Facility. Gaelectric and Tesla have also announced the purchase and planned deployment of Tesla Energy's first battery power utility-scale project in Ireland, and we expect to develop a 1 MW demonstration project in 2016.

2 COMMENTS ON CRM 2 EMERGING THINKING

Gaelectric would like to take this opportunity to provide feedback on the recent emerging thinking workshop on the CRM 2 decision paper. The key points that we would like to raise are described below;

- Gaelectric are disappointed that the regulators have decided against implementing 15 year contracts for certain projects. 15 contracts have been implemented in GB and are an important component when financing a project. Whilst we understand that there is a concern of locking technology out, there is equally a consideration of the need to secure long term security of supply, particularly in Northern Ireland, and this will not be achieved under a contractual structure which prevents new entrants from competing with existing generation. We urge the SEM Committee to reconsider the decision.
- The primary justification for introducing an availability payment for interconnectors was that they are unable to control their output. Wind energy faces a similar problem in that they cannot control their fuel source so Gaelectric request similar consideration for windfarms.
    - Gaelectric have consistently expressed our opinion that the risk of difference payments will not, and cannot change the behaviour of a wind farm. Given this, and the treatment of the interconnectors, we strongly believe that wind projects are being unjustly discriminated and we urge the SEM Committee to ensure that difference payments for renewables are capped at 100% of their option fee.
- Any provisions under the enduring arrangements for generators located abroad to participate in the I-SEM CRM auctions should be reciprocated by allowing I-SEM generators to participate in their capacity auctions.
- Reliability Option holders that are technically available but outturn unavailable due to transmission/distribution maintenance or other reasons outside of their control should be exempt from difference payments during those periods.

3 GENERAL COMMENTS

Gaelectric welcomes the opportunity to respond to the SEMC's third consultation on the Capacity Remuneration Mechanism. We have included the majority of our comments, opinions and suggestions in response to the questions listed below. However, in addition to these there are some issues we would like to see clarified addressed in the CRM 2/3 decision papers.

Profiled Option Fees

Current proposals suggest that option fee payments to capacity providers are profiled over the course of the year. We do not believe that this is necessary under the design of the Reliability Option product. The incentive to deliver is determined by the reference market price exceeding the strike price. Profiling the option fee payments across imbalance settlement periods creates calculation complexities and cashflow risk while delivering no material benefit. For this reason we request clarification that option fee payments for projects that clear the capacity auction be delivered paid on a flat rate across all imbalance settlement periods.

Under the current arrangements, below De-Minimis (10MW) generation is not required to register in the market. These generators can strike intermediary agreements with supply units who then bid the generators volume into the market on their behalf. When bid in by suppliers, this generation volume appears as a negative demand volume. Under this structure, the supply unit receives the capacity supplier charge rather than having to pay it as would be the case for the majority of suppliers that bid in a positive demand volume.

Many projects would have been financed on the basis of this structure and the associated revenue streams. Similarly, many small supply companies depend on this as an opportunity to grow and compete with larger supply companies. Eliminating this source of revenue will put these small supply companies at a competitive disadvantage and could ultimately force them out of the market. Furthermore, the decision on negative demand effectively values MWs differently depending on who they contract with, which is a clear discrimination in the market. We therefore request that the SEM Committee engage further with industry and that provisions are made in the reliability option design to accommodate these small supply companies.

Sloped Demand Curves

While sloped demand curves have been introduced in many other capacity markets as a method of mitigating market power, this can issues in the auction clearing. Measures must be taken to ensure

that the LOLE is maintained at 8 hours and should a new entrant bid be required to secure this standard, the bid should be paid. Use of a sloped demand curve should not be used as a method to eliminate expensive new entrant bids in a T-4 auction and accept incumbent bids in the T-1 auction.

Treatment of Wind

Gaelectric note the emerging thinking on consultation 2 with regard to the treatment of interconnectors. It has been suggested that interconnectors receive availability based CRM revenue on the basis of market coupling and implicit energy flows that they can't control. Wind is also in a position where it cannot control its output. This is further compounded by the fact that RO triggered events generally correlate with period of low wind. Gaelectric believe that the treating interconnectors more favourably than other generators based on shared characteristics amounts to discrimination against Wind energy and we request equitable treatment for market participants which share operational characteristics. For this reason we request that the stop loss limit be set at 1 times the option fee for wind generation.

Efficient exit signals

Gaelectric have serious concerns over the lack of exit signals in this market. Under the current proposals new entrants would find it extremely difficult to finance their new projects. This will result in an over-dependence on an aging fleet to meet rising demand. For this reason we urge the SEMC to consider the need for new entrants when deciding on contract lengths, the Net Cone calculation, demand curve slopes and market power mitigation measures when deciding on the detailed auction design.

4 CONSULTATION QUESTIONS

Q1. Do respondents agree with the proposed approach for transitional auctions, T-4 auctions and T-1 auctions? If not, please explain.

Gaelectric support the *sequential* (i.e. 4 auctions carried out one after another rather than annually, and beginning with the 2017 T-1 auction) auctioning of each transitional year's capacity in the first year. This option offers some revenue certainty to plants that have a shorter timeframe to construct and require a path to market ahead of the enduring arrangements. Gaelectric also seek clarification for the SEMC should a new entrant plant receive a long-term contract in the T-4 auction and subsequently receive a capacity contract for a transitional year, this **will not** affect the duration of their long-term contract.

Q2. What is respondents view in relation to the flexibility around the timing of the T-1 and T-4 auctions?

Under the enduring arrangements for the T-4 auctions, Gaelectric believe that 4 years from contract execution is the minimum lead time afforded to projects as new entrant must complete construction. The DS3 programme will allow auction winners up to 5 years to complete construction of their projects. For this reason, Gaelectric request the SEMC to ensure that auctions provide fora **minimum of 4 years before delivery.**

4.1 Market power

Q3. Do respondents agree that market power is a material concern in the I-SEM CRM? If no, why not? Should the SEM committee be concerned with unilateral market power, the potential for collusion or both?

Gaelectric are of the view that market power, both unilateral and tacit collusion, are challenges that must be managed in the upcoming capacity auction. For this reason Gaelectric support the implementation of both targeted and market wide market power mitigation measures.

Q4. Do respondents think that the overall market power control framework and package of mitigation measures set out in this section is comprehensive and proportionate? Are there any additional market power concerns that the SEM Committee should be focussing on? Should the SEM Committee bar any existing firm transmission access intermittent generator which has opted out of

an auction (on grounds of retiral) from bidding in subsequent auctions, if it subsequently does not retire and/or apply other sanctions?

Gaelectric are broadly in agreement with the suite of market power mitigation measures that has been proposed in the consultation document. We welcome the recognition of predatory pricing as a form of market power and request the SEMC to mitigate this risk insofar as possible. Gaelectric are of the view that in addition to the auction wide price cap, targeted price caps should be applied to those market participants that are deemed to possess market power. Similarly, we support the introduction of exemptions from the price cap should a technological price curve forecast suggest that their prices should be higher than that of the price cap. It is for discussion as to whether such projects clearing an auction should set the price for other participants, or if the price cap should set the price with the specific technology being paid as bid. Notwithstanding our comments above, provided that the administrative price capping in the market is set to a reasonable level (2x net CONE), this issue should not occur.

Incentives for market participants to take advantage of price distortions across capacity auctions should be limited and tightly monitored. Allowing generators to freely compete in subsequent T-1 auctions after reneging on previous commitments to retire could create a potentially perverse incentive encouraging this behaviour. Therefore we are of the view that should a generator opt out of a T-4 auction on the basis of retiral and subsequently decide against retiring, it should only be allowed to participate in auctions for the subsequent delivery year to that which their initial bid was for.

Q5. Do you think that firm transmission access plant which has bid at a certain point within the tolerance band in the T-4 auction (below the maximum) should be allowed to bid more capacity (up to the top of the tolerance band) in the T-1 auction?

In a market with the levels of structural power possessed by participants with firm transmission access thermal plants, we are wary of structures that could allow price distortion across the T-4 and T-1 auctions. Notwithstanding this, with adequate bid limits, carefully calculated tolerance bands and close market monitoring we would not object to permitting this.

Q6. What metrics should be used to assess whether a capacity provider is dominant, for the purpose of either applying other Bid Limits and/or controls on aggregation (the approach to setting the level of bid controls is discussed in section 6)?

Gaelectric are of the view that the levels of structural power are such that this could skew the Two/Three pivotal supplier test. Were these tests to be used, even a below de-Minimis independent generator could be found to exercise market power and have market power mitigation measures applied to it. We are therefore of the view that a combination of the HHI and Pivotal supplier index should be used when attempting to ascertain which market operators should have the targeted market power mitigation measures applied to them.

Q7. Do you agree that dominant /pivotal generators should be prohibited from acting as Capacity Aggregators? Should associated businesses of dominant / pivotal generators (e.g. their Supply arms) also be prohibited from acting as Capacity Aggregators too?

We believe that participants in positions of market power should not be allowed to act as capacity aggregators. There would only exacerbate the potential for these participants to exercise market power. Prohibiting these aggregators would succeed in encouraging smaller participants to act as capacity aggregators which would serve to increase competition resulting in a more effective functioning of the market place.

Q8. Should there be a prohibition on ESB and other dominant generators providing aggregation services?

See above regarding participants in positions of market power providing aggregation services.

4.2 Auction Design

Q9. Which auction format (simple sealed bid, multiple round descending clock, combinatorial format, i.e. Option 1 to 3 in Section 5.2) do you think is most appropriate for the transitional auctions, T-4 and T-1 auctions, and why?

Gaelectric welcome the SEM Committee's cautiousness regarding the exercise of market power in all its forms. For this reason, Gaelectric support the implementation of a single sealed bid auction. We believe that this approach will prevent the exercise of market power, and particularly predatory pricing.

Gaelectric are aware of the complexities around calculating the RO difference payment exposure and consequently pricing this into their bids. However we are of the view that any benefits of observing this behaviour in other bids will be overshadowed by the potential for predatory pricing by participants with market power. Furthermore, it is likely that under a single bid, sealed auction,

participants will consider the lack of further opportunity in their bids- potentially reducing prices to the consumer.

Q10. Do you have any preference for the structure of bids for the auctions? Explain your rationale.

Gaelectric prefer the use of simple PQ pairs when bidding in the auction. This should increase the simplicity when compared against submitting bids with price as a function of quantity.

Q11. Do stakeholders agree with the proposed approach of adopting Option 3b to deal with the lumpiness/discrete bid problem? If not, please explain why not, and your preferred alternative approach.

Moving the capacity auction towards a consumer welfare maximisation problem may present uncertainty and risk for participants, particularly surrounding the treatment capacity providers at the margin. Under option 3b, the regulators may have to reject in-merit bids which increases the risk of outcomes being challenged should higher bids be accepted.

Gaelectric are of the view that undertaking welfare maximisation calculations coupled with rejecting in-merit bids in favour of out of merit bids should be avoided. Therefore we advocate accepting the marginal bid within a certain tolerance band. Any discrepancies between the capacity requirement and procured can be managed through the T-1 auctions.

Q12. Do stakeholders agree with the approach of setting the clearing price based on the highest accepted in-merit winner, and paying any out-of-merit winners based on a pay-as-bid basis? If not, please explain why not, and your preferred alternative approach.

Gaelectric agree with this approach and are of the view that any mechanism that may pay successful participants on a pay-as-bid basis may introduce potential for distorted incentives.

Q13. Should the SEM Committee introduce a sloped demand curve, either as a market power control, or for other reasons?

Gaelectric support the introduction of a sloped demand curve with a procurement tolerance band similar to that introduced in GB. This should help to mitigate market power while allowing for greater procurement if the prices indicate good value.

Q14. Winner determination. Do you agree with winners being determined purely on price offered for each Capacity Delivery Year?

Gaelectric support the approach adopted in GB and the US whereby the length of contract is ignored and bids are accepted/rejected on the basis of price alone.

Q15. Winner determination. Do you agree that the auctioneer should be able to accept "out-of-merit" bids to manage the lumpiness problem or should only in-merit bid be accepted? What rules should be used to determine whether the marginal bidder is accepted (if only in-merit bids can be accepted) or to determine which out-of-merit bid should be accepted?

See above answer to Q11.

Q16. Price determination. Do you agree that it appropriate to pay auction winners on a "pay-as-clear" basis, with this uniform clearing price being based on the highest accepted in-merit bid price? Should any out-of-merit winners be paid a different price to in-merit winners?

All participating generators should be paid the pay-as-clear price as Gaelectric are of the view that this presents the correct incentive for auction participants not to price profit margins into their bids. This margin will come in the form of the infra-marginal rent. Pay-as-bid structures are widely recognised to be more volatile as participants are bidding to the point of their assumption of the marginal plant.

Q17. How do you think the lumpiness / discrete bid issue should be dealt with?

See above answers to Q11 and 13 regarding. These propose accepting the marginal bid within predefined tolerance bands at the T-4 auction with any discrepancies managed in the T-1 auction.

Q18. Do you have any comments on the treatment of tied bids?

We support the GB approach where bids of the highest capacity are eliminated first. This should help with any lumpiness issues that may arise and bids of finer granularity are less likely to exceed the capacity requirement.

Q19. What is the appropriate level of information to be provided: before qualification; between qualification and the auction start; between rounds in the case of a multiple round auction; and after the end of auction?

We request that all pre-qualification information required to participate in the CRM auction is as close as possible to the DS3 qualification information. Pre-auction, we request that all parameter values (net CONE, capacity requirement, demand curve etc.) are consulted on and released in advance to allow modelling of the auction by participants.

Q20. Are any additional restrictions on bidder communications (over and above existing competition law) required?

Preventing communication across bidders is desirable to prevent collusion amongst market participants and should be enforced insofar as possible.

4.3 Auction Parameters

Q21. Do you have any comments on the overall scope / process of auction parameter setting outlined above?

Gaelectric welcome the role of regulators in setting the auction parameters. We also stress the importance of both the regulators and an independent monitor to oversee the prequalification process. It is important that clear, transparent and objective criteria detail why projects may fail to qualify to participate in the CRM auction.

Q22. If a sloped demand curve is introduced, what principles should be used to determine the slope of the demand curve, and the range within which the demand curve is sloped?

Introducing a sloped demand curve introduces the possibility of under procurement should participants bid higher in the auction than was anticipated. High bids in the capacity auction is a distinct possibility given uncertainty surrounding difference payment exposure due to the lack of historical I-SEM data. For this reason, should a sloped demand curve be implemented, Gaelectric support prudent parameters that will ensure the LOLP of 8 hours is preserved and should a new entrant be required to meet this standard, their bid is accepted.

Q23. If introduced, should the sloped demand curve be different for the transitional period?

Gaelectric are of the view that the initial transitional auctions may be exposed to greater levels of market power the auction(s) procure a greater volume of capacity than the enduring T-1 auctions. One way of managing this will be through increasing the slope of the demand curve. This must be managed against ensuring the appropriate capacity requirement is procured.

Q24. What impact do you think the sloped demand curve will have on competition?

In the relevant auction, introducing a sloped demand curve will reduce demand elasticity and result in greater value for money. The effects of introducing sloped demand curve in a T-4 auction may result in greater volumes being procured in T-1 auctions so this relationship must be managed.

Q25. Do you agree with the requirement for an Auction Price Cap? What principles should be used to determine the level for the Auction Price Cap/what level should it be set at?

Gaelectric have no objection to the introduction of an upper limit price cap however we believe that this should be in the region of 2x net CONE. This is due to the contemporaneous reforms of the energy and ancillary service markets which make this calculation more difficult to arrive at. The nature of the reliability option product also mandates the inclusion of a difference exposure premium when calculating the NET CONE. The SEM Committee should consult on the parameters for net CONE and the price cap.

Q26. Do you agree with the requirement for other Bid Limits?

Gaelectric agree with the introduction of targeted bid limits, not only to prevent inflation of prices, but also to prevent predatory pricing. Although predatory pricing can lead to low prices in the short term, it eliminates the investment signal for new entrants and therefore results in higher consumer costs in the medium/long-term.

Q27. Should the other Bid Limits be applied at the same level to all existing non-intermittent firm transmission access generators, or should the limits be technology specific?

Bid limits should be applied to projects owned by participants whom, upon calculation of the market power metrics, are deemed to possess market power.

Q28. Should the other Bid Limits be applicable to all bidders, or just dominant/ pivotal generators?

The rationale for introducing bid limits is to prevent participants exercising market power. Therefore Gaelectric believe they should just be applied to dominant/pivotal participants as determined by the relevant metrics.

Q29. What principles should be used to determine the level for the other Bid Limits/what level should they be set at?

Bid limits should be set at a level to allow participants recuperate their fixed costs, difference payments with some margin. Notwithstanding this position, bid limits should prevent pivotal generators exercising market power. Similarly, they should prevent predatory pricing which distorts the long-run investment signal for new entrants and results in greater long term costs to consumers.

4.4 Auction Governance, roles and responsibilities

Q30. Do you agree on the proposed role of the TSOs with respect to the auctions?

Assigning the role of Auction Delivery Body to the TSO's will require close scrutiny. Parameters such as the capacity requirement, bid caps and other criteria which can influence bidding should lie with the regulators to avoid potential conflicts.

A clear framework detailing the criteria for qualification should be drafted to minimise the subjectivity involved in deciding whether or not a project passes prequalification to participate in the auction.

Q31. Do you agree on the requirement for an Independent Auction Monitor and its proposed roles and responsibilities? If not, please specify what changes you would make? Should this role be combined with the role of SEM/I-SEM Market Auditor?

We support the introduction of an independent auction monitor to oversee the prequalification and auctions to ensure that it is conducted in an appropriate manner.

Q32. Do you agree with the SEM Committee's proposed approach to managing conflicts of interests in the Capacity Market Code? Are any other steps appropriate to ensure that any actual or perceived conflicts of interest are managed?

We welcome the steps proposed in wish to see transparency and oversight in their choices of projects that pass pre-qualification.

Q33. Do you have any comments on the proposed auction governance arrangements?

We approve of a governance arrangements in which all key parameters are calculated and implemented in a clear transparent manner.

Q34. Do you have any views on the model and process for making modifications to the Capacity Market Code?

We are generally comfortable with the proposed modification process for the capacity market code (CMC). We would like to emphasise the importance that any modifications process facilitate delivery of changes to the CMC between auctions.

Q35.Do you think that disputes in respect of the Capacity Market Code should be resolved by a similar process to TSC disputes? Should there be a separate panel for Capacity Market Code dispute resolution?

Gaelectric support the introduction of a separate capacity market dispute resolution panel.

4.5 Strike Price

Q36. Do you agree with the proposed approach to incorporating the carbon price into the Strike Price formula?

While incorporating a carbon price calculation into the strike price calculation will likely have little impact on the absolute value of the price, we are concerned with the ever increasing uncertainty being introduced to the Reliability Option. The value of the additional carbon price, coupled with the associated price risk is likely to be priced into the option fee. We note the SEM Committee's desire to implement 10 year contracts and reiterate our desire for a review of this decision given the high risk profile for new entrants and the impact this is likely to have on investment.

Q37. Do you agree with the approach of moving to a month-ahead index?

Gaelectric support moving to month ahead index rather than spot market values as this will likely result in lower price volatility and less complexities when attempting to model the strike price.

Q38. Do you agree that a reference thermal efficiency of around 15% is appropriate? If not, why not?

While Gaelectric accept that a reference thermal efficiency of around 15% is appropriate, we are cautious of allowing this value to float (i.e. not grandfathering) for long-term contracts. Given the prospect of increases in thermal efficiency in the future, particularly over the course of a 10 year contract, this value will likely increase resulting in a lowering of the strike price and increased exposure to difference payments. Long-term contract holders will not be in a position to re-price this risk into their option fee on an annual basis as this will have been set in the initial auction. For this reason we request that the **reference unit thermal efficiency of contracts of greater than 1 year are grandfathered.**

Q39. Do you agree that the appropriate oil price is the Heavy Fuel Oil price?

Gaelectric have no major preference for oil reference price.

Q40. Do you agree with the principles / criteria set out in Section 8.2.28, that the SEM Committee proposes to use to choose between data sources for fuel and carbon prices, exchange rates?

Gaelectric are satisfied with the principles set out to acquire the required data and calculate the reference prices.

Q41. Do you agree with the proposed governance / process for changes to fuel and carbon prices, exchange rates and transport adders used in the calculation of the Strike Price?

Gaelectric are of the data sources and adders should be implemented subject to SEMC approval.

Q42. Do you agree with the proposed approach for setting the Supplier's contribution rate? If not, please explain.

Similar to concerns expressed previously as to the profiling of option fee payments to generators, Gaelectric are unsure as to why supplier contributions to the socialisation fund should be profiled across imbalance settlement periods rather than applied as a flat rate fee. This profiling increases complexity and cashflow risk and delivers no material benefit.

Q43. Do you have a preference as to which option (Suspend and Accrue or Immediate Additional Charge) should be applied to socialisation of any shortfall in Reliability Option difference payments? If not, please explain.

Gaelectric are of the view that the socialisation of difference payments should be managed through a NEMO controlled bank account. Both the "suspend and accrue" or "immediate additional charge" approach present considerable cash flow risks to suppliers. Gaelectric are therefore of the view that detailed modelling of the potential hole in the hedge and shortfall be undertaken by the NEMO with appropriate socialisation charges levied on suppliers ex-ante to cover this. Subsequently should any unforeseen shortfall occur, this should be managed by the NEMO until the fund is replenished.

5 CONCLUSION

We believe request equitable treatment of market participants should be a cornerstone of the CRM auction design. In this context we believe stop loss-limits for Wind should be set to 1 times the option fee. Furthermore, the use of sloped demand curve should not be used as an excuse to reject new entrant capacity bids should they be required to maintain the 8 hours LOLE requirement. Any denial of new entrant contracts in T-4 auctions to procure this capacity in the T-1 auction for aging plants will result in longer-term costs to the consumers.

Gaelectric would like to take this opportunity to thank the SEMC for engaging with industry on these issues. The appropriate design of the CRM auction will be fundamental to offering an investment signal to new projects, ensuring adequate capacity volumes are procured and ultimately delivering value to the consumer. Should you have any further questions on any of the issues raised above, please do not hesitate to contact us.