IWEA response to SEM Committee Consultation on the I-SEM Capacity Remuneration Mechanism Detailed Design Third Consultation Paper (SEM-16-010)

27th April 2016

Introduction

IWEA welcomes the opportunity to respond to this third consultation on the Capacity Remuneration Mechanism (CRM). The CRM has been a fundamental part of the market design on the island of Ireland to date and the move to the Reliability Option (RO) is a significant change which presents a **serious challenge to the wind industry**. With the increasing levels of wind generation in the market (40% in 2020), it is important that wind generation can participate in all aspects of the market. In previous consultation responses IWEA has outlined the significant concerns we have in relation to the RO and the associated risks for wind generation.

IWEA remains strongly opposed to the proposal to have a capacity remuneration mechanism based on reliability options (RO). The addition of Administered Scarcity Pricing (ASP) adds to the complexity of the RO. We note that reforms are ongoing in other markets with reliability options with fundamental changes being implemented to the ISO-NE scheme, including a proposal to eliminate the Peak Energy Rent (PER) adjustment (i.e. the payment back to the system in circumstances where the market prices exceed the defined strike price) in conjunction with the pay-for-performance reforms.

From a wind perspective reliability options are problematic because they create implicit penalties when market prices go high in the reference market. By definition, zero cost variable generation drives prices low when it is available (particularly when it comprises such a portion of market demand). Therefore, Contracts for Difference (CfD) penalties may occur during periods of high demand AND low wind. This means that wind may be punished most severely out of any technology class under the RO. Wind would have to account for this unfair penalty into its RO offer, likely making it uncompetitive. Defining the penalties in this manner, i.e. implicitly saying that periods when wind contributes to a high demand requirement are not periods where there may be a requirement for security of supply, is clearly discriminatory. Wind has an established capacity credit as outlined in the Generation Capacity Statement and this capacity credit needs to be recognised. The inability of wind generation to earn revenues under the RO is also likely to have a significant impact on the PSO for REFIT supported generation and may make out-of-support generators (who rely on this income stream) financially unviable, causing them to leave the market and thereby reduce Ireland's capability of reaching its 2020 Renewable goals.

Administered Scarcity Pricing

The addition of Administered Scarcity Pricing (ASP) compounds the risk for wind generation and places disproportionate risk on non-dispatchable generation and wind. The impact of ASP on wind has not

been considered in any of the consultations which is inappropriate given that 40% of energy needs will be met by wind.

The RO provides a hedge to both Suppliers through socialisation of shortfalls and to conventional generation through stop loss limits, and a reduced likelihood of not delivering traded energy when the RO is called. Wind participants will not be able to avail of the same protection against ASP given the risk associated with inaccurate forecasts.

With wind generation there is always a risk of forecast error. The signal that an ASP event is likely to occur is unlikely to be available at the day ahead timeframe, and wind generation will not be in a position to react intraday if a signal does appear as there would be no liquidity in the intra-day timeframe in such an instance. Most of the risk is associated with scarcity that occurs between Day Ahead Market and Balancing Market. Wind has a forecast error due to requirement to forecast production for a 36 hour horizon at day ahead stage. Penalising wind for this forecast error to the tune of ASP does not achieve any of the objectives of the CRM. If forecast error arises at a time of ASP, wind generation will be exposed to extremely high imbalance payments, and this exposure therefore acts as a disincentive for wind to trade in ex-ante timeframes.

The SEM Committee stated that system security objective of ASP fulfilled "*In the short term: by giving capacity providers strong marginal incentives to be available at times of system stress, and giving all Suppliers strong incentives to reduce load at times of system stress".* By its nature wind does not have the capability to react to the signal provided by ASP, or any incentive not to be available at times of scarcity, and therefore IWEA proposes that **ASP should not be applied to wind generation**. IWEA highlights that DSUs and Interconnectors are treated differently to other market participants based on their technical characteristics, therefore the same reasoning could and should be applied for wind generation. **IWEA considers that it would constitute discriminatory behaviour if wind cannot be excluded from Administered Scarcity Pricing given that it does not and cannot react to the signal to be available.**

For the remainder of this response we will be focussing on the questions posed within the consultation paper.

Consultation questions

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

IWEA supports the proposal for T-1 auctions as a transitional approach. However IWEA has concerns that any project seeking to connect in advance of 2020 to provide DS3 System Services may not be able to have clear sight of whether it will be successful in the capacity auction ahead of the first full auction.

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

The timing of the auctions needs to be clearly signalled in advance. IWEA believes that there is no significant benefit in introducing flexibility around the timing of the auctions, however it does

introduce uncertainty for capacity providers in relation to when the auctions will be run. Therefore IWEA proposes that the timing of the auctions is fixed to provide certainty to the industry.

In relation to the appropriate timing for the auction, it is essential that the timing ties in with other workstreams. In particular the results of one workstream are likely to feed into another, therefore IWEA suggests the following order for consideration:

- DS3 System Service Auction
- CRM Auction
- Forwards Products
- Market Tariffs
- PSO calculations

An assessment should be carried out to identify the most appropriate timing.

Section 4. Market Power

Market power has been identified a feature of the I-SEM and therefore must also be a consideration for the CRM. IWEA believes that the right balance needs to be found between measures that adequately mitigate against market power and achieving the long term objective of the capacity market.

Section 5. Auction Design

5.9.2 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?

IWEA supports Option 1 for the transitional auctions as this appears to be the simplest option to implement.

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

No preference.

5.9.4 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.

No preference.

5.9.5 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.

IWEA agrees with the approach of setting the clearing price based on the highest accepted in-merit winner, however IWEA would have concerns that accepting out of merit bids may result in the idea of "happy losers". These are similar to the concerns outlined in our response to the DS3 consultation.

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

N/A

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

IWEA supports Option 1 as this is the simplest Option at this time.

5.9.8 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?

IWEA would have concerns that accepting out of merit bids may result in the idea of "happy losers".

5.9.9 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?

See answer above.

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

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

No preference.

5.9.12 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?

IWEA believes that as much information as possible should be made available so long as it does not breach confidentiality or allow inferences to be made in relation to bidding behaviour of participants.

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

IWEA does not consider that additional restrictions on bidder communications are required. IWEA welcomes the comments that communication rules should not prevent Capacity Aggregators from agreeing with their clients at what price their capacity should be bid into the auction.

Section 6. Auction Parameters

In general, IWEA agrees with the overall scope of the auction parameter setting outlined in the paper.

IWEA welcomes the adjustment of the capacity requirement to reflect the actual capacity which is bidding. However, as outlined in our response to the HLD draft decision, **IWEA believes that a design principle of the CRM should be that wind generation receives fair payment for its capacity credit contribution to system security**. The current capacity mechanism does not recognise this capacity credit, and if wind does not participate in the RO due to the risk associated with it, this capacity credit remains unvalued.

Section 7. Auction Governance, Roles and Responsibilities

IWEA has no significant concerns in relation to this section of the consultation paper. It is essential that the roles and responsibilities are clearly set out, along with the requirements for participants. IWEA welcomes the proposal for a Capacity Market Code, however we would caution against having too many different sets of rules, e.g. Balancing Code, Capacity Market Code, NEMO rules etc., which all have different change processes. If these are being coordinated through committees such as the Trading and Settlement Code Modifications Committee, it could be expected that there will be significant overlap in the personnel participating. It should also be considered that changes in one may have an impact on another aspect, and there needs to be an overarching view of any changes being put forward. IWEA considered that this is a role for the Regulatory Authorities. The information also needs to be easily accessible for Market Participants and to people who are interested in entering the market.

Section 8: Other Residual Issues

IWEA has significant concerns in relation to the calculation of Base Charges in CRM settlement as outlined at the Rules Working Group. The removal of negative capacity charging was not included as part of the Capacity Remuneration Mechanism consultation. This change would have a significant impact on a number of wind energy projects through a reduction in their revenue streams. While we acknowledge the comments at the Rules Working Group that the Reliability Option is an auction based system, the expectation was that the current high level arrangements in relation to capacity charging would carry through to the new market, including negative charges for negative demand. We do not believe that this change to the algebra from Working Group 12th February to Working Group 22nd March is necessary to implement the decision.

IWEA is concerned in relation to the impact this will have on smaller generators in particular, through a potential reduction in the prices which can be obtained through the market structures. It is likely that this will constitute a shift in value from wind generators to suppliers (where there is positive demand), and no benefit will be passed on to consumers arising out of this. The proposal is discriminatory against those who have fewer demand customers and cannot always ensure that the

levels of demand exceed the levels of generators. This could apply to a supplier lite arrangement or a supplier who has contracted with larger amounts of generation and the profiles do not match.

IWEA is concerned that there a number of barriers to participation to smaller generators, and the cumulative effect of these barriers could result in projects no longer being viable, in particular for projects which are now out of support. For projects which are in receipt of REFIT, this value would need to be covered by the PSO. It is unlikely that the full value of this change will be passed on to the consumer by suppliers, but the shortfall to generators will still need to be picked up by the consumer. This would have a knock-on impact on the public perception of the cost of wind energy. In particular, this change does not appear to be a necessary change and was never clearly signalled during the consultation process.

IWEA strongly opposes the changes which have been included in the latest documentation on CRM settlement in relation to negative demand, and proposes that the previous algebra be retained.

Conclusion

In summary, IWEA still has significant concerns in relation to the Reliability Option which is being progressed. In particular we have highlighted the following concerns:

- From a wind perspective reliability options are not suitable because they create implicit penalties when market prices go high in the reference market, i.e. during periods of high demand AND low wind. This means that **wind may be punished most severely out of any technology class under the RO.**
- Wind has an established capacity credit as outlined in the Generation Capacity Statement and this capacity credit needs to be recognised. The Reliability Option does not recognise this capacity credit.
- The addition of Administered Scarcity Pricing (ASP) compounds the risk for wind generation and places disproportionate risk on non-dispatchable generation and wind since wind is not in a position to react to the pricing signal this provides. **IWEA contends that wind generation should be excluded from ASP based on its technical characteristics**, in a similar manner to DSUs and Interconnectors. Not to do so would constitute discriminatory treatment.
- IWEA strongly opposes the changes which have been included in the latest documentation to the Rules Working Group on CRM settlement in relation to negative demand which are likely to have a significant impact on De Minimis generation in particular, and proposes that the previous algebra be retained. The proposal is discriminatory against those who have fewer demand customers and cannot always ensure that the levels of demand exceed the levels of generators.

We request that serious consideration be given to the impact of the different policy decisions in relation to the I-SEM design and the Capacity Remuneration Mechanisms on different market participants. IWEA has significant concerns that the cumulative impact of the different decisions will have a material impact on the viability of many wind energy projects and on the PSO. We request that the SEM Committee reviews the overall programme to ensure that the market supports the policy objectives of moving to a market with 40% renewables in 2020, and further decarbonisation beyond 2020. We remain available to discuss these comments with you further.