Integrated Single Electricity Market (ISEM)

Capacity Remuneration Mechanism

Third Consultation Paper

SEM-16-010

Power NI Response

27 April 2016

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Introduction

Power NI notes the Regulatory Authorities (RAs) Capacity Remuneration Mechanism (CRM) Detailed Design Consultation Paper 3 and acknowledges the opportunity to respond.

As the RAs are aware, Power NI is the largest electricity retailer in Northern Ireland. Power NI is part of the Viridian Group which has within in its portfolio, a retail position in Northern Ireland and the Republic of Ireland, as well as a significant thermal and renewable generation presence.

Power NI is however a separate business. Power NI's legal, managerial and operational separation is mandated via licence condition and it is within the context of being a supplier without vertical integration; that Power NI has approached the CRM workshops, fed into ETA rules workshops, assessed the issues presented and now responds to the CRM Detailed Design Third Consultation Paper.

General Comments on CRM

This Consultation is the third and proposed final[1] Consultation Paper in respect of the CRM workstream. Power NI welcomes the continued engagement with industry as this workstream progresses. Power NI also welcomes the update given by the RAs in Dundalk on 5th April 2016 in respect of CRM 2 'Emerging Thinking'. Emerging Thinking as a concept is one that Power NI supports and feels it should be adopted not only in CRM 3 but also across other workstreams and liaison groups.

In terms of what was presented on 5th April, Power NI welcomes the decision that the RAs will complete the de-rating piece in respect of the interconnectors. In addition to this Power NI would support the publication of information provided by the TSOs to the RAs as required to complete this task. Power NI also supports the acknowledgment of potential for market power to be exerted in the secondary trading market and the proposed creation of a mandatory centralised platform for secondary trading. The proposal in respect of cross-border participation is also noted.

Power NI does however remain concerned with the proposed Administered Scarcity Pricing (ASP) mechanism. As eluded to in our CRM 2 response, the inclusion of an Administered Scarcity Price (ASP) is of concern to suppliers, especially those with a domestic or SME customer base that will undoubtedly and despite best efforts, be exposed to the Balancing Market. The proposed

[1] Aside of proposed parameters Consultation expected in July 2016

interim full ASP level of €3,000/MWh places a risk on suppliers that may not be avoidable without appropriate mitigation measures. These measures were outlined in our response to CRM 2, and include:

- A fully liquid and effective FM with appropriate market power mitigation measures.
- A fully functioning and liquid DAM and IDM to allow suppliers to trade and refine their position.
- Appropriate and timely measures to return revenues paid by generators under the one way CfD.

With heightened concerns in respect of the delivery of the above measures, Power NI would welcome further discussions in relation to the full ASP level. The level at which this is set will determine the attrition levels of stop-loss-limits and potentially exacerbate the ‘hole in the hedge’ and associated costs of socialisation.

Further to the emerging thinking on CRM 2, from a supplier perspective the settlement and collateral associated with the CRM are important considerations. SEMO have tabled a number of proposals during the Energy Trading Rules Group, which have included the consideration of capacity settlement. While Power NI welcome the holistic approach to the design of payment and collateral requirements, it is important that this cross workstream approach is appropriately co-ordinated with information and decisions clearly communicated.

In respect of the capacity settlement and what has been developed and presented to date, Power NI is of the view the algebra is overly complex. This is something that has previously been communicated back through the ETA comments process by Power NI. In relation to the option fee charging to suppliers; Power NI believes a practical implementation of this proposal could require SEMO (backed by Eirgrid and SONI) acting as Balancing Market Operator (BMO) and CRM settlement entity to forecast the quantity of money to be paid under the option fee and publish this ahead of the year.

Through each out-turned month, the sum required to be paid out would be divided by the total demand consumed in that month, shaped as the RAs require and charged accordingly. In relation to the fees therefore, on a monthly basis the money out would equal the money in. This is consistent with todays CRM operation and Power NI are unaware of any justification for changing this process. While this incurs some forecasting risk for suppliers, it relates to demand forecasting which all suppliers are familiar with managing.

Difference payments associated with ROs should be paid on a weekly basis and all avenues to net credit within the CRM and across all markets and time horizons should be exhaustively explored with a cross-workstream approach adopted.

General Comments on CRM 3 paper

As outlined in the introduction, Power NI is responding to this Consultation paper in the context of being a regulated, asset light supplier without vertical integration. On this basis, our response is focused on the supplier aspects of the paper; in this instance primarily the difference payments socialisation arrangements. Alongside this we note the following general comments and observations.

As is the case in the forwards market, the opportunity for market power to be exerted is apparent in the context of the CRM. Power NI welcomes the inclusion of market power discussions in the context of this Consultation; however feels it could and should have fed into the Consultation process sooner.

As eluded to in the Consultation Paper, consumers will ultimately pay if capacity prices are inflated through market power being exerted in CRM auctions. Understandably, this potential inflation of prices has been the focus of mitigation measures outlined and discussed in the paper. Power NI also feels the converse of this should be considered i.e. market power being exerted in the form of predatory pricing to dampen prices. Instinctively, this would be to the benefit of suppliers and ultimately consumers. However, the degree to which it dampens investment signals and hampers delivery of security standards is ultimately to the detriment of consumers.

A balance has to be struck with the package of measures being proportionate and built on lessons learned from international best practice. As well as being proportionate in terms of striking the right balance between the risk of under-mitigation and the risk of over-mitigation, the measures need to be targeted at those who have the ability to exert market power.

Perception of market power or the ability to exert market power could undermine confidence in the scheme. It is therefore important that mitigation measures, approaches and any associated outcomes are transparent and reported on in a timely manner. The onus must be on the RAs to conduct robust and proactive market monitoring in this regard.

In relation to the strike price formula, Power NI notes the proposal to use a floating strike price, reflecting a hypothetical low efficiency peaking plant. The proposed inclusion of carbon in the formula would seem logical and consistent with for example the current Directed Contracts pricing formula and also other European markets and mechanisms. It would however appear that the use of forward prices for both gas and oil has the potential to introduce a basis risk resulting from within month movements. For this reason it would seem that spot prices would be more appropriate.

Power NI has highlighted concerns above in respect of the full level of ASP and notes the intention to include enduring full ASP levels in the proposed parameters Consultation Paper in July 2016. In terms of governance of the CRM, Power NI would like to see Consultations around parameterisation such as this to be an enduring feature of how the CRM is governed. Lessons learnt should facilitate refinement of the CRM mechanism and parameters such as, but not limited to full ASP levels should be consulted on pre and post transition from SEM to I-SEM.

In respect of the transition from CRM in SEM to CRM in I-SEM, Power NI notes some of the features that will be enduring, for example, the security standard the mechanism is designed to deliver. Evolutionary transition in this respect should be, and is supported, however, Power NI would ask the RAs to be mindful of incompatibilities / inconsistencies that do not facilitate a lift and shift approach. An example of such an incompatibility may be the use of the SEM Best New Entrant (BNE) in the Net Cost of New Entry (Net CONE) calculations given the longer time horizons involved in determining the BNE.

Specific areas for consideration

Difference Payments Socialisation Arrangements

While the topic of socialisation is subject to the RA's third Capacity Remuneration Mechanism Consultation Paper, Power NI notes with concern that the issue has already progressed to design proposals at the Energy Trading Arrangements Rules Working Group. Such dual considerations highlight the inherent risk of having separate workstreams attempting to deal with issues which have clear inter-dependencies.

The concept of a socialisation fund requires careful consideration. Due to the wider development and design of the CRM it is clear that the mechanism, application of a scarcity price and one-way CfD rules will not provide the desired supplier hedge in all instances. This "hole in the hedge" is clearly undesirable, represents a significant risk and requires addressing.

The socialisation fund is in essence an insurance policy for suppliers complete with premiums to be paid and returns at times of duress.

Supplier's contributions to the fund

Power NI welcomes and supports both the two objectives (adequate funding and avoiding shocks) and set of principles outlined in Sections 8.3.7 and 8.3.8 of the Consultation Paper. The RA's have outlined a funding arrangement which is predictable and therefore manageable by suppliers i.e. "*recovered from Suppliers by increasing the amount they are charged for capacity*".

For the avoidance of doubt, Power NI believes the practical implementation of this proposal would require SEMO (backed by Eirgrid and SONI) acting as

Balancing Market Operator (BMO) and CRM settlement entity to forecast the quantity of money to be paid under the option fee and publish this ahead of the year. Through each out-turned month, the sum required to be paid out would be divided by the total demand consumed in that month, shaped as the RAs require and charged accordingly. In relation to the fees therefore, on a monthly basis the money out would equal the money in. This is consistent with todays CRM operation. While this incurs some forecasting risk for suppliers, it relates to demand forecasting which all suppliers are familiar with managing.

The price per MWh (shaped as the RAs require) would then have a "top up" applied to fund the socialisation fund e.g. if the outturn calculation in a a particular half hour was £10/MWh to pay the fees a £1/MWh additional could be added for the socialisation fund. The supplier would then be charged £11/MWh.

Power NI notes that the RAs are proposing a 90% confidence level in setting the contribution rate and would support this confidence level being a parameter that is consulted on.

Power NI also welcomes the statement "*In general, any shortfall can be covered through borrowing*". In Power NI's view this statement by the RA's sets the expectation that the BMO will manage within year shortfalls through a corrective K-Factor.

Shortfalls in the fund

The RA's have however highlighted that the BMO may not be able to cover all shortfalls through borrowing. Power NI has interpreted this to mean that should an under recovery become too large, the RAs do not expect the BMO to cover the shortfall and recover through the following years correction. Power NI does not agree with this approach and believes the BMO should manage all shortfalls through a corrective K-Factor.

Power NI does not support either of the proposed solutions put forward by the RAs in the Consultation Paper in relation to dealing with shortfalls. Both options expose suppliers to unmanageable financial risk. The 'suspend and accrue' simply pushes the working capital obligations to suppliers who tend to be asset light organisations with a cost of capital likely to be significantly higher than Eirgrid/SONI. The 'immediate additional charge' option is equally unacceptable as this cannot be forecast or included in retail tariffs. This simply also moves the working capital obligation to suppliers. These options therefore represent a significant risk to existing suppliers, are distortive and will act as a barrier to entry.

While Power NI expects a shortfall to be an exceptional circumstance, we do recognise the working capital obligations the above arrangements place on the BMO, especially until the fund is fully established. To mitigate against such a concern, Power NI would welcome and support the RA's approving the transitionary inclusion of a small socialisation fund charge being added to the capacity requirement for tariff year 2016/17 i.e. a small levy on a per MWh basis added to the CPDP (Capacity Period Demand Price) for October 2016 to September 2017 to create the fund for the start of the ISEM. Power NI would expect this to be subject to all relevant due diligence, regulatory audit and contractual trust arrangements. This has the advantage of establishing the fund ready for Day 1 of the I-SEM while smoothing the required contributions necessary to meet the proposed confidence metrics over a longer duration.

Such an approach would reduce the BMO's working capital concerns and facilitate the management of shortfalls within year. This removes the need for the options proposed. Additionally, such an approach would provide a further incentive on the TSO's (as ultimate owner of the BMO), to actively manage system capacity in such a manner as to avoid scarcity events.

Power NI would strongly urge the RAs giving this proposal full consideration.

Conclusions

Power NI is supportive of the inclusion of a CRM in the I-SEM and for the continued stakeholder engagement on its design. The CRM should be fair, cost effective and backed by physical generation able to provide energy at times of system stress, thereby maintaining the agreed security standards. The correct balance needs to be struck that adequately rewards providers of capacity and sends appropriate investment signals whilst at the same time does not burden consumers with excessive costs.

Power NI has focussed primarily on the difference payments socialisation arrangements which, as described, are in essence an insurance policy for suppliers complete with premiums to be paid and returns at times of duress. Given the inherent "hole in the hedge" risk associated with reliability options, Power NI supports the creation of this fund and the two objectives (adequate funding and avoiding shocks) and set of principles outlined in Sections 8.3.7 and 8.3.8 of the Consultation Paper upon which it will be established.

In terms of potential shortfalls in the fund and how they are dealt with, Power NI does not support either of the proposed solutions put forward by the RAs in the Consultation Paper. Power NI feels a more appropriate solution would involve the BMO managing all shortfalls through a corrective K-Factor.

Power NI has also suggested and would welcome and support the RA's approving the transitionary inclusion of a small socialisation fund charge being added to the capacity requirement for tariff year 2016/17 i.e. a small levy on a per MWh basis added to the CPDP (Capacity Period Demand Price) for October 2016 to September 2017 to create the fund for the start of the ISEM.

Whilst focusing on the supplier arrangements, Power NI also recognises the importance of other issues raised in the Consultation Paper, including market power. Consumers will ultimately pay if capacity prices are inflated through market power being exerted in CRM auctions. For this reason a robust, targeted, transparent and enforced package of measures must be implemented to mitigate opportunities to exert market power.

Power NI is happy to engage further with the RAs in respect of the points raised in this response.