

## **SEM Consultation Paper SEM-16-010 Capacity Remuneration Mechanism – Detailed Design**

Vayu welcomes the opportunity to comment on the SEM Committee's ("SEMC") consultation paper – SEM-16-010 on the detailed design of the Capacity Remuneration Mechanism ("CRM"), which covers the overall auction design and governance arrangements.

In general, Vayu would have preferred to see more consideration given to developers, potential new entrants and to alternative and renewable technologies in the development of the CRM rules. As it stands, the CRM appears to have been designed almost exclusively to support incumbent generators and developers of conventional thermal plant only.

In particular, we would like to see a larger share of the capacity market reserved until T-1 to allow greater participation from the demand side and innovative technologies. We note that the consultation report refers to GB procuring only 800MW of T-1 capacity for 2016 as some 2% of demand. However, the target procurement capacity was 1500MW, a larger requirement, and the 45.4GW of T-4 capacity procured comprises 87% of expected peak demand of 52GW. Vayu would prefer to see closer to 20% of capacity purchased at the T-1 stage. We believe this would encourage greater competition by creating a larger market for new-entrants and by encouraging market exit of older, incumbent plant at an earlier stage.

With regard to the governance arrangements and administrative processes, Vayu would prefer to see a much reduced involvement by the TSOs. This becomes significantly more important when the cross-border trading arrangements involve capacity payments to the full availability of the interconnectors. If the auction cannot be administered by a third-party organisation, we would strongly advocate the setting up of a completely ring-fenced entity with full business separation from the main part of the TSOs to undertake this activity.

Finally, we would like to make the suggestion of introducing horizontal ring-fencing between each generation plant of any dominant market players and requiring them to bid as individual business units. This would have the effect of introducing many more individual bids into the auction, reducing the potential for market power to operate and promoting competition, with each station manager submitting individual bids for their plant.

We are, as always, open to discussing our views in more detail and our comments on the specific consultation questions are as follows:

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

Vayu agree with the proposed approach for transitional auctions and argued in support of this in the previous consultation.

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

Vayu are pragmatic in relation to the flexibility around the timing of the auctions and are comfortable with some limited variability in the proposed dates.

**4.8.2 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?**

Vayu believe that market power is a material concern in the I-SEM CRM where there is a high concentration of ownership of capacity and that the SEM committee should focus strongly on methods to limit this power and mitigate its impact. Both unilateral market power and tacit collusion should be of concern. However, tacit collusion is a problem in any periodically repeated auction; it is often difficult to identify and mitigate its effects so it should be of primary concern to the SEM Committee. Vayu believe that regulation based on principles, rather than prescriptive rules, is best placed to mitigate these issues and that it is the role of the Regulatory Authorities to apply these to market participants individually or collectively as required.

**4.8.3 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?**

Vayu believe that the overall market control framework proposed is robust and proportionate, but may not be sufficiently comprehensive to cover all situations of market power abuse. The SEM Committee should focus on a principle of evolving towards a competitive market.

Incumbent plant owned by dominant generators should be subject to forced divestment where it has opted out of an auction. This should promote competition by removing the advantage of existing low-cost sites from dominant generators and prevent them holding a portfolio of 'retired' generation capacity that could deter new entrants by the threat of its return to service reducing prices below their costs. This situation occurred in the 1990s in the England and Wales Pool, where the dominant incumbents, National Power and PowerGen held large portfolios of 'mothballed' small coal and oil-fired generation plant that could return to service at short notice and suppress prices to the detriment of new entrants.

Finally, an additional market power mitigation measure would be to introduce horizontal ring-fencing on dominant generators and require them to bid each plant individually as a separate business unit without knowledge of or reference to the other plant in the portfolio. This would effectively introduce many more individual participants into the auction, increasing competition and reducing market power concerns.

**4.8.4 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?**

Vayu are comfortable that this behaviour may be normal commercial behaviour or risk management and should not be specifically prohibited. The owner of generation capacity may have modified its plant between the T-4 and T-1 auctions or just generally have greater confidence in its operation allowing it to bid closer to the tolerance band. However, where this behaviour is undertaken on a frequent basis by dominant generators, the SEM Committee and Regulatory Authorities should query the reasons and seek supporting evidence from the generator for these decisions.

**4.8.5 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)?**

The competitive benchmark of an HHI less than 1,000 broadly envisages 10 equally sized market participants. Any participant with a capacity market share greater than 10% should, therefore, be considered as dominant for the purpose of either applying bid limits or controls on aggregation. This, and other, measures provide clear indications of dominant market participants in the Irish context and it should, therefore, be relatively straightforward to identify where bid limits and/or aggregation controls apply.

**4.8.6 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?**

Vayu believe very strongly that dominant generators and their associated businesses (e.g. Supply arms) should be prohibited from acting as Capacity Aggregators. Changes to market rules and arrangements do not in themselves guarantee a competitive market and optimal outcomes for consumers and participants. A flawed market structure (in terms of number and size of participants) with a high degree of concentration of ownership will almost always produce uncompetitive outcomes and the SEM Committee should be mindful of this and act to prevent any dominant participants from further increasing their level of ownership or control.

**4.8.7 Should there be a prohibition on ESB and other dominant generators providing aggregation Services?**

Consistent with our response to Question 4.8.5 and 4.8.6, Vayu strongly believe that ESB and other dominant generators should be prohibited from providing aggregation services.

**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?**

Vayu believe that simple sealed bids should be used initially in all cases. There remains too much scope for application of market power in the CRM to use a different format, providing additional information to dominant market players. However, Vayu would consider it acceptable to have some relaxation of the simplicity of bids to allow for combinatorial or mutually exclusive bids to allow smaller tranches of capacity to be entered in the market and avoid the 'lumpiness' problem of large volume bids at the margin.

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

Vayu would prefer Option 2, the submission of a supply curve which is a function of  $Q_i(P_i)$  as this goes some way to mitigating the 'lumpiness' problem of large volume bids at the margin. However, Vayu would consider the possibility of relaxing the requirement for this curve to be monotonically increasing (or some combinatorial approach for bids) to further address this issue.

**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.**

Vayu generally agree with the approach of Option 3b, accepting out-of-merit bids based on optimisation of net consumer welfare. Vayu would further suggest some relaxation of the requirement for monotonically increasing bids or other methods are explored to encourage the availability of smaller volumes at marginal prices. A further suggestion would be to consider having larger tolerance bands in the T-4 auction to encourage improved bids on smaller, residual volumes at the T-1 stage.

**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.**

Vayu agree with this approach as a reasonable methodology and as it is similar to energy market rules on acceptance of out-of-merit bids.

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

Vayu believe the SEM Committee should introduce a sloped demand curve. This would go some way to controlling market power, reducing the 'lumpiness' problem and is consistent with practice in other capacity markets.

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

Vayu do not agree with auction winners being determined purely on price offered for each Capacity Delivery Year. This runs a risk of the short-term capacity prices being insufficient to attract new entrants and favouring incumbent participants, a situation that is not in the long-term interests of the market or consumers. Ideally, the auction should take a longer-term view and award longer-term contracts to new entrants before short-term prices greatly exceed the cost of new-entry.

**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?**

As detailed above, Vayu support the ability of the auctioneer to accept out-of-merit bids, on a net consumer welfare basis, to manage the 'lumpiness' problem.

**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?**

Vayu believe that it is appropriate to pay-as-bid for out-of-merit bids and for the in-merit bids to be paid at the uniform clearing price based on the highest accepted in-merit bid.

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

In addition to the measures outlined in the consultation and discussed above, Vayu would be supportive of measures to relax some of the bidding constraints to encourage smaller volume bids at the margin.

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

The proposals for tied bids, including a coin-toss for the ultimate resolution of tied bids, seem fair. One further suggestion would be to have a preference for new entrants over incumbents or generators with a dominant position to encourage further competition in the market.

**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?**

Vayu believe that a minimum of information should be provided in order to reduce the market power of dominant incumbents and that multiple round auctions are, therefore, inappropriate. Pre-auction, information should be limited to simply the quantity that the CRM is seeking to procure and post-auction only the clearing price and quantities awarded should be announced.

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

Vayu are comfortable that the sanctions and measures within existing competition law should provide sufficient restriction on bidder communications, provided it is made clear that these will apply in full to any attempt to exchange information to affect the auction outcome. Vayu would suggest that the individual generating plant of participants with a dominant market share should be forced to bid as individual businesses and that restrictions on communications should apply equally to them.

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

The overall scope/process of auction parameter setting appears to be well thought out and comprehensive.

**6.5.3 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?**

The principles listed cover the requirements to determine the slope and range of the demand curve, provided these can be reviewed in the light of experience of completed auctions.

**6.5.4 If introduced, should the sloped demand curve be different for the transitional period?**

Ideally the sloped demand curve should be as consistent as possible to allow participants to get comfortable with its operation. However, Vayu would not object to a different curve for the transitional period if circumstances warrant it.

**6.5.5 What impact do you think the sloped demand curve will have on competition?**

Vayu believe that a sloped demand curve should help competition at the margin by providing an incentive to marginal bidders to keep prices low rather than an 'all or nothing' result from a vertical demand curve.

**6.5.6 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?**

Vayu believe that there should be an Auction Price Cap as consumers should not be paying an unlimited price for security of supply (this is consistent with concept of VOLL). We are comfortable with a multiple of 1.5x of the estimated CONE as a starting point, although this may need to be revised between the T-4 and T-1 auctions for any year if the capacity margin is particularly tight.

**6.5.7 Do you agree with the requirement for other Bid Limits?**

Vayu believe that the market for capacity is not sufficiently deep, liquid or competitive to operate without other Bid Limits.

**6.5.8 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?**

Vayu believe that the Bid Limits should be technology, or potentially even plant, specific, as there is the potential for radically different costs for capacity by technology.

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

Bid Limits should be applicable to only the dominant/pivotal generators with other participants and new entrants allowed to compete freely.

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

The principle of aiming to ultimately deliver an open, competitive market should be used to determine Bid Limits. Vayu believe they should be set in a band around allowable fixed costs plus a reasonable return on assets for incumbent generators. Incumbent generators should not generally be bidding well above CONE (extracting too much value from an uncompetitive market) or well below their costs (undercutting competition and deterring new entry).

**7. The SEM Committee welcomes views on all aspects of this section, including:**

**A) Do you agree on the proposed role of the TSOs with respect to the auctions?**

Vayu disagree with the proposed role of the TSOs with respect to the auctions. While the TSOs may have a licence obligation to administer the Capacity Market and auctions, Vayu believe this obligation should be discharged by procuring an independent third-party organisation to carry out these requirements on behalf

of the TSOs. The TSOs' role in this process should be minimised to provision of forecast demand and capacity requirement for the auctions.

In the event that the TSOs are left to administer the auctions, they should create, as a minimum, a separate, ring-fenced entity to carry out these functions that is based in a separate office with completely independent communications channels (email and telephone systems).

**B) 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?**

Vayu are in broad agreement on the requirement for an Independent Auction Monitor and its proposed roles and responsibilities. We would note, however, that simply ensuring the rules for the operation of the auction are correctly administered does not of itself ensure that the capacity auctions generate a fair result.

Combining the role with the SEM/I-SEM Market Auditor in the interests of efficiency and consistency seems sensible and acceptable.

**C) 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 agree with the SEM Committee's proposed approach to managing conflicts of interest in the Capacity Market Code as a bare minimum requirement. Vayu believe that actual or perceived conflicts of interest would be better managed by the creation of an organisation entirely separate or ring-fenced from the TSOs to administer the capacity remuneration mechanism (see answer to 7.A, above).

**D) Do you have any comments on the proposed auction governance arrangements?**

Vayu believe that actual or perceived conflicts of interest would be better managed by the creation of an organisation entirely separate or ring-fenced from the TSOs to administer the capacity remuneration mechanism (see answer to 7.A and 7.C, above).

**E) Do you have any views on the model and process for making modifications to the Capacity Market Code?**

Vayu would suggest that the model and process for making modifications to the Capacity Market Code be aligned to the process for other industry code modifications. The process should be made as simple as possible and operate only infrequently to allow better participation by smaller market participants and new entrants.

**F) 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?**

Vayu support the principle of aligning the dispute processes across market codes for clarity and simplicity. Using the same panel for TSC and CMC disputes would promote efficiency and consistency and the ability to deal with issues that cross both codes. The main caveat to this would be to ensure that the panel has sufficient expertise, understanding and independence to cover all issues.



**8. The SEM Committee welcomes views on all aspects of this section, including:**

**A) Do you agree with the proposed approach to incorporating the carbon price into the Strike Price formula?**

Vayu agree with the proposed approach to incorporating the carbon price into the Strike Price formula. Generator's requirement for emission's allowances are broadly equivalent to their requirement for fuel when they operate so it is logical to include these costs in the strike price.

**B) Do you agree with the approach of moving to a month-ahead index?**

Vayu disagree with the approach of moving to a month-ahead index. We believe that the Strike price for Reliability Options should reflect the short-run marginal costs of operation of generation plant as much as possible which would be a day-ahead or within day index for gas prices. This is consistent with the operation of the current TSC and we do not see an overriding reason to move away from this. This approach should not be changed until there is greater understanding of the Administered Scarcity Price and its operation in the market.

**C) Do you agree that a reference thermal efficiency of around 15% is appropriate? If not, why not?**

A thermal efficiency of 15% seems appropriate to reflect the low efficiency of peaking plant and to generate a strike price that is generally above 'normal' market energy prices.

**D) Do you agree that the appropriate oil price is the Heavy Fuel Oil price?**

Vayu agree that the Heavy Fuel Oil price is the appropriate oil price, reflecting the lower thermal efficiency of HFO plant operating for short periods.

**E) 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?**

Vayu agree with the principles used to choose between the data sources for these variables.

**F) 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?**

Again, Vayu agree that this proposed governance process is sensible and pragmatic.

**8. The SEM Committee welcomes views on all aspects of this section, including:**

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

The proposed approach for setting the Suppliers' contribution rate seems broadly sensible and fair. However, as this fund is effectively collateral we would expect that Suppliers would receive back any interest on their contribution to the fund and, in the event of withdrawal from the market or reduction in their deemed share of the socialisation fund (e.g. from reduction in supply market share) any supplier should receive back a proportionate share of the fund.



**B) 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.**

Vayu do not believe either option is satisfactory as an immediate solution to socialisation of any shortfall in Reliability Option difference payments. Both options are prejudicial to the interests of suppliers and/or consumers.

In the 'suspend and accrue' option, suppliers are faced with a shortfall in their difference payments and an impact on their cashflow that could be damaging to suppliers with weaker balance sheets. In the immediate additional charge option, suppliers are forced to pay an additional charge immediately where they may not have any mechanism to recover this from consumers in the current year and no guarantee they can recover it in future years.

We also see no reason why the costs of this shortfall should only be socialised across suppliers. If there is insufficient cash in the capacity remuneration mechanism to cover difference payments due to suppliers, fixed capacity payments to generators for the remainder of the capacity year should also be reduced such that the generator community bear their share of 'socialisation'.

We believe the SEM Committee should more fully consider additional and alternative methods for shortfall socialisation beyond the immediate use of the socialisation fund. The consultation mentions borrowing to cover any shortfall. We believe that the TSOs would be best placed to take on this borrowing, being asset heavy businesses with a strong cashflow and a better mechanism than most suppliers to recover the cost of this borrowing in future capacity years. If the costs of borrowing becomes too high to be efficient, it would seem sensible to purchase insurance against this risk, with the cost of this insurance taken from the socialisation fund on an ongoing basis. Such methods have been used by regulated clearing houses to ensure that market participants receive payments with an extremely high level of certainty and their use in this situation should be considered.