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12th May 2017

RE: Balancing Market Principles Code of Practice ("BMPCOP"), Consultation, SEM-17-026

Dear James, Brian,

Bord Gáis Energy ("**BGE**") welcomes this opportunity to comment on the BMPCOP Consultation. As outlined in our 18th November 2016 response to the Complex Bid Offer Controls in the I-SEM Balancing Market ("**BM**") consultation, BGE has significant concerns regarding the scope for the exercise of market power in the BM, particularly by units operating in non-competitive constraint locations. In this regard, we welcome the Decision made pursuant to that consultation (SEM-17-020), to apply an Offer Principles as opposed to an Offer Limits approach. A principles approach will in our view aid transparency and predictability in terms of price outcomes and will help ensure that costs, particularly Dispatch Balancing Costs which are ultimately paid for by the consumer, will be minimized.

Other key elements of Decision SEM-17-020 that BGE welcomes include the decision to assess Short Run Marginal Costs over the Imbalance Settlement Period and the decision to enable market participants to account for certain foregone revenues in their bidding. However, BGE has outstanding concerns on a number of aspects of the proposed BMPCOP document itself. Chief among these is the effect of assessing marginal cost on the basis of an increment or decrement of 1MW, particularly in the context of its potential for abuse when submitting gas transportation capacity costs. We believe that this issue, together with a number of other issues outlined below have the potential to inadvertently result in outcomes which are either not in the interest of consumers in terms of costs, or practical from a market participant perspective. We do not believe that it was the intention of the SEM Committee ("**SEMC**") to allow such outcomes. We urge the SEMC to take the below comments into account before finalising this draft version of the new Balancing Market Principles Code of Practice ("**BMPCOP**").

1. Assessing the marginal price by reference to 1MW

BGE's primary concern with the current drafting of the BMPCOP relates to the cost metric used to define the incremental cost of increasing or decreasing output. Requiring costs to reflect the change in total Eligible Costs for a 1MW change in output could have unintended consequences and influence market participant behavior such that costs are applied in a way that could drastically increase Dispatch Balancing Costs ("**DBCs**"). This could have knock-on negative impacts for consumers.

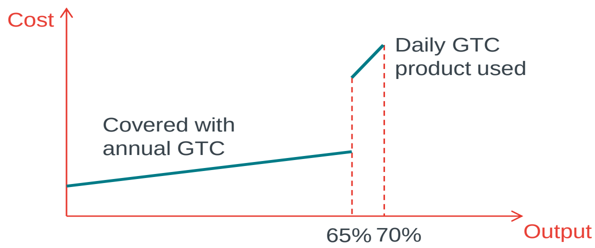
The primary example of where this concern may materialise is in the bidding in of Gas Transportation Capacity ("**GTC**") costs. Under Section V (Valuation of Cost Items at Opportunity Cost) of the draft BMPCOP, GTC shall be either the cost of purchasing more GTC (if it is not already held) or the amount which would be realised by disposing of unused GTC, referenced to the price of the product on a generally accessible and liquid market. Where there exists a recognised and generally accessible trading market in the relevant cost item, the Opportunity Cost ("**OC**") of that item should reflect its prevailing market value or spot price for the operating day. Where no recognised and generally accessible trading market exists in that cost item, its OC should reflect the costs which would be incurred by the Licensee in replacing that cost item.

BGE's concern is that assessing marginal cost using a 1MW change in output could result in: a) bids that are not particularly cost-reflective; and b) use of a GTC procurement strategy to the detriment of consumers who pay higher DBCs.

The textbook definition of marginal cost is a change in total cost for a small change in output. The straight application of this definition in scenarios where market participants can influence the cost at which they purchase a particular input over different volume ranges (e.g. through their procurement actions), can however lead to a risk of manipulation. BGE submits that application of a cost metric of 1MW is appropriate only in competitive environments where for example *efficient* marginal cost pricing would be observed as competition would prevent any plant attempting to manipulate pricing outcomes.

Generation costs vary non-linearly with output. However, in I-SEM participants are free to choose the spacing between price-quantity ("**PQ**") pairs they submit to the BM. In situations where competition is lacking (either locationally or through the merit order), the combination of the ability to choose the number of PQ pairs and the rule that it is the last MW of production which should determine a cost reflective bid or offer could result in non-cost-reflective pricing. Take for example the scenario where a participant can engineer their procurement of inputs such that the costs rose with outputs. Under the SEMC's proposed BMPCOP drafting, in scenarios where no effective competition exists, these units may be able to submit an offer to sell energy that is not reflective of reasonable costs. In the case of GTC, this could be achieved relatively simply. Suppose that a participant knows that, relatively frequently, they are likely to be dispatched to 70% plant capacity as a result of a transmission constraint. That participant could purchase annual GTC sufficient to operate their plant at say 65% capacity, leaving the GTC for the last 5% of capacity to be met through purchases of (more expensive) short term products.

Figure 1. Example of GTC procurement option - concern



Under the proposed BMPCOP drafting, the above unit's commercial offer data would be determined in relation to the cost of the last MW produced which can include short term GTC products as an Eligible Cost. This would allow the unit to make excess profit on the first 65% of their output. Such a scenario would ultimately end up being paid for through DBCs (by the end consumer).

We do not believe that the SEMC intended to leave this possibility open in the draft of the BMPCOP. In our 18th November 2016 response to the Complex Bid Offer Controls in the I-SEM consultation, we also highlighted the risk that the proposed drafting would not result in cost-reflectivity and suggested that the cost metric used to define appropriate incremental costs should instead be defined in terms of the incremental cost associated with altering output as specified in the relevant offer. In the case of energy offers, this would imply the incremental costs of increasing or decreasing output by the specified volume for the specified Imbalance Settlement Period.

Even if the SEMC is not minded to fully adopt this proposed approach, we suggest that there is an absolute need to increase the range of output over which marginal costs are assessed from the 1MW proposal. BGE further submits that the risk of manipulation in the manner described above should be addressed by requiring that participants' procurement strategies in relation to all relevant inputs are cost minimising. Otherwise, there are considerable concerns around the possible negative impacts on DBCs paid for by end consumers.

2. Double counting of gas transportation capacity costs

BGE has a further concern regarding GTC costs under Section IV (Eligible Cost Items) of the draft BMPCOP. The drafting in that Section states that where a gas price index that is outside the island of Ireland is used in the fuel costs calculation method, then the method may include an element to account for relevant incremental GTC costs. BGE understands that at certain times of the year the GTC for the gas IBP already includes transportation costs. It is critical that provision is made in the BMPCOP to prevent the double-counting of GTC in such instances.

BGE suggests that this could be addressed for example by requiring that, GTC should only be included in the fuel costs calculation method where such GTC costs have not already been incorporated in the relevant fuel costs.

3. Removal of "reasonable provision for increased risks" and start up costs

At a high level, BGE does not agree with the removal, under Section V (Valuation of Cost Items at Opportunity Costs), of the provision allowing for "reasonable provision for increased risks to plant and equipment as a result of the operation of a generation set or unit". This in BGE's view misrepresents the costs that are relevant for generation units from an economic perspective.

BGE's main concern with providing for inclusion of a reasonable degree of risk of operating a plant is in the context of starting a plant. With increasing levels of variable renewables on the system, coupled with the dynamic nature of the new I-SEM trading arrangements it is very likely, if not unavoidable, that thermal plants will succumb to significantly more two-shifting in future. Studies have shown that increased cyclic operation of a plant has effects such as lowering availability due to increases in failure rates and increased outage time, reductions in efficiency and needs for increased spend on component replacement and operation.

BGE therefore urges the SEMC to consider including the paragraph of "reasonable provision for increased risks to plant and equipment as a result of the operation of a generation set or unit", only for the start costs component of bid offer data. To do otherwise undermines the practical and economic realities of operating a thermal unit in a market that is increasingly dominated by variable renewables. It could also have a knock-on negative impact on the continued viability of units that are critical as back up sources for variable renewables.

4. Variable Operating and Maintenance Costs and valuation at Opportunity Cost

BGE welcomes the SEM-17-020 decision to permit Variable Operating and Maintenance ("**VOM**") costs to be included as relevant Eligible Cost Items. From BGE's interpretation of the draft BMPCOP however, it appears that VOM are Eligible Cost Items that must be valued at the defined Opportunity Cost – i.e. using the approach of referring to a prevailing market value or spot price for VOM or else providing at least 3 bilateral offers evidencing the VOM cost.

BGE believes that this is not the intention of the SEMC as neither of these situations for calculating OC apply to VOM. There is no recognised and generally accessible market to point to and with regard to providing 3 bilateral offers, as we understand it the majority of plant would have already entered long term contracts with relevant manufacturers to provide the VOM work required.

BGE therefore requests that the SEMC confirms that the OC approach does not apply in the case of VOM.

5. Summary and Conclusion

In summary, an Offer Principles approach provides a degree of transparency, predictability and certainty with regard to market outcomes which BGE welcomes. BGE's key concerns regarding the draft BMPCOP which we urge the SEMC to take into account before finalising the BMPCOP however, include:

i. The need to re-consider increasing the range of output over which marginal costs are assessed from 1MW. Otherwise there is significant potential for market power abuse and increased DBC costs for consumers. The issue is most evident in the context of the procurement of GTC costs as outlined in section 1 above. BGE does not believe the SEMC intends the BMPCOP to allow for such outcomes and urges correction of the issue before finalising these principles;
ii. The need to include provision in the BMPCOP to prevent market participants from double counting GTC costs where the fuel cost already incorporates an element of GTC cost, as outlined in section 2 above;
iii. The need to allow for reasonable provision for risks to operating a plant for start costs only, given the real economic impact increased cycling will have in future. Otherwise, legitimate cost recovery will be undermined and the continued viability of plant required to support renewables would be put at risk;
iv. Confirmation that the Opportunity Costs calculation does not apply to VOM costs given the impracticalities of such as outlined in section 4 above.

I hope that you find the above comments and suggestions helpful. Please do not hesitate to contact me should you have any queries.

Yours sincerely,

Julie-Anne Hannon
Regulatory Affairs – Commercial
Bord Gáis Energy

{By email}