Single Electricity Market

Decision Paper on the

Criteria for Approval of Intermediary Applications under the Trading and Settlement Code

28 February 2007

AIP/SEM/07/029

1. Introduction

Version 1.0[1] of the Trading and Settlement Code (TSC) published on 15 February 2006 (AIP/SEM/10/06) provided for the registration of Intermediaries with the express approval of the Regulatory Authorities (RAs). The role of Intermediaries is to act for licensees in relation to specific generator units under the TSC, taking on, for example, their rights and responsibilities including bidding, settlement and provision of credit cover. The TSC provides that the RAs may specify the time period for which the Intermediary may participate in the SEM.

Accordingly, the RAs drew up on 26 September 2006 a proposal outlining the criteria to be applied by them in considering whether a Party to the TSC may be permitted to register an Intermediary to act on its behalf in relation to one or more generator units. The paper also considered the extent to which such registration should be subject to specific time limitations.

Comments were invited on the basis of this proposal and were received from a range of participants. This paper sets out an overview of these comments and the RAs' response to these. The purpose of this paper is to identify the key issues and present the RAs' conclusions on the criteria for approval of Intermediary Applications under the TSC.

The structure of this paper is as follows:

Section 2 outlines the background of the Single Electricity Market and the idea of a gross mandatory pool and goes on to describe the concept of Intermediaries.

Section 3 gives a brief description of the RAs' original proposal as set out in the consultation paper.

Section 4 considers the responses from various parties consulted on the criteria that will apply to Intermediary applications.

Section 5 outlines the principal issues and arguments arising out of the consultation process.

Section 6 sets out the RAs' final conclusions and decision.

2. Background

One of the key principles upon which the Single Electricity Market is based is that of a gross mandatory pool, as established by the rules set out in the TSC. This assumes that all energy traded in the SEM will pass through the pool with no bilateral arrangements for the physical trading of energy (other than for that generated by units with a capacity below a de minimis threshold). The RAs have expected, throughout this process, that all market participants will use best endeavours to transition existing physical arrangements to financial instruments in line with the requirements of the new market.

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[1] The position of Intermediaries remains largely unchanged in Version 1.2 of the Trading and Settlement Code published on 31 January 2007.

The concept of Intermediaries provides an exception to this rule, to the extent that energy would first be sold bilaterally outside the pool, before it is bid into the market by the purchaser of the energy (as against the generator). Intermediaries were originally proposed as a means of dealing with exceptional circumstances under which pre-existing bilateral arrangements could not readily be transitioned to the new market. The power purchase arrangements in Northern Ireland between the power procurement business of Northern Ireland Electricity plc. and a number of generators are a specific example of such arrangements.

The use of Intermediaries by generators would thus provide for a straightforward and transparent means of dealing with specific types of legacy arrangements under the SEM, effectively minimising disruption caused to existing arrangements that otherwise would be impractical.

While in one sense, such provisions constitute bilateral arrangements outside the pool, the energy is still bid through the pool (by the Intermediary) and it can be argued that it does not significantly alter the position that would arise if the specific legacy arrangements were capable of being easily transitioned across to CfDs.

Nonetheless, permitting all participants in the SEM to make use of Intermediary arrangements without restriction has several significant drawbacks:

- The existence of Intermediary arrangements has the potential to create additional concentrations of market power - e.g. if unchecked, provision for Intermediaries could, at the extreme, allow one person to bid in all available generation into the market

- In this respect market monitoring in the SEM could be made more difficult if Intermediaries were to be permitted across the board

- It is more complex to ensure that generation licensing obligations such as compliance with the TSC, obligations to comply with the Grid Code, restrictions on bidding behaviour; compliance with other codes and contracts etc. can be applied in relation to Intermediary generator units

3. Original RA Proposal – Consultation Paper of 26 September 2006

In view of the above considerations, the Regulatory Authorities proposed in their consultation paper - *Single Electricity Market: Intermediaries under the Trading and Settlement Code: Criteria for Approval of Intermediary Application* that the registration of Intermediaries should be confined to a small number of instances under limited circumstances. The Regulatory Authorities took the view that strict criteria should be applied in assessing applications, such criteria being driven by the objectives of counterbalancing a simplified transition, which would avoid significant additional pressure (financial or otherwise) on market participants in advance of go-live, whilst ensuring the retention of proper regulatory controls on the market.

The following criteria were proposed, each necessary for an application for Intermediaries to be successful:

a. Legitimate Expectations/Whether the contract was imposed by Government

b. Whether the contract was entered into before the SEM market design was published

c. Whether appropriate regulatory arrangements continue to apply in relation to the generator units

AER (Alternative Energy Requirement) contracts, NFFO contracts and NI Power Purchase Agreements were considered to meet these criteria.

The proposal also took the view that an Intermediary arrangement should not be permitted to run longer than the underlying contract.

Furthermore, while the TSC provides that the Intermediary and the licensee in relation to the relevant generator unit should be jointly and severally liable, the RAs mooted the possibility of removing this owing to a concern that the Generator Unit may be liable for actions of the Intermediary over which they have no control.

4. Responses to the Consultation Paper

Responses from market participants to the Regulatory Authority proposal focussed on a number of key areas:

- **Contracts eligible to avail of Intermediary provisions**

  Market participants expressed concerns that transitioning PPAs to CfDs would be financially burdensome and would merely achieve the same result as the appointment of Intermediaries. The view was expressed by several participants that Intermediaries should be extended to all legacy contracts.

  Another issue raised by market participants is the differing treatment of AER and REFIT (Renewable Energy Feed in Tariff) contracts under the proposed Intermediary provisions. Respondents suggested that renegotiation of REFIT contracts would prove more onerous than renegotiation of AER contracts as requiring wholesale renegotiation of REFIT PPAs would be impermissible under REFIT rules, according to one response. Respondents also pointed to the lack of corporate structures for small renewable generators undertaking the role of generator in the TSC and stressed the need for a standard form of agreement governing third parties in the SEM.

  Other responses stated a preference for having no Intermediaries in the SEM and suggested that, at most, it be used as a last resort option which should be phased out as soon as possible.

- **Contract timeframe to apply to applications for Intermediaries**

  Respondents pointed to the difficulty in transposing physical bilateral contracts to financial contracts for the purposes of the SEM and expressed concern that the

selection of the High Level Design as the relevant cut-off date would discriminate against new market entrants who have recently entered into PPAs.

Other responses suggested introducing a prohibition on the renegotiation of contracts to take advantage of market rules as a fourth condition to be met before an Intermediary application can be approved.

- **Regulatory oversight of Generators**

In general, responses asked for clarity on the issue of enforcing the licence obligations of generators on Intermediaries and whether a specific Intermediary licence would be required. Several responses also suggested that the Intermediary should bid in the Short Run Marginal Cost (SRMC) of the generator unit into the pool and not the SRMC that the contract imposes on the Intermediary.

- **Joint and Several Liability**

There was a preference from many market participants for the removal of joint and several liability from the TSC in order to prevent the bearing of financial risk by the generator. Other responses suggested that a generator would have to become party to the TSC and accept all the liabilities set out there under.

5. Consideration of Issues arising out of the Consultation

The above responses give rise to a range of issues around the provision of Intermediaries under the TSC. The arguments below consider whether Intermediaries should be an enduring arrangement in the SEM or limited to legacy contracts under specific circumstances.

- **Extent of Intermediary Application in the SEM**

In discussions relating to the appointment of Intermediaries, the RAs have pointed out that there will be no specific restrictions on the ability of market participants to act through agents in discharging their obligations in relation to generator units under the TSC. Whilst acting through agents would still require the generator to be a party to the TSC, their agent (who would not need to be a party) would simply discharge their obligations for them. If the agent failed to discharge the obligations of the generator then the contractual breach under the TSC (and consequent licence breach) would fall on the generator. Under such an arrangement, the regulatory and central contractual arrangements would be “blind” to the use of agents. The RAs have argued that given this flexibility there is no need for the TSC to accommodate the use of agents in the general case.

A converse argument has also been put forward which is that if it is generally permissible for market participants to use agents to discharge their obligations under the TSC, and if the agency approach can effectively achieve the same solution as the Intermediary approach, then there should be no reason not to accommodate the Intermediary solution. Furthermore, it is argued that it would be costly to convert existing power purchase agreements into contracts for difference (CfDs) in order to support the agency route, and consequently that prohibiting the use of Intermediaries would

unnecessarily require market participants to incur costs in amending their existing contracts.

The RAs are however of the view that there are a number of material differences between the agency and Intermediary approaches, these are:

The use of Intermediaries would potentially dilute the RAs' ability to take enforcement action in the event of breaches of the TSC. If an Intermediary breaches the TSC the RAs would only be in a position to take licence enforcement action against the generator appointing the Intermediary (for failing to procure that the Intermediary has met its obligations under the TSC) and not the Intermediary who has actually failed to meet its obligations. From a regulatory perspective this compares unfavourably with the position under an agency arrangement where the generator is responsible under its licence for compliance with the TSC and obligations in the TSC in relation to generator units are obligations of the generator. In those circumstances in the event of a breach of the TSC, the RAs have the ability to bring enforcement action against the party that has failed to meet its obligations (the generator) directly.

In the RAs' view therefore, the interposition of the Intermediary in this process is both inappropriate and unnecessary and may adversely affect the RAs' ability to take quick, effective and appropriate action where a breach of the TSC has occurred. The RAs therefore wish to retain the ability to take direct enforcement action against the person which fails to meet its obligations under the TSC and hence do not support the widespread enduring use of Intermediary arrangements.

A failure to comply with an obligation under the TSC which affects generator units of more than one generator would potentially require action under the licences of a number of generators. Again, the RAs are of the view that this would inappropriately complicate and potentially dilute the arrangements for regulatory enforcement. For example it may result in the RAs having to examine the details of the Intermediary agreements as part of the licence enforcement process.

Whilst the potential liabilities of market participants are, in principle, fully secured under the TSC, there are instances in which unsecured debts may arise. For example following a breach which leads to a successful claim for damages, approximations and time-lags in the process for determining required levels of security cover etc. This opens up the possibility that licensees may be able to gain additional protection against such potential liabilities through the use of Intermediaries in a way that it would not be possible to achieve through the agency route.

The RAs are also concerned that by explicitly including provisions for dealing with Intermediaries in the TSC, the SEM arrangements may be argued to endorse commercial collusion between generators by facilitating such action through the Intermediary mechanism. Whilst such collusion would in principle also be possible through agency arrangements, in the latter case, it would not be explicitly endorsed by the trading arrangements themselves. Not only would such implicit endorsement be inappropriate, the RAs are of the view that it would be likely to lead to unnecessary and complex enduring rules governing the detailed circumstances in which Intermediaries can and cannot be appointed, something that would not be necessary under the agency model.

- **Conditions to apply in cases where Intermediaries are permitted**

If the option of using an Intermediary is to apply to legacy arrangements for a specified period, the point at which a contract is deemed to be a "legacy contract" clearly needs to be included in any criteria for permitting this. Respondents made valid points on the publication of High Level Design not being an appropriate date in this regard, with a later date preferred to allow for the requisite clarity of market rules. The RAs have taken this on board in this Decision Paper.

Further, any renegotiation of existing contracts with a view to taking advantage of market rules regarding Intermediaries should not be permitted, as Intermediaries are not intended to be an enduring mechanism in the SEM.

The RAs wish to ensure that they can take direct licence enforcement action against a licensed entity when an Intermediary appointed by it does not comply with its obligations under the TSC in relation to a generator unit for which it is responsible under that document.

Regarding the adherence to bidding principles by Intermediaries, the RAs wish to ensure that an Intermediary that is bidding into the pool is obliged to bid in at the Short Run Marginal Cost of the relevant generator unit in question.

6. Regulatory Authorities Decision

In view of the considerations set out in Section 5, the RAs have reached the following decision regarding Intermediaries under the Single Electricity Market TSC.

- **What Criteria Should Apply**

The RAs propose to limit the ability to appoint Intermediaries under the TSC to generator units which are subject to contracts entered into which meet all of the following criteria:

I. Where the Contract was entered into before the date of publication of this Decision Paper (that is on or before 27 February 2007)

It shall be possible under the TSC to appoint an Intermediary in relation to any generator unit in respect of contracts entered into on or before 27 February 2007.

II. Such arrangements (under I. above) shall be limited to 12 months from Market Go-Live. (PSO contracts are to be exempted from this condition)

The RAs consider a period of 12 months to be ample time for participants to adapt their contractual set up to comply with the SEM. Where a party's participation in a bilateral agreement was under a PSO contract,[2] the use of an Intermediary will be permitted for the duration of the contract.

[2] For the purposes of this paper, a PSO Contract is contract provided for in relevant legislation in Ireland or Northern Ireland, payments under which are underwritten by a Public Service Obligation levy.

III. Limited to the duration of the current contracts

The appointment of an Intermediary under the TSC by a PSO generator shall cease on termination or expiry of the underlying contract.

- **Regulatory oversight of Intermediary in respect of generator units**

Under the conditions set out above regarding the scenarios and duration that Intermediaries are to be permitted in the SEM, the RAs intend to include a condition in generator licences requiring them, where they appoint an Intermediary under the TSC in respect of generator units, to procure that the Intermediary complies with all of its obligations under the TSC in relation to those generator units[3].

Further, generators will be required to comply with other applicable conditions in their licences relating to their generator units - including ensuring that where an Intermediary is bidding in its electricity into the pool, the Short Run Marginal Cost of the generator unit is bid in[4].

Where a generator appoints such an Intermediary under the TSC, the generator shall ensure that the Intermediary complies with the TSC in relation to the relevant generator units, thus ensuring appropriate regulatory oversight of the Intermediary. In view of this, the obligation on generators to be a party to the TSC in order to avail of the Intermediary provisions will be removed from the TSC. When the period permitting the use of an Intermediary elapses in relation to a particular generator unit, to bid that unit into the pool the generator will need to accede to the TSC and comply with all the obligations under the TSC in relation to that generator unit.

In order to allow for the differing distribution of financial risk in underlying bilateral contracts, the prior proposal of joint and several liability for the Intermediary and its appointing generator in respect of a generator unit which is the subject of an intermediary agreement will be removed form the TSC. The Intermediary will be the party to the TSC which is contractually obliged to comply with obligations relating to that generator unit under the TSC.

Any generator availing of an Intermediary will nonetheless continue to be required to sign up to the Grid Code with the requisite connection agreement in place. The TSC will provide that an Intermediary cannot bid energy into the pool without the generator having a connection agreement in place.

Supplier units under the TSC will not be permitted to have an Intermediary act on their behalf.

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[3] Note that in the case of PSO generators this arrangement may be replaced with direct obligations to comply in the licences of the relevant intermediaries. In these cases, licence breach would be pursued against the intermediary.

[4] For PSO related generators, an obligation to bid in SRMC may be placed directly on the intermediary through its licence.