Response of Bord Gáis Energy Supply
to

The All Island Project Consultation
on

The Value of Lost Load, the Market Price Cap and the Market Price Floor Consultation Paper

AIP/SEM/07/381

Bord Gáis Energy Supply (BGES) appreciates having the opportunity to comment on "The Value of Lost load, the Market Price Cap and the Market Price Floor" consultation paper issued by the All Island Project on 2nd July 2007. The following is our response in relation to the proposals contained within that paper, certain elements of which we have serious concerns.

BGES agree with the proposed derivation of the implicit value for VOLL from the costs of a Best New Entrant peaking plant and the generation adequacy standard as set out in the consultation paper. We have no objection to the relevant constituent elements of the capacity payment sum calculations being used each year to derive the implicit value for VOLL for that year.

We do however have significant concern with regard to the proposed level of the PCAP. While generators are mandated to bid into the SEM at Short Run Marginal Cost (SRMC), the market rules state that in the event of insufficient capacity the SMP shall be set equal to the PCAP. Given the current level of generation in the SEM, both now and in the short term, this event could happen and possibly on a sustained or frequent basis. Should the market appear short on generation, the imposition of a very high PCAP could have perverse effects. An SMP of even half of the proposed value of PCAP would materially impact the profitability of most supplier organisations and in particular those who are not organised as part of a vertically integrated company. The resulting effect to credit cover requirements and cash flows may be detrimental to the financial stability of a supplier in the SEM and may invoke a default event, which is not in the overall market interest. The proposal will also have serious financial consequences for customers at the larger end of the retail market where pool price pass through tariffs are proposed. The proposed PCAP amount is simply not conducive to providing a stable business environment/market or for allowing fair treatment of all market participants.

Whilst an argument may be made that hedging contracts will reduce exposure to high pool prices for suppliers, it cannot be assumed that all participants will be fully hedged nor at all times. Certain suppliers may have difficulty obtaining adequate hedge contracts in the market. An independent generator could be actually reluctant to offer hedge contracts to the market (or at levels equivalent to their maximum generation capacity) in case their generator unit not being available happened to have been a catalyst, or a contributory reason, for SMP being equal to PCAP. The proposed PCAP may therefore result in fewer amounts of hedge contracts being made available to the market because of the uncontrollable risk element (while the reward for being uncontracted during a PCAP event may be considerable). The repercussions for suppliers are now further magnified if PCAP sets the SMP. A spike in normal market demand could also be a catalyst, or a contributory reason, for the market reaching the PCAP value. Suppliers could be exposed to extreme price volatility up to the value of PCAP for an unexpected increase in demand, which may reasonably be outside their control.

One of the stated justifications for the possible implementation of a PCAP is to mitigate against the potential exercise of market power in the SEM. However, in the consultation paper, the Regulatory Authorities (RAs) state that the various SEM market power mitigation measures are adequate and therefore the use of a PCAP as a defense against possible abuse of a market power position is not warranted. BGES disagrees with this viewpoint of the current market environment. Although there are license conditions placing SRMC bidding obligations on generators, BGES does not believe that the quantity of Directed Contracts that have been sold is sufficiently high to provide total mitigation of market power. Therefore, the existence of potential market power in the SEM does require the implementation of a PCAP. Furthermore, it warrants against having a PCAP value that is unreasonably high. A considerably lower PCAP than the one proposed should be incorporated for this reason.

The consultation paper acknowledges that SRMC bidding will not prevent prices from spiking if there are increases in SRMC or spikes in uplift, nor should it. However, it is extremely unlikely that even large increases in either would result in costs equal to the PCAP level. It is more possible that generation may not be equal to supply at times when neither SRMC nor uplift increases are anyway near as high as the proposed PCAP, yet during those trading periods, all dispatched generators will receive the PCAP SMP. Whilst we welcome the RAs intention to monitor the uplift methodology and reduce PCAP if any problems occur, suppliers/customers will be exposed to paying excessive power prices from the time that a problem may occur to the time that a decision can be made to reduce the PCAP. As before, the financial implications are significant and could result in negative financial consequences for all market participants.

We believe that an appropriate value for PCAP should be set at a maximum of 50% of VOLL at the outset of the SEM - with ongoing review as to the effectiveness of a cap at this level. We note that in ascertaining an appropriate price floor, the RAs wished to maintain a balance between minimising the exposure of participants to negative prices and dulling efficient price signals and proposed a price floor accordingly. The corresponding exposure of participants to excessively high prices should also be similarly considered by the RAs.

Conclusion

BGES believe that the proposed value of PCAP put forward by the RAs is unacceptable. Given the market environment, it is not inconceivable that implementation of the proposed value of PCAP will have material financial consequences on the profitability of independent suppliers. This could impede the development of a competitive market. Customers who are subject to market cost pass through tariffs could also face serious financial difficulties. It can therefore be reasonably deduced that a PCAP equivalent to VOLL may lead to an unstable trading and business environment. A PCAP value set at a maximum of 50% of the proposed €10,000 should be adequate for the SEM, given the supply/demand dynamics that will exist in the short/medium future at least.

BGES welcome the RAs intention to keep the values of VOLL, PCAP and PFLOOR under review for the first year of operation of the SEM. However, simply reviewing without being able to revise these values on a fairly immediate basis - particularly if they are causing severe financial hardship for suppliers and customers - may well result in an unfeasible market for all market participants.