

# **Single Electricity Market Committee**

## **Bidding the Opportunity Cost of Carbon Allowances A Decision Paper**

SEM-08-32

27 March 2008

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# 1 Introduction

The SEM Committee published a Consultation Paper (SEM-08-05) on 20<sup>th</sup> February 2008 which fulfilled a commitment given in August 2007 to consult on whether to allow greater flexibility in the Bidding Code of Practice to give generators the opportunity to compete away some or all of the benefits of the allocation of free carbon allowances.

The Consultation Paper discussed the arguments for and against allowing greater flexibility in the bidding of the opportunity costs of carbon. While the SEM Committee acknowledged that giving generators leeway in the bidding of carbon allowances might give a short-term benefit to customers in the form of lower electricity tariffs, it believed that such a change would mark an untenable move away from the explicit position on the bidding of carbon allowances which was taken (and generally endorsed by market participants) during the course of the development of the SEM. The SEM Committee was therefore minded not to change the Bidding Code of Practice to allow generators to bid less than the full opportunity cost of carbon.

Thirteen interested parties submitted responses to the Consultation Paper. They were:

- Airtricity
- Aughinish Alumina
- Bord Gáis Energy Supply (BGES)
- ESB Customer Supply (ESB CS)
- ESB Power Generation (ESB PG)
- Forfás, IDA Ireland and Enterprise Ireland (jointly the ‘development agencies’)
- IBEC Large Energy Consumers Group (LECG)
- Irish Wind Energy Association (IWEA)
- NIE Energy PPB (PPB)
- Single Electricity Market Operator (SEMO)
- SWS Natural Resources Limited
- Tynagh Energy Limited (TEL)
- Viridian Power & Energy (VPE)

The next section summarises these thirteen submissions by topic. The paper concludes with the SEM Committee’s final decision.

The SEM Committee has determined that the implementation of the market power mitigation strategy is an SEM Committee matter within the meaning of the legislation.<sup>1</sup>

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<sup>1</sup> The SEM Committee is established in Ireland and Northern Ireland by virtue of Section 8A of the Electricity Regulation Act 1999 as inserted by Section 4 of the Electricity Regulation(Amendment) Act 2007, and Article 6 (1) of the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 respectively. The SEM Committee is a Committee of both CER and NIAUR (together the Regulatory Authorities) that, on behalf of the Regulatory Authorities, takes any decision as to the exercise of a relevant function of CER or NIAUR in relation to an SEM matter.

## **2 Respondents' Comments**

### **2.1 Responses Supporting the SEM Committee's Decision**

Of the thirteen responses to the Consultation Paper, twelve supported the SEM Committee's proposed decision not to change the requirement in the Bidding Code of Practice (BCOP) that generators must include the full opportunity costs of carbon allowances in their commercial offers.

#### **Regulatory risk**

A number of responses – including from Airtricity, BGES, ESB PG, PPB and Tynagh – argued that allowing greater flexibility in the bidding of carbon costs would constitute a fundamental alteration to the BCOP and one which would at this early stage in the SEM's life create a perception of a high risk of regulatory intervention in the market. Such a change would be a retrograde step, particularly given the consensus achieved across participants in the process of designing the market. An effective and efficient SEM, and its related retail market, required much needed investment in the short term. This investment was dependent upon a reasonable level of regulatory certainty in relation to bidding practices in the wholesale market.

#### **Price and investment signals**

Airtricity and ESB Customer Supply (ESB CS) argued that the full pass-through of carbon would ensure that dispatch decisions were made on environmental, as well as fuel, cost optimisation grounds. Without the inclusion of carbon, more fossil intensive plant would be likely to be dispatched. This would discourage investment in renewable generation. BGES also argued that bidding less than the full opportunity cost of carbon would not maintain efficient incentives for entry/exit and would not provide efficient signals to the market. The IWEA argued that it was essential that the full costs of generation were reflected in participants' bids to ensure an efficient market outcome in both the short and long term.

The development agencies, Forfás, IDA Ireland and Enterprise Ireland, agreed that bidding the full opportunity costs of carbon would incentivise generators to be more efficient by sending signals to investors to develop clean technologies and renewable energy sources.

ESB Customer Supply (ESB CS) recognised the importance of having prices that correctly reflected the true underlying costs of generation and provided the consumer with appropriate price signals. The development agencies agreed that prices that truly reflected costs would incentivise more efficient energy use, though they argued that it was hard to see an additional price signal having much impact on demand, especially for business users, in a country where industrial electricity prices were currently almost 19% above the EU-15 average.

SWS Natural Resources argued that it was important that the cost of carbon was reflected in electricity generation prices so that the benefits of wind generation could be seen clearly.

SEMO acknowledged that an important factor in the bidding of carbon costs was the establishment of a clear signal for investment in less carbon intensive technologies. However, SEMO also pointed out that, while allowing greater flexibility in the bidding of carbon costs would partially dampen this signal in the short term, the more important medium to long term investment signals would be retained. This was because the current allocation plan extended only until 2012. Those seeking to build new generation would be more concerned with carbon policy post-2012. With the auctioning of allowances more likely in Phase III of the EU Emissions Trading Scheme (ETS), it could be expected that the full cost of carbon will be bid post-2012.

Airtricity pointed to the beneficial effect of the full-pass through of carbon on the development of “green” suppliers in the market. Full pass-through would allow green suppliers to offer competitive tariffs, resulting in a further deployment of renewable energy. This would contribute towards meeting renewable penetration targets, assist with security of supply and encourage competition in the market.

Finally, while ESB PG accepted that a market would not necessarily guarantee that an individual generator would make a return, the market must ensure that new generation was built to meet increasing demand. ESB PG was concerned that one element of the market was being examined without reference to its affect on the overall economics of the market. Any changes - internal or external to the SEM – had to be viewed in light of the overall market design to ensure that the market would continue to function.

### **Market power mitigation**

Bord Gáis Energy Supply (BGES) and SEMO argued that to allow anything other than the bidding of the full opportunity cost of carbon would - at this early stage in the SEM's life - diminish the effectiveness of the bidding principles as a market power mitigation tool. They also argued that giving flexibility in the bidding of carbon would lessen the transparency of generators' bids and would make the already difficult task of monitoring the market even more difficult.

PPB also argued that allowing flexibility would make modelling of the market pricing uncertain and would make the application of, and compliance with, the economic purchasing obligation in PPB's licence (which is also deemed to cover sales) difficult.

### **Competitive effects**

SEMO argued that if flexibility of bidding up to the opportunity cost of carbon were allowed, a generator in one jurisdiction of the SEM might be at a competitive disadvantage over one in the other jurisdiction. This would be the result of the cost of carbon for one generator being greater than that of another depending on its jurisdiction, given the different methodologies employed by the relevant authorities in each jurisdiction for the allocation of free allowances. SEMO believed that introducing further inter-jurisdictional distortions would run counter to the objectives of the TSC to promote competition in the Single Electricity Market.

Tynagh argued that allowing generators flexibility in their treatment of carbon costs would place some generators at an unequal commercial advantage and ultimately promote generators that had a dominant market position.

PPB argued that carbon allowances had a market value and to include anything less than this value in generator bids would be anti-competitive. There was no scope for general “efficiency improvements” with carbon allowances unlike other components of cost (e.g., operating efficiency) where it would be legitimate to expect costs to be ‘competed away’ in the market. There was no real case for flexibility other than as a pseudo taxation/clawback measure.

## **Recycling**

A number of respondents – including Airtricity, BGES, ESB CS, the development agencies and VPE – all agreed with the SEM Committee that it was the role of government, not the regulator, to take action - if action was needed – to capture the windfall gains from the full pass-through of carbon allowances and redistribute the proceeds. The development agencies argued that, with generators benefiting from significant carbon credit allowances, the expected effects of the full pass-through of the cost of carbon on the behaviour of electricity generators would largely be negated unless the issue of windfall gains was addressed.

A number of respondents also advocated the recycling of the windfall gains. Airtricity argued that, if the concern was to keep down generation costs, one focus could be pool payment incentives/penalties to ensure that generators acted more flexibly.

## **2.2 Responses Criticising the SEM Committee’s Decision**

Of the thirteen responses, only one - the IBEC Large Energy Consumers Group (LECG) – took issue with the SEM Committee’s proposed decision.

LECG argued that secure, competitive and environmentally sustainable energy supply was crucial to Ireland’s economic prosperity. Ireland had experienced a significant loss in international price competitiveness, particularly in energy, in recent years. While the LECG recognised the Regulatory Authorities’ commitment to the delivery of a cost reflective wholesale single electricity market, the LECG did not believe it was equitable that generators could charge the full opportunity cost of carbon while, as stated in Ireland’s National Allocation Plan 2008-2012, the power sector would receive up to 68 percent of carbon credits free under the EU-ETS.

The LECG did not accept the view that it was not the Regulatory Authorities’ responsibility but that of the Governments to intervene through the implementation of a windfall gains tax. It was the role of the Regulatory Authorities’ to act in the interests of the consumer. In the absence of action by the two Governments, the Regulatory Authorities must meet that obligation. It called on the Regulatory Authorities urgently to agree a strategy with the Governments in both jurisdictions on how best to recoup the excessive carbon costs to the benefit of end-consumer electricity prices.

### 3 Decision

In the light of the various responses to the Consultation Paper on the Bidding the Opportunity Cost of Carbon, the SEM Committee has decided against allowing greater flexibility in the bidding of carbon.

The SEM Committee is persuaded by those responses that such a step at this stage of the SEM would:

- create regulatory risk;
- raise the cost of capital and harm investment, particularly in clean technologies and renewable sources of generation;
- distort market price signals;
- inhibit efficient entry/exit decisions;
- make the monitoring of the SEM more difficult; and
- diminish the effectiveness of the bidding principles as a market power mitigation tool.

The SEM Committee concludes that the disadvantage of regulatory action outweigh the advantages. Any action to recover the windfall gains from the full pass-through of carbon allowances would therefore be for Government. The recovery of windfall gains could deliver benefits for consumers and the SEM Committee would wish to be consulted on the design of any recovery scheme so as to maximise such benefits in the market context.