Regulatory Authorities' Consultation on Bidding the Opportunity Cost of Carbon Allowances

A Response by SEMO

March 2008

1. Introduction

The Single Electricity Market Operator (SEMO) welcomes the opportunity to comment on the Regulatory Authorities' Consultation on Bidding the Opportunity Cost of Carbon Allowances.

2. Response Context

In its response, SEMO refers to the objectives of the Trading and Settlement Code (TSC)[1]. In particular:

- To promote competition in the single electricity wholesale market on the island of Ireland;
- To provide transparency in the operation of the Single Electricity market;
- To ensure no undue discrimination between persons who are parties to the code; and
- To promote the short-term and long-term interests of the consumers of electricity on the island of Ireland with respect to price, quality, reliability; and security of supply of electricity.

3. The case for allowing greater flexibility

To promote competition in the single electricity wholesale market on the island of Ireland

Were the Bidding Code of Practice (BCOP) to allow generators to bid *up to* the full opportunity costs of carbon, a generator could decide to bid between the net cost of carbon and the full cost of carbon to ensure that they are consistently scheduled. This could lead to an increase in the generator's load factor and could prove more profitable for the generator, while also serving to reduce the wholesale price of electricity. These competitive forces could serve to reduce price, thereby reducing the extent of windfall profits retained by generators[2].

However, SEMO recognises that changing the BCOP to allow generators to bid up to the full opportunity costs of carbon may not result in lower prices, as generators may continue to bid the full cost of carbon and thus retain the associated windfall gains.

To promote the short-term and long-term interests of the consumers of electricity on the island of Ireland with respect to price, quality, reliability; and security of supply of electricity.

---

[1] http://www.sem-o.com/MarketRules/, v4.1, Sec 1.3
[2] http://www.electricitypolicy.org.uk/pubs/wp/eprg0617.pdf

An important factor in the bidding of costs associated with the EU Emissions Trading Scheme (ETS), is the establishment of a clear signal for investment in less carbon intensive technologies. 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 is due to the fact that the current allocation plan extends only until 2012. It could be argued that investment horizons stretch well beyond 2012 and those seeking to build new generation on the system will be more concerned with carbon policy post 2012. As it is likely that the EU ETS phase III National Allocation Plan (NAP) policy will be to auction more of the allocations, rather than giving them for free, it could be expected that the full cost of carbon will be bid post 2012[3].

4. The case against allowing greater flexibility

To ensure no undue discrimination between persons who are parties to the code.

Different methodologies are employed by the relevant authorities in each jurisdiction for the allocation of free allowances. The UK phase II NAP states that 7% of the total quantity of allowances will be auctioned or otherwise sold in phase II, in contrast to 0.5% in the RoI phase II NAP. Further, the sector allocation methodology in the UK was based on the assumption that Large Electricity Producers would pass through the full cost of carbon to the wholesale price of electricity[4], whereas in RoI the assumption was that only the cost of allowances above those allocated would be passed through[5].

As a result, if the flexibility of bidding up to the opportunity cost of carbon were introduced, a generator in one jurisdiction might be at a disadvantage over a generator in the other jurisdiction. This would be due to the cost of carbon for one generator being greater than that of another depending on its jurisdiction.

SEMO is committed to promoting competition in the Single Electricity Market on the island of Ireland, and insofar as is possible, this requires a level playing field. While it is acknowledged that there are already differences between the policies of each jurisdiction with regard to the cost items included in generators' Short Run Marginal Cost (SRMC)[6], SEMO believe that introducing further inter-jurisdictional distortions would run counter to the objectives of the TSC.

---

[3] http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/35&format=HTML&aged=0&language=EN&guiLanguage=en, Q. 7

[4] http://www.defra.gov.uk/environment/climatechange/trading/eu/phase2/pdf/ria-allocation-methodology.pdf, section 5.3.6.

[5] http://www.epa.ie/downloads/pubs/air/etu/epa_%20icf_and_boc_final_report_2006.pdf, page 75

[6] Examples of these inter-jurisdictional differences include the transportation charges on gas and excise charges on oil products.

To promote competition in the single electricity wholesale market on the island of Ireland. To provide transparency in the operation of the Single Electricity market. To promote the short-term and long-term interests of the consumers of electricity on the island of Ireland with respect to price, quality, reliability; and security of supply of electricity.

SEMO notes that the end result of obliging generators to bid their SRMC as defined in the BCOP may actually result in higher wholesale electricity prices and windfall gains to generators due to the free allocation of carbon credits. In a competitive bidding environment, were the BCOP not in place, competitive forces would put downward pressure on wholesale prices and reduce, in part at least, the windfall gains to generators.

However, SEMO recognises that a fully competitive bidding environment does not yet exist and that the RAs have developed the market power mitigation strategy in order to allow this competitive environment to emerge. SEMO would highlight that the RA's market power mitigation strategy comes at a cost, in this case, through directing 100% pass through of carbon costs. When a fully competitive environment is established, the BCOP could be relaxed to allow greater competition.

With this in mind, SEMO is concerned that changing the BCOP to allow anything other than SRMC bidding of carbon, at this early stage, may undermine the effectiveness of the market power mitigation strategy. 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.

5. Conclusions

SEMO acknowledges the RA's wish not to change the BCOP to allow generators to bid less than the full opportunity cost of carbon. In SEMO's view, the objectives of the TSC may be better met by adopting this approach, with the governments in both jurisdictions taking action to address the issue of windfall gains.