

20th December 2010

Clive Bowers
The Commission for Energy Regulation
The Exchange
Belgard Square North
Tallaght
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Colin Broomfield
The Utility Regulator
Queens House
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Dear Clive, Colin,

RE: Harmonised Ancillary Service Arrangements and the Bidding Code of Practice

The Regulatory Authorities (RAs) are to be commended for their transparency in dealing with the issue of how harmonised ancillary service arrangements are treated in the commercial offer data (COD) bids submitted by generators in the Single Electricity Market (SEM). Bord Gáis Energy (BG Energy) agrees with the RAs that Option 3, to retain the status quo is not practical as it would undermine the Bidding Code of Practice (BCOP) which was provided to both “*define the concept of opportunity cost*” and to set out “*principles of good behaviour in the Single Electricity Market*”. For this reason, clarity is needed to ensure ancillary service payments are treated as consistently in the market as all other input items.

The paper attempts to delineate the treatment of costs incurred by generators simply by whether they are fixed or variable costs. Such an approach is over-simplifying the nature of costs and the nature of the market. As previous directions from the RAs show (the treatment of gas contracts, gas transportation costs and carbon taxes), not all *technically* variable costs are accounted for in the short-run marginal costs (SRMC) of generators. On that basis, other factors apart from the variability of an item, such as the intended economic value of the item and the relevant market for the item, should also be considered when determining whether it should be included in commercial offer data bids.

According to the all-island system operators, ancillary services are “services necessary for the secure operation and restoration of the electricity system”. Ancillary services are essentially balancing services provided by generators to the system operator to allow for adjustments in the transmission network. The SEM Committee decided at the outset of the SEM design that the SEM would be an energy only market and that ancillary services would be procured and

priced outside of the energy market and on a bi-lateral basis with potential service providers and the system operators.

The consultation paper states that “the BCOP was written to permit generators to treat as Variable the effect of short-term variability in the price of cost-items available from generally accessible, *liquid markets*”. An essential characteristic of a liquid market is that there are ready and willing buyers and sellers at all times. The ancillary service market is not a liquid market as there is no market in which the services can be regularly traded - it is simply a bi-lateral contract entered into between the system operator and the service provider as provided for in the design of the SEM. Therefore, the terms of the BCOP would suggest that it would not be appropriate to include ancillary services in the calculation of the ‘benefit foregone’ in generating energy.

Furthermore, treating ancillary service payments as a ‘benefit foregone’, for the purposes of the BCOP, would have a perverse impact on the value of ancillary services and the incentives on generators to provide them. For instance, if a generator was to enter into a contract for the provision of ancillary services and to then bid this cost into the energy market such that it reduced its commercial offer data by the same amount, the generator would be nullifying any benefit accruing from the provision of the service. This would disincentivise the provision of ancillary services and accordingly put the safety and flexibility of the system at risk. It would also act to disincentivise investments in flexible plant as the added expense would not be recovered in the market or through ancillary service payments

From a practical perspective, directing the inclusion of ancillary service payments in the commercial offer data will also add significant complexity to the bid structure of participants. This in turn will provide opportunities for gaming in the market and may impede the ability of the Market Monitoring Unit to monitor the market effectively. Given the role of the Market Monitoring Unit in mitigating market power and providing confidence to stakeholders this uncertainty may act to increase risks in the market.

Finally, it is suggested by the RAs that option 2 will not provide for customers to “enjoy economic efficiency brought about by the new AS arrangements”. BG Energy does not agree with this assertion. Ancillary service products have been introduced to improve the flexibility of the system, which will allow the system operators to operate the system in the most efficient and dynamic way which will in turn reduce production costs. Studies show that the introduction of ancillary services which compliment the system also act to reduce constraint costs. These reduced production and constraint costs will be passed on to customers through

reductions in imperfection charges. In short, although not directly passed through via the SMP, the economic benefits of ancillary services will, and are currently, being passed on to the customer.

Overall, BG Energy agrees with the RAs objectives which are; to ensure consumers do not pay twice for ancillary services, that the market is not distorted and that the value of ancillary services is passed on to customers. However, given; that the market design provides two separate “markets” for energy and ancillary services; that there is no liquid ancillary services market for it to be considered an ‘opportunity cost’; and the perverse impact of its inclusion in bids on the actual value of ancillary services, BG Energy does not believe that the stated objectives are best met by option 1 – including ancillary service payments in commercial offer data bids. For consistency purposes (both for bids and for the spirit of the BCOP), option 2 is the most appropriate option and will ensure that all of the desired objectives are met in the most transparent manner.

Yours sincerely,

Jill Murray
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