Power NI Energy Limited
Power Procurement Business (PPB)

I-SEM Detailed Design

Offers in the I-SEM Balancing Market

SEM-16-059

Response by Power NI Energy (PPB)

18 November 2016.

Introduction

PPB welcomes the opportunity to respond to the RAs consultation on the I-SEM consultation on Offers in the I-SEM Balancing Market.

To assist in the consideration of these complex issues, Viridian commissioned a report from NERA (the NERA Report)[1] which comments on the content and proposals set out in the consultation paper. NERA's report is appended and we draw from it in this response.

PPB also endorses the EAI response to the consultation paper.

General Comments

We are concerned that the premise of the consultation paper and the proposals therein are contradictory to the stated views of the SEMC that the existing BCOP has been effective in mitigating market power. For example, in the Market Power Mitigation consultation paper[2], paragraph 7.2.10 states "*Overall, the SEM Committee believes that the MMU has been effective at ensuring the market participants adhere to their licence obligations, in particular the requirements under the BCoP, with market pricing set at the appropriate Short-Run Marginal Cost (SRMC) level.*" The Market Power decision paper[3], indicates in paragraph 7.2.1 that the majority of respondents agreed with this assessment. It is therefore difficult to conflate such assessment that the current BCOP is delivering SRMC outcomes with the conflicting proposals that seek to exclude certain costs, which must result in prices that are below SRMC, distorting competition, impinging on a generator's ability to finance its activities, and which we believe would be illegal under various laws, including general competition law.

We are equally concerned that the proposals seek to exclude costs that were previously stated by the SEMC in its final 2008 inquiry report on Complaints on Bidding Practices in the SEM[4]. The decisions and statements in the 2008 report were rational and reflected the normal economic interpretation of SRMC which the current proposals totally contradict.

The consultation paper states that "*the I-SEM is very different in nature to the current market in which the current arrangements operate*". However, while that may be true for the overall market, there is very little difference between the current SEM and the Non-Energy BM arrangements, other than the

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[1] NERA Report titled "Consultation Paper SEM-16-059: Offers in the I-SEM Balancing Market"
[2] SEM-15-094
[3] SEM-16-024
[4] Complaints on Bidding Practices in the SEM – SEM Committee Inquiry – Final Report (SEM-08-069)

volumes traded. The Short Run Costs that need to be recovered are largely unchanged and the bid formats are identical. This further highlights that there is no compelling requirement or reason to deviate from the current arrangements that are acknowledged to have been successful.

We are also concerned that the consultation paper makes unsupported proposals that seem to be focused on price regulation, not for purposes of ensuring competitive outcomes but more to dampen consumer prices in the short term. However, seeking to impose below cost pricing will result in higher costs for customers in the long term as the effect will distort competition and, allied to the ongoing regulatory risk, will have a detrimental impact on longer term investment and security of supply in the market.

The proposal to de-scope the licence condition and to restructure the legal framework to move all of the detail into a separate code is stated to be beneficial by providing greater clarity, flexibility and detail to market participants. We are greatly concerned that such restructuring weakens the governance over the arrangements, substantially changing the balance of power in consideration of what costs are marginal costs and removing the protections available to market participants to challenge future changes in interpretation. As the NERA Report highlights[5] the existing structure provides stability and predictability that will better foster competition than would exist under the proposals that significantly increase regulatory risk and the scope for dispute.

As the disputes that have arisen confirm, different interpretations do arise and the SEMC proposal to seek to tightly prescribe which costs are marginal costs will merely serve to bring forward the disputes to the drafting of that prescription. This will inevitably require a lengthy process as it represents a one-off opportunity to capture all possible appropriate costs (whether they exist now or could materialise in future) that could be a marginal cost. This is likely to be an emotive debate that has a high potential for legal challenge.

We do not consider the legal challenges that have occurred to date as negative outcomes. Instead they highlight that seeking to tightly define marginal costs is a complex task and the legal contests were in part driven by the RAs failure to consider the evidence that costs were indeed marginal. It therefore seems perverse that the RAs are now seeking to give themselves

[5] See Section 3.1 of the NERA Report

greater powers to get it even more wrong in future. This is not a sustainable basis for the market and is not in the long term interests of customers.

NERA's Main Conclusions

For ease of reference the following is NERA's main conclusions from their report (Section 1.3).

<u>Chapter 2 of the Consultation Paper</u> proposes the introduction of bidding controls, in the first instance only on non-energy actions in the balancing market, with the possibility of extending them in future to energy actions. The proposals create regulatory risk for market participants over both the distinction between energy and non-energy actions and over the prospect of more intrusive regulation in the future.

- *Regulatory risk stems both from the regulation itself and from the process governing changes to regulation. In the short term, the design of the algorithm determining energy and non-energy actions is subjective and lacks transparency. In the longer term, there is no defined process for overseeing changes to the algorithm by the TSO, and no basis for market participants to know what behaviour might provoke an extension of the controls. This regulatory risk will discourage some competitive behaviour by market participants and therefore threatens to raise prices to consumers.*
- *In order to diminish regulatory risk and to reduce costs to consumers, the SEM Committee will need to support any bidding controls with clear guiding principles that are robust to changing circumstances and founded in economics. Prescriptive rules that become obsolete or that do not reflect economic fundamentals will come under pressure over time and expose market participants to additional regulatory risk.*

<u>Chapter 3 of the Consultation Paper</u> lists objections to the current form of bidding controls derived from the experience of applying them. Our analysis of these objections shows that they arise from a purely partial application of appraisal criteria and a misunderstanding of the cause and nature of disputes over the interpretation or design of regulatory rules.

- *Such disputes are inevitable, due to the "incompleteness" of any rules, and need not be regarded as a failure, but rather as the process for providing greater clarity. As a result, Chapter 3 of the Consultation Paper gives the*

SEM Committee no procedural or intellectual basis for the proposals that follow in later chapters.

- *The opportunity to dispute the market rules provides an important protection against regulatory failure: if the SEM Committee were to set offer price limits below marginal costs, market participants would exit the market and security of supply would be threatened. The prospect of contesting offer price limits lessens the chance of such outcomes and mitigates regulatory risk, as long market participants can refer to a stable and clearly defined basis for such limits.*
- *Setting out such guiding principles in licence conditions (or another document with an equivalent change management process) provides the necessary clarity and stability, and therefore protects consumers as well as market participants from regulatory failure.*

<u>Chapter 4 of the Consultation Paper</u> sets out the SEM Committee's proposed high-level options for imposing offer limits. It contains a number of flaws.

- *The SEM Committee describes Option 1 as a principles-based approach similar in outline to the current BCOP. In practice, however, Option 1 consists of a prescriptive list of costs that may be included in offer prices, along with rules for defining those costs. These rules are so narrowly defined that they offer no guidance on how to incorporate new costs when circumstances change over time. Even in the short term, the proposals exclude for no good reason several potentially important categories of cost, such as costs which may be jointly incurred over multiple settlement periods and the opportunity costs of additional risks.*
- *The SEM Committee contradicts the conclusions from its 2008 inquiry into bidding practices. At the time, the SEM Committee concluded that it "does not consider that a generator should be required under its Licence to incur significant avoidable costs without the prospect of being able to recover them"; "that all the avoidable costs outlined above – the additional O&M expenditure, the additional equipment costs, the increased risk of failure to plant and equipment as a result of the plant's running regime and the concomitant loss of revenue from capacity payments and inframarginal rents from SMP – are allowable costs"; and that "to do otherwise could threaten the development of efficient new entry and effective competition, given that it may dissuade generators from entering the market if they*

perceive that they may incur irrecoverable forward-looking costs when doing so."[6]

- *Option 2 consists of simplified rules which impose offer limits on generators according to calculations carried out by the SEM Committee on behalf of market participants. However, as the SEM Committee implicitly acknowledges by providing for exceptions, that it will need to ensure any offer limits remain in line with generators' SRMC. That need will not only require frequent and rapid changes to the rules, but will also require the SEM Committee to set out and apply clear guiding principles for managing adjustments to the simplified rules; only then will the regime minimise regulatory risk and incentivise efficient, competitive behaviour. Option 1 and Option 2 therefore both require the development of the same guiding principles to allow their adaptation over time. In the case of Option 2, the need to adapt rules over time applies not only to the definition of new cost items but also to the calculation itself. Option 2 does not in effect represent a different approach from Option 1, only a less complete one.*
- *The similarities between the Options, and the gaps in each of them, are not brought to light in the evaluation set out in the Consultation Paper, because it has not been properly conducted. The evaluation of the Options does not apply the criteria used in other I-SEM papers, or any similar set, but only identifies vaguely articulated "advantages" and "disadvantages" relative to some nebulous (and possibly shifting) alternative. The evaluation is therefore partial and unsound as a basis for making any decision.*

[6] SEM Committee (2008), Complaints on Bidding Practices in the Single Electricity Market: SEM Committee Inquiry, Final Report, SEM-08-069, 12 June 2008, pages 31-32.

Responses to the Specific Questions

Q1: Do you agree with the proposed approaches to offer controls in the balancing Market for the I-SEM outlined above? If a respondent does not agree with any part of the proposed approach, please specify why and provide detailed alternative.

We disagree with the proposed approach.

As stated in our general comments, we do not agree that the challenges that have arisen over the course of the SEM are a consequence of the BCOP being "principles based". The economic concept of SRMC is clear and, as the NERA report concludes, the objections that are raised based on the RAs experience of disputes to date seem to be based on a misunderstanding of the cause and nature of disputes over the interpretation of rules, which in the case of the major challenges, resulted from errors in interpretation by the RAs.

We do not agree that the proposals provide additional clarity or flexibility for participants and we do not believe they lessen any perceived administrative burden but instead increases regulatory risk and will actually increase the operational burden for participants and the RAs. For example, the change in the legal framework, means that the RAs can impose changes to the "Code" with more limited recourse for participants. This reduction in rights will accelerate and focus the attention on the initial rules that are established to define which costs are permitted SRMC costs and has the potential to bring forward any challenges (whether through courts or through licence change provisions) to before the start of the I-SEM. This is likely to become a contentious area, based on the proposals presented by the RAs in the consultation paper that seek to exclude a number of costs that are marginal costs and the exclusion of risk valuations that were previously deemed valid SRMC costs by the SEMC in its 2008 final report[7].

We believe that the existing legislative framework provides an appropriate balance and that the BCOP must remain principles based and that only minor changes are required to adapt it for application to complex bids that are used for Non-Energy Bid/Offer Acceptances in the Balancing Market.

[7] Complaints on Bidding Practices in the SEM – SEM Committee Inquiry – Final Report (SEM-08-069)

NERA's Summary Comments

For ease of reference the following is NERA's summary comments from their report (Section 3.3).

The SEM Committee has never questioned "the effectiveness of the existing BCOP" and acknowledges it once again in the opening sentence of section 3.3 of the Consultation Paper. The performance of the BCOP therefore provides no grounds for changing the current approach, except to the extent that is required to accommodate new market institutions under the I-SEM (i.e. switching the focus from day-ahead markets to balancing markets). However, the SEM Committee has used this Consultation Paper to raise questions unrelated to the creation of the I-SEM.

In particular, chapter 3 of the Consultation Paper raises objections to the form of the current controls derived from the RAs' experience of applying them. Our analysis of these objections shows that they arise from:

1. *a purely partial application of appraisal criteria (unduly favouring administrative convenience to the regulatory authorities and their preference for "flexibility", to the exclusion of other criteria such as transparency and efficiency); and*
2. *a misunderstanding of the cause and nature of disputes over the interpretation or design of regulatory rules. Such disputes are inevitable, due to the "incompleteness" of any rules.*

In any case, disputes need not be regarded as a flaw in the system, but rather as the process for providing greater clarity. The opportunity to dispute the market rules provides an important protection against regulatory failure: if the SEM Committee were to set offer price limits below actual marginal costs, market participants would exit the market and security of supply would be threatened. The prospect of contesting offer price limits lessens the chance of such outcomes and mitigates regulatory risk, as long market participants can refer to a stable and clearly defined basis for such limits. Setting out such principles in licence conditions provides clarity and stability, and therefore protects consumers as well as market participants from regulatory failure. Any delay in amending offer limits to comply with these principles would distort competition and reduce efficiency. Rather, Option 2 would only lead to efficient outcomes if these underlying principles effectively determined bidding behaviour, and offer limits merely tracked these bidding costs at each point in time.

The Consultation Paper therefore follows a truncated decision-making process which fails to consider key questions in the design of the rules. Instead, it rushes headlong towards conclusions that are premature, and possibly prejudicial. As a result, Chapter 3 of the Consultation Paper gives the SEM Committee no procedural or intellectual basis for the proposals that follow later.

Q2: Which of the options identified within this consultation paper would be most appropriate for the introduction of offer controls under I-SEM? If a respondent does not agree with any of the options identified, please specify why and provide detailed alternative. If a respondent has a preferred option, please indicate whether any aspect of the preferred options should be amended.

Neither of the options are workable or sustainable and, as the NERA Report highlights, both options are severely flawed and would not result in efficient outcomes or competition.

The proposals in the consultation also represent further evidence of the RAs failure to comprehend marginal costs which mirrors the failings that led to the challenges the RAs point to as reasons for change. In fact those challenges and the unfathomable proposals presented by the RAs demonstrate the need to maintain high level principles since otherwise it is likely that the RAs position will be challenged.

Views on Option 1

Option 1 is falsely described as “Offer Principles” whereas they actually prescribe rules defining the allowed costs and how they should be calculated. Further, the proposals exclude a number of cost elements that are legitimate short run marginal costs such that by excluding them, a participant would be offering to increase output but by doing so would be incurring a loss and hence would be reluctant to actually do so because that would destroy value for the generator. Such an outcome cannot be described as representing Short Run Marginal Costs and would have significant consequences for the ongoing efficiency of the market by distorting competition in the market and impacting negatively on the longer term outcomes for customers.

Redefinition of SRMC

We do not agree that the current definition of SRMC has any confusion in relation to incremental costs. It is defined as the difference between total costs of generating that extra unit and the total cost of not generating such output which can only result in the incremental cost. Similarly, where costs are fixed for the day, those will be common to both “total” costs and hence will cancel out and are not therefore incremental under the current definition of SRMC and hence again the RA concern is unfounded.

As the NERA report highlights, there are also costs (which NERA define as “joint costs”) that may not explicitly relate to a single BM settlement period but to a number of settlement periods. However we do not believe that this is an issue and the principle of SRMC remains valid and viable.

Eligible Cost Items

In relation to “Eligible Cost Items”, the first error is the reference to the fact SRMC must reflect “Actual costs”. In many cases such actual costs will not be known until after the event and at the time of submitting offers and bids they will be a forecast of such costs. For example, in relation to gas, the gas will not be purchased at the time the offer is made since if the offer is not accepted then the participant would have to sell the gas back which will be at a different cost with additional transaction fees. Where the gas is purchased following acceptance of the offer and instruction from the TSO, the gas price will likely have changed and there are also risks, given the gas market rules that require 4 hour notice of gas renominations that such renominations are not possible or are rejected in which case the participant is exposed to gas imbalances. Hence even in a short window the “Actual price” could be very different to the price forecast at the time the Offer is made.

Similar issues apply in the case of Coal and Carbon where the timeline between the point of making the Offer and buying the commodity will be even greater. For example in relation to carbon, a 1MWh increase in output may correspond to 0.4 tonnes of carbon. However the standard clip size for buying carbon is significantly higher and therefore the participant will have to wait a number of days or weeks to roll up sufficient volumes to enact such a trade and again the price will have moved. Other costs may require a forecast over substantially greater timeframes. An example is gas transportation costs in Northern Ireland that have reconciliation charges applied up to 3 months following the end of the gas year. Hence the cost of within day gas transportation products for the first day in October may be revised in

December of the following year. These are just some examples of variable costs that demonstrate it is impossible to know the “actual” cost at the time of the submission of the Bid/Offers. Hence such Bids/Offers must reflect a forecast of the costs which requires inclusion of an appropriate allowance for the risks inherent is committing to such forecasts through the submission of firm Bids/Offers into the BM.

We are also confused by the RAs current comments in relation to maintenance costs and risk which are the polar opposite of the SEMC’s conclusions in its 2008 Final Report. It is a simple fact that there are variable maintenance costs as any cursory assessment of for example CCGT maintenance requirements would show that the maintenance is driven by Equivalent Operating Hours (EOH) that is based on operational hours and where a Start is equivalent to a multiple of operating hours. Therefore where CCGTs are operating to a mid-merit regime, this will advance the maintenance and result in higher maintenance costs for the generating unit. The proposals also contradict and conflict with the RAs position as set out in the recently published CRM Parameters consultation paper[8] which states that the assumption is that market participants will recover Variable O&M costs from the energy and ancillary services market.

Definition of Opportunity Costs

Similarly, the proposal to revise the definition of Opportunity Costs to remove the right to include provision for “risks to plant and equipment” is also not justified. As the NERA report highlights (in section 4.2.3), the consequences are that it will distort the market by not providing for the recovery of legitimate costs (which may be higher or lower that was assessed when forecasting the risk). Further the proposal is again in conflict with, being the polar opposite to, the decisions reached in the SEMC’s 2008 Final Report[9].

Foregone Revenues

As we have highlighted above, the arguments in support of removing foregone revenues are incorrect. There are few “actual” costs known at the time Bids and Offers are submitted and hence most of the marginal costs included are estimates of what the participant expects the costs to be, taking account of the risks of movement in the intervening period. The RAs argue that by allowing the inclusion of future foregone revenues, there is a risk that

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[8] SEM-16-073 published 8 November 2016

[9] Complaints on Bidding Practices in the SEM – SEM Committee Inquiry – Final Report (SEM-08-069)

the generator over-recovers. However this fails to reflect that where the assessment is risk weighted, there is also the possibility that the risk actually materialises and the generator loses more than it had forecast. As the NERA Report highlights, foregone revenues are a well established kind of opportunity cost and again the proposals are in conflict with the SEMC's conclusions in its 2008 Final Report.

Gas Transportation Capacity Costs

In relation to Gas Transportation Capacity costs, the proposals are unworkable and would not provide for recovery of costs for a generator unless they were running continually throughout the year. The RAs should address the issue by ensuring there is equitable access to gas capacity products. Further it should be noted that not all of the products are priced off tariffs since for example Moffat Entry is secured through an auction process and the tariff rate represents the reserve price.

NERA's Conclusions on Option 1

For ease of reference the following is NERA's conclusions on Option 1 from their report on (Section 4.2.5).

SRMC is an incremental cost concept. The SRMC of generation is the difference between the total costs incurred with, and total costs without, generating output over a given period. It will be important for competition and efficiency that any incremental costs incurred in order to generate over multiple ISPs are allowed in offer prices, but the SEM Committee's current proposals appear to have disallowed a number of such costs.

Some maintenance costs are related to hours of running or levels of output, and so form part of SRMC. The proposal to disallow maintenance costs is therefore unduly restrictive – and contradicts other statements by the SEM Committee. The proposal to remove the provision for costs resulting from increased risks has no basis in economics, logic or fact, and also contradicts previous decisions reached by the SEM Committee. It would reduce transparency by making the rules less clear and consistent. It would undermine generators' ability to recover costs, thereby hindering competition and reducing efficiency. In some cases, forecast revenues form part of opportunity cost, so there is no rationale for the SEM Committee's proposal to exclude them in their entirety, either.

Views on Option 2

Firstly, and as we have already stated, we do not agree with the statements in the first paragraph of Section 4.3 that disagreements on the interpretation of bidding principles in the SEM has led to challenges that result in an inefficient draw on resources which are a consequence of the BCOP being ambiguous and open to interpretation. As we have already explained we believe this highlights precisely the difficulty that arises from being prescriptive and the evidential experience has been that the primary interpretation errors have been made by the RAs on the occasions where they have sought to restrict the inclusion of costs that were marginal. Given the proposals in the consultation paper are even more perverse, the scope for challenge is likely to be high, particularly given the change in governance that is also proposed.

Option 2 is effectively Option 1 with the RAs applying their view of costs to determine Offer limits. The proposal is that generators could submit any offer less than or equal to these limits but it isn't clear if this could also facilitate market power through predatory pricing. Further as option 2 is an extension of Option 1, all of the flaws identified above for Option 1 equally apply to Option 2.

<u>Quarterly Review of Bid limits</u>

In addition to the flaws identified above, the further proposals specific to Option 2, for example to amend the limits on a quarterly basis, are ludicrous. Commodity prices change significantly over the course of 3 months and there have been within day gas price movements of over 10%. Prices between August and November have increased by c20%. Also a simple look at forward quarterly gas prices compared to the individual monthly prices within the quarter shows that an individual monthly price to be c10% higher than the quarterly price. Coal price movements have been even greater with coal prices (in dollars) increasing by c 33% in the last 3 months and the reduction in the value of Sterling increases this by a further 10%. Similarly Daily Gas transportation charges are over thirteen times higher in April than they are in May and June.

This demonstrates that there would be a high risk that limits that are amended only quarterly would present a high risk that generators costs would exceed the limits and hence capping prices at the limits would result in a major market distortion and could result in substantial losses for generators. This will result a requirement for increased RA resources to enable prices to be amended quickly and hence will not reduce the regulatory burden.

Grouping of Generating Units

Similarly the proposals to Group generators into clusters risks being arbitrary and even within CCGTs, the efficiency differences could be quite different (in excess of 10%).

Alleged Precedent for the Framework

In relation to the alleged precedent for the framework, the NERA report highlights that the Italian arrangement identified does not provide any reliable precedent and indeed the general practice, where bid controls have been utilised, is for the adoption of high level principles.

Implementation

It is not clear why the proposals would not affect the TSOs or require any interaction with the I-SEM IT systems development. If limits were imposed then there must be some need to validate them and reject them at the point of submission or else to apply a different price in settlement.

NERA's Conclusions on Option 2

For ease of reference the following is NERA's conclusions on Option 1 from their report on (Section 4.3.6).

As we explained in section 2.4, discretionary regulation requires a framework of principles, to avoid creating unnecessary regulatory risk and jeopardising efficient competition. The UK Competition Commission set out these arguments in relation to the Market Abuse Licence Condition in 2001[10]. Defining a set of guiding principles in the licence would also enable better scrutiny of regulatory proposals before they take effect; the alternative is to wait until adverse effects become apparent before reversing a decision, a process that would be highly damaging to the interests of consumers and to the credibility of regulation. Therefore, we repeat here the conclusions we reached in relation to Option 1.

Whilst the desire to preserve flexibility is understandable, sound decision-making must rely on something more stable and objective than the subjective views of the regulatory authorities of the day to justify interventions in competition. The only practical means of overcoming this problem is to set out (and apply) clearly defined principles that allow market participants to

[10] Competition Commission, AES and British Energy: A report on references made under section 12 of the Electricity Act 1989, CC No. 453, 31 January 2001.

anticipate when and how the regulatory authorities would intervene. Only then can market participants safely adopt efficient, competitive behaviour without fear of triggering sanctions. Only then can the quality of regulatory decisions be tested, before they take effect.

The need to set clearly defined principles (which we have described in comments on previous papers in this workstream[11]) applies both to the desire to extend controls and also to tightly defined rules that do not anticipate all possible future situations. It has important implications for the evaluation of both Option 1 ("Offer Principles") and Option 2 ("Offer Limits"), as we explain in section 4.4 below.

The SEM Committee's proposals for Option 2 would impose cost-based offer limits on groups of generators, for one quarter at a time. The SEM Committee does not explain how it will ensure that these offer limits will cover the short run marginal costs incurred by generators, raising the prospect that offer limits set too low will systematically deny cost recovery and discourage generation – with potentially catastrophic results for security of supply. The SEM Committee proposes some exceptions to the overarching approach, such as defining tighter limits for must-run generators, adjusting for certain physical conditions, and allowing for unforeseen rises in costs, but the frequency and importance of these exceptions merely illustrate the inadequacy of relying on simple rules in the first instance.

In practice, if the SEM Committee decides to impose offer limits, it will be necessary to ensure that every offer limit at least covers the SRMC of the generator concerned, and that the system adjusts or relaxes these rules whenever conditions change, according to predefined principles. These principles need to be entrenched in a licence condition, to provide the required degree of stability, and to allow proper scrutiny of proposals.

Assessment of options

The Assessment of the options set out in Section 4.4 is not objective and the assessment criteria are not explicit. There is also the flaw that the options are not assessed relative to a minimal change approach given both the options are particularly inflexible and will likely lead to challenges at the point of attempted implementation because of the impact on participants and the

[11] NERA (2016), Review of the Capacity Remuneration Mechanism Local Issues Paper, 22 September 2016, page 15.

proposals to exclude costs that are, have been, and were previously determined by the SEMC to have been legitimate short run marginal costs.

Further there is no consideration given to the impact on the CRM if legitimate costs were to be excluded from the Energy Market. The proposals would create a new component of “missing money” that would need to be recovered in the CRM, which on one level could increase the CRM clearing price for everyone which could be detrimental to customers. Further, given the proposals for Bid caps in the CRM, this could result in more generators seeking approval for higher Net Going Forward costs. Hence this may increase the burden on RA resources required which seems at odds with the stated desire to reduce the regulatory overhead. There is also a significant issue in relation to ensuring generation can obtain a reasonable return on their investment and the impacts proposals such as those proposed for the BM and for the CRM have on perceived risk in the I-SEM and the future willingness to invest given the regulatory risk

We are also confused by the statement in Section 4.4.2(i) that seems to indicate that generators would be incentivised to increase efficiency because “the unit will be able to offer up to the offer limit”. This is at odds with the objective of SRMC bidding by stating that units can legitimately bid above their SRMC and therefore seems to be encouraging an un-competitive market which is not in accordance with the statutory objectives of the RAs.

We also disagree that Offer limits make it easier for new investors since there are many risks including basis risk and regulatory risks that would impact on the ability to finance any project.

Conclusions

Our conclusion is that both of the options are unworkable and will create significant problems for both participants and the RAs.

We consider that the principles need to remain at a high level which will provide the flexibility for participants to bid in their SRMC. As the RAs have consistently stated, the existing BCOP has been effective delivering SRMC bidding and we believe the existing legal framework provides an appropriate balance for the RAs and participants. We also consider that only minor changes are needed to reflect the change from a trading day to balancing periods.

Additional Comments on the Annexes

Annex A

We have already provided detailed comments above in response to Question 2, relating to the Eligible Cost Items and references to “Actual Prices” when in fact very few cost items are known at the time Bids and Offers are made. We also highlighted that there are a number of risks that a generator is exposed to when making such bids, including movement in gas prices, availability of gas and risk of gas imbalances, availability of gas transportation capacity and risk of overruns, auction price of daily gas transportation capacity, etc. These risks are an inherent risk of placing an Offer or Bid that could result in a change in output levels and excluding any provision being made for such risks means a generator will not recover their costs on each occasion such risk crystallises. This will create a competitive distortion and a disincentive for the generator who will prefer not to operate since by operating they would be destroying value.

Again as previously noted, the same issues arise with the proposal to disallow variable maintenance costs when they are clearly known to be a genuine cost that in incurred when a unit changes output levels.

The proposals to only allow exit gas transportation capacity to be included on a “baseload” basis means that gas fired generator could not recover such costs. A peaking or low mid-merit generator whose output is heavily dictated by wind output may only generate in a few hours. If this amounted to a 20% load factor, the generator would only recover 20% of the gas exit transportation cost.

These are illustrations of the problems the proposals create by seeking to be prescriptive. We do not believe such an approach is workable since that would require significant effort to identify all possible costs that are marginal or avoidable costs and this is likely to be a time consuming and contentious process. Even then, there will inevitably be costs items that cannot be forseen and hence there would need to be a rigorously defined process to enable very swift variations to be made. We do not believe this is a viable approach and will not benefit customers or investors in the longer term.

Annex B

The initial drafting of the licence conditions to which the licensee must comply seek to place obligations on Regulatory Authority to undertake various actions e.g. "The [Commission][Authority] ***shall*** ……". However the licence is only binding on the licensee and such obligations on the Regulatory Authority are meaningless and we believe unenforceable.

As already outlined above and as NERA's report concludes, retaining important principles in the Licence remains a more appropriate framework as it provides a more appropriate balance for both the licensee and the Regulator, providing stability and predictability for both parties within the existing governance framework.

We do not believe there is any need to change the existing framework and a few simple changes, e.g. to change the reference from trading day to the balancing action, is all that is required.