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Ref: TEL/CJD/16/178

18th November 2016

RE: Offers in the I-SEM Balancing Market Consultation Paper (SEM-16-059)

Dear Sirs,

Tynagh Energy Limited (TEL) welcomes the opportunity to respond to the I-SEM Offers in the Balancing Market Consultation Paper (SEM-16-059).

This response paper has been separated into two sections: Section A sets out TEL's views generally on the Consultation Paper, while Section B contains TEL's responses to the specific questions raised in the Consultation Paper.

<u>Section A</u>

TEL have a number of concerns with the consultation paper:

- Non-targeted approach to the market power issue.
    - Controls applied to energy actions as well as non-energy actions.
    - Units not behind a constraint treated the same as constrained units.
- Implicit bidding controls in the Day Ahead and Intra Day markets.
- Combined BMOP and CRM Locational Issues penalise participants who lack market power.
- BMOP proposal needs to include:
    - Greater freedom regarding gas capacity bidding
    - Eligible Costs: OM cost that vary with generation.
    - Opportunity Cost: Risks associated with start-up costs.
    - Ability to recover losses from TSO actions.

<u>Non-targeted approach to the market power issue.</u>

TEL does not believe that the proposals in the consultation paper address the aims of the Market Power Mitigation Decision Paper (SEM-16-024) for two reasons. Firstly, the decision paper stated that energy actions in the Balancing Market (BM) will have no explicit ex-ante offer controls whereas non-energy actions will be settled based on 3-part offers and will have an explicit ex-ante control applied to them. Secondly, the decision paper aimed to address market power concerns from units behind a system operating constraint. Neither of these aims will be met in an efficient manner via the proposed Balancing Market Offer Principles (BMOP) or Balancing Market Offer Limits (BMOL).

The BMOP and BMOL are non-targeted approaches that will place ex-ante controls on **both** energy and non-energy actions, directly contradicting the SEMC decision in the Market Power Mitigation Decision Paper. TEL does not believe it is possible to apply the current proposal of controls on the 3-part offers in the BM for non-energy actions only. The T&SC and Grid Code highlights that complex offers (3-part offers) will be used in the scheduling and dispatching decisions by the TSO[1]. The primary source of commercial data for the Long Term Schedule (LTS) and Real Time Commitment (RTC) schedules is the complex offers. It is possible that energy actions could be issued through the LTS or RTC if the TSOs identify a lack of generation to meet demand and determine that an early energy action is required to rectify the issue. Considering that complex (3-part offers) can be used for energy actions it is inappropriate to apply ex-ante BMOP or BMOL to the non-energy complex bids when they are only determined to be non-energy actions ex-post.

The flagging and tagging approach, which will be used to determine energy and non-energy actions, will flag the majority of actions taken by the TSO as a non-energy actions i.e. for every non-energy action taken by the TSO, the resulting action will be flagged as non-energy. This double tagging of actions as non-energy will result in bids submitted by participants who are not behind a constraint being forced to be BMOP compliant i.e. short run marginal costs (SRMC). If a plant is being constrained on it is the plant with market power, however the current proposal classifies any plant that can be constrained off as having market power. This is not the case as the cheapest plant to turn off will be selected. If a potential constrained off plant increases their price they will not be selected and the next cheapest plant will i.e. the constrained off plant holds no market power. As a consequence of the flagging and tagging approach the SEMC decision to only[2] target bids submitted by generators that are behind a system operating constraint is not being achieved. TEL believes that this issue needs to be addressed before making a decision otherwise participants will be subject to market power restrictions without having the upside of the locational constraint payments. This will see temporary constraints drive the energy markets.

Furthermore, the proposal to possibly include ex-ante controls on the energy action simple bids is a concerning step away from the Market Power Mitigation Decision Paper. This proposal is an over regulated approach and will distort bidding in the DAM and IDM. This is contrary to the decision paper where it states "no ex-ante bidding controls will be applied to offers submitted by market participant in the DAM and IDM".

Implicit bidding controls in the Day Ahead and Intra Day markets.
TEL think two possible scenarios could occur with the proposed offer controls.

Scenario 1:
TEL are concerned that the proposed BMOP could have a negative impact on the DAM and IDM. The over flagging of actions as non-energy actions and the potential to apply controls on the incs and decs for energy actions could result in distorted prices in the BM. The enforced SRMC bidding in the BM will force market participants, who have not recovered all their fixed costs in CRM, to bid their fixed costs in the DAM and IDM. TEL believes that most participants that clear in the unconstrained CRM auction will not recover all of their fixed costs and will have to recover their remaining fixed costs in the energy markets. As a result of the CRM and the proposed BMOP, this may result in DAM and IDM prices being higher than the BM price. The expectation of lower BM prices could see suppliers not clearing or worse not participating in the DAM and IDM. The combined effects of the reduced CRM and a BMOP could result in a DAM and IDM with limited liquidity which is fundamental to the success of I-SEM.

[1] The Scheduling and Dispatch Process Plain English – Source of Commercial Data

[2] Market Power Mitigation Decision Paper (SEM-16-024).

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Scenario 2:
Participants will require a DAM/IDM position to fulfil their CRM Reliability Options (RO) requirement otherwise they are reliant on the TSO actions in the BM. Considering suppliers will know there is SRMC bidding in the BM and could be willing to spill into the BM if prices are not favourable in the DAM/IDM, RO holders will be forced into bidding close to SRMC in the DAM/IDM in order to limit their exposure to the RO. This indirect SRMC control of bids in the DAM and IDM implicitly contradicts the Market Power Mitigation Decision Paper when it stated that no ex-ante controls will be applied to offers submitted by market participants in the DAM and IDM. This will see plants not recover their fixed cost shortfall.

Inequitable consequences from combined BMOP and CRM locational proposal.
TEL believe that the CRM locational paper will result in participants not recovering all of their fixed costs assuming similar capacity auction results to ISO-NE (capacity auction cleared at $0). It is highly likely that unconstrained participants will have to recover their remaining fixed costs through the energy markets. However, if the BMOP is applied participants will be exposed to directly regulated SRMC bidding in the BM and indirectly regulated SRMC bidding in the DAM and IDM. If participants are unable to recover fixed costs due to the BMOP it could lead to distorted exit signals.

TEL would urge the SEMC to perform the necessary analysis before making such a significant decision that may (in conjunction with a locational CRM) lead to uncontrolled exit.

BMOP changes:

- Greater freedom regarding gas capacity bidding
- Eligible Costs: OM cost that vary with generation.
- Opportunity Cost: Risks associated with start-up costs.
- Ability to recover losses from TSO actions.

TEL believe that the revisions to eligible costs, the definition of opportunity cost, foregone revenues and unintended consequence (dec prices) of exposing participants to additional costs due to TSO actions are penal to generators.

While TEL see some merit with the inclusion of Long Term Gas Transportation Capacity costs, the removal of daily and monthly gas capacity costs will not provide the greatest benefit to consumers. If plants are only able to bid in annual gas capacity costs, then they will need to recover these over their projected running. Hence, if they rarely run this may be far higher than bidding in daily gas capacity. Possibly this should refer to a split of annual and daily with direct reference to their previous years physical running.

The removal of Variable Maintenance (VM) costs in the SRMC must be considered in conjunction with the CRM locational issues paper. If VM is no longer applied through VOM and must be recovered through fixed costs i.e. CRM payments, this will place locational constrained plants at an advantage. Locational constrained plants are guaranteed to recover all of their fixed costs whereas unconstrained plants have to consider bidding strategies that will be successful in the CRM auction i.e. bid below fixed costs in order to be successful in the auction. The proposal to remove VM from the SRMC bidding reduces the ability of plants which have no market power to recover maintenance costs, whereas the plants with market power will safely recover all of their maintenance costs.

It appears that the CRM parameters paper has taken a different view on fixed and variable cost recovery than the Offers consultation. In paragraph 6.2.23 of the CRM paper, the SEM Committee seems to suggest that generators will recover a portion of variable maintenance costs in the energy market. However, in Section 4.2.2 of the bidding paper the SEM Committee states that maintenance costs are not considered variable in nature and are therefore not considered by SEM Committee as eligible cost items for inclusion in offers.

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TEL does not agree that a "*reasonable provision for increased risk to plant…*" should be removed from the BMOP. These risks are real and it should not be expected for generators to take all of the exposure especially considering the potential impact the BMOP will have on the DAM and IDM.

The proposal to structure decremental offers similar to incremental offers exposes market participants to unjust costs due to TSO actions. The following scenario was presented to the Rules Working Group:
A plant is running from D-1 and has an ex ante PN to run through D, but is constrained off at 10AM prior to their EUPHEMIA bid submission. If the plant has to bid in their start-up cost into EUPHEMIA they are far less likely to be on in the market (as shown from the EUPHEMIA trials) than they would have been if they did not bid in their start-up costs. The plant may lose out on a number of days running if they are forced to bid in their start-up costs purely because they were constrained off. This would put the plant at a significant financial disadvantage.

The response[3] from the project team was:

"…*If a unit is constrained off with its Simple COD applicable for settlement (which do not have a BCOP applied), units can bid in a way that they can recover subsequent start costs through submitting a negative dec price, which is consistent with the requirement that inc prices would always have to be greater than dec prices. With the sign convention, a negative dec price times a negative dec quantity, as would be the case for a constraint action, would result in a payment to the generator to be constrained off...*".

The proposed BMOP states that incremental offers cannot include fuel costs for "*preparing the set or unit for generation (starting up)*" and that "*eligible cost items in respect of decremental offers shall be calculated using the same principles and methodology used to calculate those in respect of incremental offers*". This proposal places significant cost and scheduling risk on participants due to TSO actions that unfairly impacts on the participants DAM/IDM scheduling. Specifically this targets those plant who do not have market power at times when other plant have market power and have been more than adequately compensated elsewhere.

<u>Section B</u>

Consultation Question 1 - Do you agree with the proposed approaches to offer controls in the Balancing Market for I-SEM outlined above? If a respondent does not agree with any part of a proposed approach, please specify why and provide detailed alternative.

TEL do not agree with the proposed approaches to offer controls in the BM. As stated in Section A, the proposals are a blanket approach that do not solve the issues identified in the Market Power Mitigation Decision Paper. TEL have provided an alternative in our response to the CRM locational issues paper. This can be found in the appendix.

TEL does not agree with the proposed approaches to offer controls in the BM. The proposed approach does not target market power and its affects are not limited solely to the Balancing Market as specified in the Market Power Mitigation Decision Paper. The proposed BMOP and BMOL are non-target approaches to the market power arising from the system operating constraints and CRM locational constraints. The proposed controls affect units which have no market power as well as potentially controlling all energy actions in the Balancing Market. The knock on affects on the Day Ahead Market and Intra Day Market could result in significant liquidity issues. The combined impact of the CRM locational issues and the proposed offer controls could result in an uncontrolled exit of plants in the near term which is not a desirable scenario for all market participants.

[3] Comment 752 from the Market Rules Working Group Comments and Feedback spreadsheet.

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Consultation Question 2 - Which of the options identified within this Consultation Paper would be most appropriate for the introduction of offer controls under I-SEM?11 If a respondent does not agree with any of options identified, please specify why and provide detailed alternative. If a respondent has a preferred option, please indicate whether any aspect of the preferred option should be amended?

TEL would urge the SEMC to reconsider their proposed approaches as we think both the BMOP and BMOL are non-targeted approaches that do not solve the issues raised in the Market Power Mitigation Decision Paper.

TEL think a second viable alternative would be for participants to offer two sets of complex offers, a non-energy offer (SRMC) and an energy offer (no controls). The TSO would use the energy complex offers to schedule the system. If a non-energy decision was made, the bid would be cleared from the non-energy offer. Whereas, if an energy decision was made the participant would receive their energy offer price. Such a solution would identify and not penalise the energy actions in the LTS and RTC models.

I trust that these comments will prove helpful and should you have any queries, please do not hesitate to contact me.

Yours sincerely,

Cormac Daly

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Appendix

The problem that has to be solved has two aspects to it:

- the need to adequately reward the availability of generating capacity in a manner that complies with State aid guidelines and does not distort the energy market (we will refer to this as the “Capacity Issue”); and
- system constraints issues that require the continued viability of certain constrained-on plant (we will refer to this as the “System Constraints Issue”).

A potential solution is to split these two issues up and to resolve each one on a self-contained basis. TEL proposes the following package of solutions:

- Capacity Issue: operate an unconstrained capacity market under which ROs are allocated solely by auction result (and might therefore be expected to be awarded to the most efficient plant). In the event of excessive capacity on a market-wide basis, the RO price would be expected to tend towards zero. This will be more likely to meet State aid requirements.
- System Constraints Issue: offer a “Strategic Reserve” contract (being, we acknowledge, a new form of contract that would need to be designed) to each plant that is identified as being required for system security reasons, but which has not been successful in the RO auction. The contract will be for audited fixed costs plus a normal profit. These plant will be required to bid into the Energy Markets at a price of long run fixed costs minus the clearing price in the CRM Auction. There would also be a claw back of 95% on any additional profit that the plant would make through the energy markets. The plants will then earn sufficient revenue that they will meet their fixed costs, but will not effectively be double paid.

This type of contract is already being offered by National Grid in GB (though granted currently for durations of 3-6 months).

Some features of the proposed solution are:

1) It solves the Capacity Issue
2) It solves the System Constraints Issue
3) This will not cause a distortion of the energy market as the less efficient plant will be required to bid in their LRMC less the capacity clearing price. Subsequently they should stay in the same merit order position as they would with an unconstrained auction. This assumes that all other participants will seek to recover their fixed costs in the energy market.
4) There will be no perverse incentive. The constraint affected efficient plants would have an incentive to win in the auction, and earn greater profit in the energy markets rather than have a limited regulated profit through the strategic reserve.
5) The CRM cost to the consumer as modelled in Appendix B is likely to be reduced.
6) Most significantly the auction will be far more likely to clear a European State aid test.

The table below highlights a comparison of the proposal with ”Option C and no compensation”(which appears to be the option preferred by the Regulatory Authorities), using the criteria that have been considered in the consultation:

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Criterion	Option C With No Compensation (favoured in Consultation Paper)	"Preferred Plants" bid in LRMC
Internal Electricity Market	This could distort cross border markets as some highly inefficient plants may become competitive in the market. This is in direct violation of State aid.	No distortion in the cross border market, GB plants can compete in CRM and if successful, would receive the same payment as all other participants.
Security of Supply	This system does not guarantee Long Term Generation Adequacy as it has the potential to lead to a very low RO price, leading to successful bidders not being able to meet their fixed costs and subsequently leaving the system	Similar to Option B, there may be more than the minimum of plants in the market.
Competition	Reduces competition through guaranteed selection. Poor entry signals. Lack of transparency as it may not be clear why a bid has been accepted. Uncompetitive bidding process Is very likely to distort the Energy Markets, both I-SEM and cross border	Promotes competition through an unconstrained competitive auction Clear entry and exit signals Transparent winner determination Will not distort the energy markets
Equity	Is inequitable as more efficient plant are likely to lose out on both the Energy and Capacity markets.	Provides fairness to all participants, and will not distort the energy market
Environmental	This does not promote renewable generation, due to the reduction in capacity requirement for non-system constrained units.	Provides an equitable CRM auction for renewable generation
Adaptive	Has to be continually updated to take account of the changing temporary system constraints	This option is more likely to give a predictable capacity market, with price responding to relative scarcity.
Stability	The system is not stable as the risk of system constraint changes will not give investors' confidence in the market.	No exposure to constraints in the capacity market, therefore price is only subject to generation adequacy.
Efficiency	As explained in Appendix B this does not result in the most economical solution to these twin problems. There is unlikely to be a significant difference in cost, as the energy cost is likely to be significantly higher if the RO winners were forced to bid in their Fixed costs.	This may provide the cheapest solution to the capacity issue and the cheapest solution to the System Constraint issue. While the RO price may be higher, the cost of energy is likely to be lower. Furthermore, this method is more likely to show the true cost of constraints, and incentivise a speedy fix.
Practicality/ Cost	Option C requires a heuristic mechanism to be developed, this will require a greater solving time that the proposed solution.	The simple constrained auction will be the simpler and quicker to solve than any of the options proposed in the consultation.