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Ibec views on I-SEM Draft decision and initial impact assessment.

Dear Jean-Pierre, Dear Philip,

Ibec, the group that represents Irish business, welcomes this opportunity to comment on Draft Decision Paper SEM-14-045 and the associated Initial Impact Assessment (SEM-14-046). This response should be read in conjunction with my previous letter dated 3 April, which set out the criteria by which our members would evaluate the preferred design option. To recap, our key points of concern were:

- the need to present a RIA that incorporates plausible market outcomes under different interconnector flow directions;
- the need to understand whether wholesale prices under the proposed new arrangement would be more or less volatile than hitherto;
- the need for the preferred option to be assessed against a hypothetical alternative that minimally achieved compliance with the EU Target Model at least possible cost;
- the need to ensure that any proposed change to the CRM would not require the RAs to seek approval from the European Commission.

In addition, we queried:

- potential incompatibility between price-making obligations and priority dispatch for renewable generators
- the role of bidding price rules, particularly across interconnectors
- the potential unsuitability of daily reference prices for PSO purposes.

The draft decision goes some way towards addressing these issues, but substantial further work will be required in order to achieve our members' broad support. The following comments outline our remaining concerns.

1. Plausible market outcomes under different interconnector flows

The RAs' analysis includes a range of modeling scenarios, but all of these appear to assume a preponderance of electricity import flows from Great Britain. One obvious implication is that optimally efficient dispatch of interconnectors would primarily benefit energy users in the I-SEM through lower wholesale prices. However, given the continuing uncertainty over UK energy policy, it would have been sensible to include some economic assessment of alternative scenarios in which exports from I-SEM to GB turned out to be much more substantial.

Efficient export flows may help to maximize congestion revenues that can offset network charges, but this may be outweighed by the impact on I-SEM wholesale prices. It is worth bearing in mind that the RAs have a joint obligation to protect the interests of end-users on the island of Ireland. Any 'concomitant benefits to GB consumers' are outside the regulatory remit, and arguably should be excluded from the cost-benefit analysis.

2. Volatility and level of wholesale prices

Although the proposed energy trading arrangements are similar in some respects to Option 3, participation will not be mandatory in the Day Ahead Market (DAM). This appears to be a response to concerns on the part of wind generators regarding excessive exposure to imbalance costs due to unavoidable forecast uncertainty.

The Draft Decision Paper expresses the hope that renewable generators can be encouraged to participate voluntarily in the DAM, particularly if day-ahead spot prices are to be used for calculating the annual reference price for REFIT contracts. Nevertheless, it is reasonable to expect that a substantial proportion of renewable generation will not willingly bid into the DAM.

If not all Irish-based supply will be active in the DAM, the EUPHEMIA algorithm could consistently dispatch mid-merit and peaking gas-fired generators who would not otherwise have been in the market schedule. Assuming that their marginal bids will recover start-up and no-load cost, won't the resulting day-ahead prices be more volatile (and higher on average) than would have been the case in an ex post Pool, other things being equal? In turn, regardless of whatever EU-compliant bidding regime

eventually emerges in GB, wouldn't this increase the risk of economically inefficient Interconnector flow nominations, consistently biased towards imports? The expected efficiency savings for the proposed market arrangements may therefore be illusory. Moreover, to the extent that renewable generators become major players in the Intra-Day Market (IDM) won't it become necessary for at least some of them to start acting as price-makers, thereby compromising their Priority Dispatch status under the Renewables Directive?

3. Appropriate counterfactual scenario

The initial impact assessment appears to show that the four design options would all have set-up, regulatory and operational costs in the region of €12 million per annum over a 14 year period. At an assumed 3.5% real discount rate, this is equivalent to an upfront single payment of circa €140 million. Ibec strongly suspects that a minimally-compliant market arrangement could be put in place for substantially less than this amount. We are not proposing that this be done, but simply that the additional (potentially avoidable) systems costs should be properly quantified in the full impact analysis, alongside the expected efficiency benefits. It would also be desirable to allow a period of time for testing the systems on a 'shadow' basis alongside the existing SEM, even if this meant not strictly meeting the EU deadline for target model compliance. Given the magnitude of investment that will be required by market participants, and the radical nature of the reforms being proposed, these are not unreasonable requests.

In addition to the foregoing concerns, we would offer the following observations about the market arrangements proposed in the Draft Decision Paper.

- It is argued that the I-SEM's liquid Day-Ahead spot price will inherently promote greater liquidity in the forward timescale. No empirical evidence is presented to support this, but if true, to what extent would it mitigate the perceived need for additional Forward Market liquidity measures?
- It is argued that the I-SEM will also promote more active competition between generators as they learn to adapt their bidding behaviour. Does this mean a relaxation of the inflexible bidding rules, as previously suggested by the International Energy Agency's country review report? It would be helpful to have an impact assessment of the proposed changes to the bidding code *prior* to publication of a Final Decision. The desire to meet our EU-imposed deadline for Target Model compliance does not trump the need to follow good regulatory process.

- Any CRM deemed to involve state aid must be available to cross-border participants. In the case of the I-SEM, given the possibility of import bias at the day-Ahead stage, would this create a risk that congestion on the Interconnectors might prevent GB-based holders of Reliability Options (ROs) from participating in the market schedule whenever the day-ahead reference price goes above the strike price? Would this potentially constitute a Force Majeure event?
- It is argued that ROs will not unduly affect the spot electricity price. Surely this depends on how high the strike price is set, and whether the revenue to peaking plants is likely to be affected? This may in turn have implications for the bidding strategies that may be adopted by participants in CRM auctions.
- It would in any case be helpful to have a somewhat more robust justification for the proposed particular choice of CRM in the final Impact Analysis, given that another of the options previously under consideration would appear to offer substantially greater potential for end-user cost savings, at least in the short-term.
- It is argued that the I-SEM needs to provide better locational signals for investment. The idea of Locational Marginal Pricing was previously explored by CER prior to the SEM being established, but it was rejected as an unnecessary complication in a geographically small market. There may be other, simpler means of discouraging new generation capacity from being inefficiently located behind network constraints. This could well help to reduce constraint costs, to the benefit of end-users. However, it would seem unfair to retrospectively disadvantage existing generators who have made locational decisions in good faith.

In conclusion, I would re-emphasize the need for the Regulatory Authorities to keep *all* of Ibec's members engaged in this market reform process. The high degree of technical complexity in the recent consultation documents has presented a challenge for our electricity suppliers, let alone our large energy users. It would be helpful if the Regulatory Authorities could provide illustrative examples in other EU member states of market structures similar in concept to I-SEM that are successfully working to the benefit of customers.

Yours sincerely,

Neil Walker
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