

13th August 2010

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Commission for Energy Regulation,
The Exchange,
Belgard Square North,
Tallaght,
Dublin 24

Mr. Billy Walker
The Utility Regulator
Queens House
14 Queen Street
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RE: Proposed RAs option for all-island harmonised Transmission Loss Adjustment Factors [Proposed Decision Paper 18 June 2010 SEM-10-039]

Dear Jamie, Billy,

Bord Gáis Energy (BG Energy) strongly supports the Regulatory Authorities' (RAs) proposed decision (the Proposed Decision) on the interim and long-term treatment of Transmission Loss Adjustment Factors (TLAFs) in the Single Electricity Market (SEM). In moving towards a long-term solution which will deliver the stated objectives of TLAFs, it is essential that the RAs implement an interim solution which both acts to stabilise the market and is consistent with the consensus that the current regime is unfit for purpose.

As an all-island commercial company, which is seeking to invest, compete and add value to both the wholesale and retail markets on the island, BG Energy is concerned about the impact that TLAFs are having on investor confidence and the development of the market. The current methodology is not just flawed but also wholly inadequate having regard to the size and expected future growth of the all-island market over the coming years. Given the general acceptance amongst participants and the RAs that the current methodology is not fit for purpose, it would be entirely remiss of the RAs not to take immediate action to address the issue.

The RAs and market participants have undergone over 18 months of consultation and have considered and discussed at considerable length the optimal treatment of losses. This has involved 4 consultation papers, 3 workshops and numerous bi-laterals with stakeholders. The consultation process up to and including the Proposed Decision has been painstaking and robust. It is simply not credible to argue (as we note one participant has done) that adequate analysis has not been carried out or that the process has been inadequate. The Proposed Decision recognises the responses and overall consensus of market participants that uniformly TLAFs is the only appropriate and consistent approach until such time as losses can be accurately and reliably measured and therefore allocated proportionately and fairly.

BG Energy is strongly of the view that if a methodology cannot be devised to accurately measure/reflect the costs of losses thereby providing for a legitimate differentiation between participants, the costs of losses should be spread uniformly among participants thereby treating all participants equally. The current discredited methodology (as acknowledged by participants and the RAs) discriminates between plant without a proper basis for doing so and therefore the RAs have an obligation to rectify the system immediately and in a meaningful way. This obligation is clearly accepted by the RAs and is reflected in their Proposed Decision in the interim and long-term treatment of TLAFs. On this basis and given the wide recognition that the current methodology is flawed, BG Energy supports the RAs decision to uniform TLAFs in the interim while moving to more robust solution in the long-term.

1. The Current Methodology is Flawed and Distorts the Market

The stated function of locational TLAFs is to aid in the delivery of efficient generation dispatch and to provide a locational signal to investors. We note the RAs' view that:

“the principal objective of transmission losses arrangements is to deliver efficient generation dispatch in an optimised close to real-time fashion. The application of appropriate TLAFs enables the impact of each generator on the overall volume of transmission losses to be taken into account in dispatch decisions. It has been previously argued that appropriate TLAFs also provide signals to generators of their impact upon losses on the system, which could be considered when taking siting/entry decisions and exit decisions. Achieving this objective must be balanced against the cost involved in delivering this optimised dispatch and the associated quantifiable benefit. It is important for the methodology to be transparent and provide predictability.”¹

The RAs have clear and resounding evidence before them that the current TLAF methodology achieves neither aspect of the stated function above. We note that the RAs acknowledge:

“the concerns that have been raised regarding the accuracy of the existing TLAF methodology. Based on these concerns, it is apparent that the existing methodology is not promoting efficient dispatch, given the variation between the ex-ante determined TLAF values and actual losses in real-time and is having an undue impact on the market schedule”.²

¹ Section 2.1 of the Paper.

² Section 2.4.2 of the Paper.

In short, the current methodology is flawed and unfit for purpose because it does not deliver the primary objective of a transmission losses arrangement identified by the RAs (efficient dispatch). It is inaccurate, volatile, unpredictable and disproportionately places significant costs on market players. The methodology was designed for a more stable, settled market than the SEM.

As outlined above the RAs have acknowledged that the current TLAF methodology is flawed and this has been echoed by all participants in the market. To retain a flawed system, which clearly discriminates against certain participants, is unacceptable and entirely inconsistent with the RAs' statutory functions in relation to the operation and effectiveness of the SEM. The RAs have an obligation to deliver stability to the market immediately while they work with the SOs and industry to deliver a more suitable and appropriate mechanism for the market in the long-term. Considering that the issue has been consulted on at length, further inaction or purported change which produces substantively the same effect as the current methodology (e.g. the application of compression factors) would be unacceptable, irrational and indeed perverse. Again, BG Energy advocates that until such time as a methodology can be devised which provides a reasonable basis for treating parties differently, all parties should be treated equally.

There has been a suggestion that, as the Proposed Decision is only a bridging decision until a long-term methodology is implemented in October 2011, the implications of the decision is negligible in the short-term. This is not the case. As the RAs have pointed out³ the proposed interim decision is a first step towards the RAs preferred long-term solution of splitting, which will see TLAFs uniformed in the market schedule and calculated closer to real time in the dispatch schedule. It is hoped that this will be delivered in 12 months. In the meantime, investors are facing operational and financial decisions, which, if the Proposed Decision is not taken, will place them in an environment of abject uncertainty and risk.

The benefit of taking the first step to uniform TLAFs immediately is that it will stabilise the market while the RAs continue to assess how best losses can be calculated in the dispatch schedule. In the meantime, parties investing in both generation and retail will be in a better position to take financing, operational and expansion decisions. Inaction or inadequate action at this time on the part of the RAs will add risks and costs to these decisions, which will ultimately increase the costs borne by customers. For this reason and in order to negate the cost and effect of what is a discredited signalling methodology, it is imperative that the RAs take the initiative and the impetus from over 18 months of consultation and resolve the issue in the near term by issuing the Proposed Decision as final.

³ See Section 2.4.1.

2. The Consultation Process To-Date

Since the establishment of the SEM there have been numerous consultations relating to TLAFs and their application in the market. The most recent review began in January 2009, since when there have been 4 consultation papers and 3 workshops (including those related to this most recent consultation) to ascertain the views of participants, discuss a number of different options for TLAFs and outline the different forms of analysis that have been undertaken.

The consultation process has been extensive over a sustained period of time. A legal view sought by BG Energy indicates that up to and including the Proposed Decision the review has been robust and consistent with the RAs' statutory functions in regard to the operation and effectiveness of the SEM. The RAs have consulted at length, taken technical advice and liaised with market participants' through-out the process. They have assessed the Proposed Decision against the various criteria for loss arrangements and considered it the best solution.

Throughout this consultation process, industry participants have called for stability and transparency in the calculation and a more equitable and efficient approach to the process and its application. A large majority of participants have called for uniform TLAFs or a variation of uniform TLAFs during this consultation.

We note that the views of a minority have changed of late following the publication of indicative TLAFs for 2010 and 2011 which reversed unfavourable TLAFs in certain areas. However it seems clear that even this minority continues to support change from the current flawed methodology. It appears that they wish to perpetuate this flawed methodology (or some version of it) in the short-term solely in order to take the benefit of positive impacts for them. Accordingly they are now arguing that uniform TLAFs should not be implemented for the 2010/11 tariff year. However, to delay the implementation of a remedial solution which avoids the acknowledged failures of the current methodologies would set a dangerous precedent and send damaging signals to investors and financiers relating to the governance of the market and comprise a failure by the RAs to fulfil their statutory functions.

Furthermore, given the length and depth of consultation to-date, the RAs must reinstate confidence into the market and issue the Proposed Decision which will markedly improve the current arrangements. The Proposed Decision (to implement uniform TLAFs until such time as a longer-term optimal solution can be designed and implemented) will work to both stabilise the market in the short term and signal to investors and other stakeholders that the RAs will amend market flaws in a timely and effective manner. Again, it is BG Energy's view that it would be remiss of the RAs not to address the fundamental issues with the current

methodology and to persist with a flawed methodology (or a variant of a flawed methodology).

3. Rationale for Supporting the RAs' Proposed Decision

BG Energy has examined the different options for TLAFs with respect to a number of aspects, namely; its impact on the investment environment, its impact on customers and market costs and its adherence to the high level design of the SEM and objectives of TLAFs. Under each of these criteria, BG Energy has found that the Proposed Decision is the optimal solution for the market and its participants.

3.1 Investment Environment

As an investor in conventional and renewable generation across the island, BG Energy is of the view that the Proposed Decision will deliver reliable signals to the market and enhance the investment environment. Stability and predictability are imperative for the market if renewable projects are to be successfully rolled out and the renewable targets across the island are to be achieved. Certain investors have witnessed a 14% drop in their TLAFs within 5 years under the current methodology. This level of swing is intolerable not just for the investor but also the financiers who will be required for the financing of similar projects in the future.

BG Energy is currently planning and developing a number of wind projects around the island. Specifically, BG Energy has two renewable projects which are expected to be brought to a financial close within the coming months. The Proposed Decision, if implemented, will have a significant and positive impact on these projects both in terms of cost of debt and cost of equity. It will also greatly improve the economics of Gate 3 and other renewable projects. If the identified flaws with the current methodology are not addressed any investor who has seen TLAFs previously fall significantly to within the region of 0.91 will use this as a starting point for future investment decisions, modelling TLAFs in the low 80's. If continued, this could therefore result in projects being marginal and perhaps unsustainable in such a volatile environment.

BG Energy is also planning and developing a number of other non-renewable plant on the island, some of which have positive TLAFs at this time. Notwithstanding these favourable TLAFs, BG Energy is still in favour of uniform TLAFs as it will provide a level of predictability, which is key in any investment plan and decision.

In short, the current TLAF regime is undermining the investment environment, in particular the renewable investment environment. It is seen as a major obstacle to both investors and banks to investing in the SEM. History has shown that the signal cannot be relied upon. Investors now ignore the signals given by TLAFs, instead looking towards other signals provided through constraints and connection costs. Uniforming TLAFs and stabilising the signal for investors will improve the overall investment environment and investors confidence in the market in general.

3.2 Customers and Market Costs

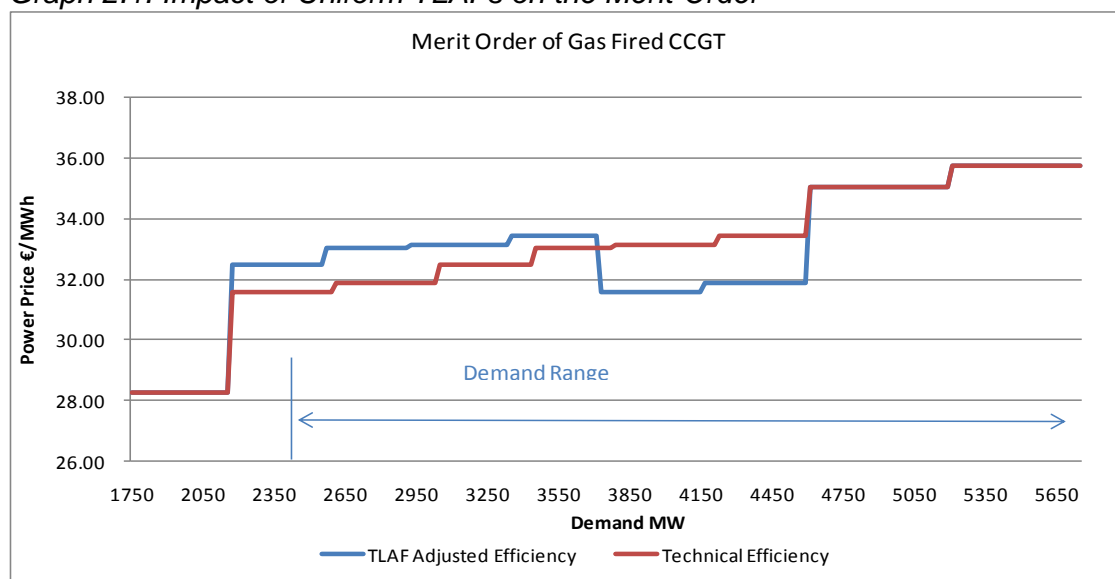
As a retailer with positions and growth ambitions in the retail markets in both Northern Ireland and the Republic of Ireland, BG Energy believes that the Proposed Decision will also aid competition and deliver cheaper and more innovative products to customers. Robust competition between the most efficient plant will act to deliver a more liquid market and lower wholesale prices, which in a competitive environment will be passed directly onto consumers. This is critical in the current market where there is intense focus on the competitiveness of electricity prices.

As outlined previously, the current methodology of calculating TLAFs is erroneous, discredited and flawed which results in less efficient plant being run more regularly or higher up the merit order than the most technically efficient plant on the system.

The current distorted merit order can be seen in the graph below. The blue line is the current merit order and shows that plant are not being scheduled on a 'cheapest first' basis. In times of low demand the market price is being set by less efficient plant, with technically more efficient plant being excluded from the merit order. Patently the current methodology fails utterly to deliver the primary objective of TLAFs as identified by the RAs in the Proposed Decision.

Using a uniform TLAF however as shown by the red line, schedules plant in an economically efficient manner. Dispatching the plant in this fashion will deliver cheaper electricity prices in the Single Electricity Market.

Graph 2.1: Impact of Uniform TLAFs on the Merit Order



It has been suggested by one participant in its individual analysis that the Proposed Decision will increase consumer costs by €81.4 million in 2010/11 through increases in constraint payments and the error supply unit. This figure appears to be a scenario analysis in the extreme and misrepresents the forecasting and modelling for the coming year. BG Energy has conducted analysis using the RAs validated model and compared prices for 2010/11 using 2010 TLAFs and uniform TLAFs of 0.98⁴. This direct comparison shows a price impact of less than 1% between the two TLAF methodologies for the coming year (and actually shows SMP decreases in future years), which is the equivalent of less than €9 million over the course of the year. BG Energy sought an independent view from a third party consultant who stated there is no systemic reason for prices to increase as a result of uniform losses being implemented.

The SOs have simultaneously conducted the relevant analysis on constraint costs as market participants do not have the relevant information to reasonably assess changes in this area. They have concluded that there is “no systematic reason for impact on Constraints Forecast”. While the particular scenario modelled by the SOs increased constraints by just 2%, in reality the actual outcome could be positive or negative.

BG Energy sees no reason for further analysis in regard to the impact of the short-term aspect of Proposed Decision as the analysis already carried out shows there

⁴ In taking the RAs validated model, BG Energy made assumptions for fuel costs (based on observed market forward prices) and on the non-energy portion of start costs (based on observed bidding behaviour).

is either no systematic reason for cost impacts or the impact is not material to the customer. All-in-all, the impact of uniform TLAFs on system costs is nominal while the benefits to the market and its investors are real and significant. In reducing market risks and thus costs, the decision will stimulate investment and competition which will ultimately deliver lower prices to customers in the long-term.

It has also been suggested by certain participants that the Proposed Decision will result in a cross-subsidisation between parties and between jurisdictions. This is simply not the case. The Proposed Decision would address current unfairness in the allocation of losses by allocating them uniformly in the short-term. Until such time as an appropriate mechanism is devised to accurately calculate and distribute losses, any methodology which approximates losses will result in a cross-subsidisation between market participants. In brief, the current methodology is simply not fair.

With respect to the Northern Irish PSO levy, the impacts which the participant has sought to attribute to the Proposed Decision are in fact the result of how PSO backed generators are performing in the market relative to other market participants and of the high level policy decision, which obliges the Northern Irish customer to underwrite a number of commercial entities. That is to say, those participants currently backed by the Generator User Agreements in Northern Ireland are under-performing relative to newer more efficient plant that have recently entered the generation market. This is a natural exit signal in the SEM and should not be supported either by customers or policy decisions in the market.

Similar decisions are under review in the Republic of Ireland in a bid to minimise costs and risks placed on the general customer. Changes in market arrangements such as the Proposed Decision which address well recognised flaws in the current arrangements are essential to improve the market and its environment and should not be hindered by local policy issues decided outside of the market. Similarly such local policy issues provide no proper basis or justification for a decision to retain arrangements which have been acknowledged to be flawed and accordingly are not in the interests of an effective of a SEM.

3.3 Is in Keeping with the High Level Design of the SEM and the Objectives of TLAFs

In its high level design decision paper (AIP-SEM-042-05) the RAs outlined the key features of the SEM as being:

“a central commitment Market with a single clearing price and an explicit capacity payment mechanism.... The SEM will apply static locational loss

factors (set annually) to all generator outputs. Finally, a shallow connection policy will be applied in the SEM.”

In a later consultation paper providing for the first tranche of all-island loss-adjustment factors the RAs noted that:

“volatility of TLAFs, and the modeling of wind generation and use of historic data in the calculation of TLAFs will be reviewed during future refinement of the methodology” (AIP-SEM-07-47).”

At the time the SEM was being developed, the RAs recognized the potential hazards of volatile TLAFs and committed to reviewing the methodology in future years in keeping with their statutory functions in this regard. To this end, the RAs’ review and subsequent Proposed Decision is in keeping with their commitment to review the applicability of marginal locational TLAFs as the market changed. Now that the SEM has been established it is important that it develops in a manner that is effective and incentivises investment while ensuring costs are minimized for customers. This is key to the current review and the need for change to the current TLAF methodology.

When designing the high level features of the SEM, the RAs and industry participants at the time evaluated the key features against potential alternatives using 6 criteria: 1) security of supply, 2) stability, 3) efficiency, 4) practicality, 5) equity and 6) competitiveness (AIP-SEM-06-05). Applying the same criteria to the uniforming and later splitting of TLAFs compared to the status quo yields positive results in favour of uniform TLAFs. Uniform TLAFs will provide security of supply (through the incentivisation of investments), stability, practicality, equity and competitiveness, while splitting (if real time losses can be accurately calculated) will further provide the desired efficiency effects.

The status quo on the other hand adheres to none of the criteria, most notably not even one of its founding criteria of efficiency. At the time of designing the SEM marginal TLAFs were believed to be the most efficient mechanism in allocating the costs of transmission losses while also optimising the dispatch of plant on the system. However, the inaccuracy of the methodology in reflecting system realities have dissolved any perceived efficiency gains.

Furthermore, through consultation in 2009 a number of objectives were agreed by industry, the RAs and the SOs for the identification of an optimal TLAF methodology for the SEM. The primary objectives of a SEM appropriate TLAF methodology are: 1) efficiency; 2) transparency; 3) predictability; 4) volatility; 5) short-term efficient dispatch and 6) cost reflective. Differences of opinions exist amongst different stakeholders as to the weightings of these objectives. Notwithstanding these differences of opinions, a high-level comparison of the different

options (Table 1.1) shows a stark snapshot of their performance against the primary objectives.

Table 1.1: Comparison of Options Against Primary Objectives

Objectives	Current Methodology	Uniform TLAFs	Splitting TLAFs
Efficiency	x	Neutral	?
Transparency	x	✓	✓
Predictability	x	✓	✓
Volatility (reduced / removed)	x	✓	✓
Short-term efficient dispatch	x	Neutral	?
Cost Reflective	x	Neutral	?

The current methodology clearly achieves none of the primary objectives of an optimal TLAf methodology. The inability of the methodology to accurately reflect losses and actual dispatch scenarios (as recognised by the RAs) has the result that it cannot achieve the objectives of efficiency and cost reflectivity. Added to this failure are the extreme volatility, a lack of transparency and predictability of the current methodology. Uniform TLAFs on the other-hand removes the issue of volatility and provides transparency and predictability to the methodology.

With respect to the splitting option, there are still certain unknowns around how actual losses will be calculated and how these will be fed into the dispatch schedule. Although uniforming TLAFs in the market schedule will equally provide transparency, predictability and reduce volatility for market participants, it cannot be determined at this time how the objectives of efficiency, short-term efficient dispatch and cost reflectivity will be met and therefore affected. To this end, it is right that the RAs engage in further assessment and consultation on the calculation of losses and their use in the dispatch schedule before deciding on the exact implementation of the splitting option.

In short, referring to the SEM high-level design criteria and the primary objectives for a TLAF methodology, it is clear that the Proposed Decision to uniform TLAFs is the optimal decision for the SEM at this time. This conclusion has been made following 18 months of consultation and at least 3 years of objections to the current methodology by industry participants. It is therefore timely and reasonable for the market that uniform TLAFs are implemented at this time.

Executive Summary and Conclusions

To summarise, the RAs have conducted a lengthy and painstaking consultation on the issue of TLAFs and their impact on the market and its participants. During this process there has been unanimous agreement that the current TLAF methodology is flawed. In addition to this, there has been majority agreement that uniform TLAFs should be implemented to stabilise the market and provide a level of certainty to participants.

The consultation process on TLAFs has been long and has involved numerous papers, analysis and industry input. To say it has been conducted without sufficient analysis or adequate impact assessments on consumers is not acknowledging the efforts and input provided by all market participants to-date and is not credible. A legal view sought by BG Energy indicates that up to and including the Proposed Decision the review has been robust and consistent with the RAs' statutory functions in regard to the operation and effectiveness of the SEM. [Similarly, BG Energy feels that certain workshop materials presented by a participant which in effect amount to some type of veiled legal threat are entirely inappropriate and unfounded and should be regarded as such by the RAs.

The RAs have acknowledged that the current TLAF methodology is flawed and unfit for purpose and this has been echoed by all participants in the market. To retain a flawed system, which clearly discriminates against certain participants, is unacceptable and entirely inconsistent with the RAs' statutory functions in relation to the operation and effectiveness of the SEM.

BG Energy agrees with the longer-term strategy set-out in the Proposed Decision subject to the need for analysis of that strategy in accordance with the Proposed Decision to understand and quantify the impact of splitting on the market and market participants. However, the short-term strategy to uniform TLAFs has been assessed and considered by all market participants previously and again as part of this consultation on the Proposed Decision. Analysis conducted by the SOs and RAs has shown that the impact of the Proposed Decision on consumers is minimal. This is echoed by BG Energy's own analysis, which actually shows that uniform TLAFs will reduce wholesale prices in future years.

Given the evidence before the RAs and the wider implications for market participants, investment and the achievement of energy policy across the island, BG Energy believes that it is not just reasonable but also essential to the stability of the market and confidence in the decision-making process to uniform TLAFs immediately. Indeed BG Energy believes it would be perverse to take any approach which perpetuates the current flawed methodology or replaces it with a methodology which has substantively the same effect. If the RAs do not follow-up on the impetus of over 18 months of consultation and deliver change to the market, they will be exposed to challenges in relation to their governance over a clearly defunct and market distortionary methodology. Adoption of the Proposed Decision must follow. To do otherwise would amount to an irrational and unreasonable action on the part of the RAs particularly in light of their statutory functions and the evidence before them following a robust consultation process.

Yours sincerely

Jill Murray
Commercial Regulation
Bord Gáis Energy

{by e-mail}