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Ref: TEL/CJD/15/198

2nd November 2015

RE: DS3 Competition Metrics Consultation Paper (SEM-15-068)

Dear Sirs,

Tynagh Energy Limited (TEL) welcomes the opportunity to respond to the DS3 Competition Metrics Consultation Paper (SEM-15-068).

TEL believes that the fundamental point of DS3 is to maximise the benefit for consumers of the high levels of Wind Capacity on the island, and that this requires significant and timely investment primarily from thermal generators.
TEL has divided its response into two sections: Section A describes TEL's specific views on the Competition Metrics for DS3 and Section B answers the questions raised in the Consultation.

SECTION A

TEL would like to raise the following points in response to this consultation:

1. Competition test will lead to under investment
2. Separate auctions will undermine long term contracts
3. Suggested Competitive Framework

1. Competition test will lead to under-investment

The competitive procurement of System Services is a whole new concept in the SEM. There is a requirement for these services to be delivered as soon as possible to enable the increase in SNSP that will ensure Ireland and Northern Ireland meet their renewable energy targets. Seven of the required services are new services. As a result, there will be a requirement for significant capital investment from Market Participants in order for the required volume of services to be delivered.

TEL supports the objective of the RAs to ensure that value for money is delivered for consumers. Competition is the best way to deliver this value for money. However as this is an emerging market, real competition is not going to arrive fully-formed. The RAs must ensure that they put in place a framework that enables competition to develop taking account of the long lead time required for Market Participants, both existing and new, to make investments to deliver these services.

TEL argues that the proposal to perform a competition test prior to holding an auction to award long term contracts is poorly conceived. Any rational investor would defer investment until such time as a contract to support the significant capital investment is available. This test therefore could result in a delay in full competition being achieved and ultimately result in the required services not being delivered. The RAs must be patient and allow for full competition to arrive in the medium term.

2. Separate auctions will undermine long term contracts

Building a business case for investment in system services is a challenging proposition at present. The capital cost of modifying generators to deliver these system services was estimated by DNV KEMA at €535 million. Retrofitting an existing plant will be significantly quicker to deploy than constructing a new build. However, an investment of this magnitude would require the delivery of multiple services in order to be viable. The RAs appear to recognise this risk and the previous decision to award multiannual contracts was designed to provide some certainty to investors[1]. TEL has serious concerns that a competition test per service, or group of services, will undermine the intended aim of offering long term contracts in the first place.

It would appear individual services that are deemed to have insufficient competition will not clear volumes at auction. A rational investor would therefore defer investment until a contract is available. However, if some of the services are deemed competitive an auction will be held. This would undermine any business case that relied on volume from both the competitive and non-competitive services. It is the non-competitive services that require the most investment. By only awarding contracts for the competitive services the RAs are reducing the likelihood that this investment would occur at the lowest cost possible, if at all.

TEL strongly urges the RAs to hold a competitive auction for all system services as early as possible. It is only through auctioning all system services together that the greatest value for money is delivered for consumers.

3. Suggested Competitive Framework

TEL recognised the RAs concerns that holding an auction in the absence of real competition could result in consumers paying more than necessary for these services. There are, however, some simple solutions that could be employed to ensure that this is not the case. These solutions could have the following framework:

i) Determine volumes for each service
ii) Eliminate the possibility for significant market power to be exercised
iii) Ensure bidders at auction bid below the regulated tariff

This framework is explained in greater detail as follows:

i) Determine volumes for each service

The first step for developing a competitive framework is to determine the required volumes for each service. These volumes should provide clear signals for investment. Where substitution exists between services the RAs should set a minimum volume for each service that will be procured. Setting a minimum volume will provide certainty for investors in developing their upgrade packages for existing generators while enabling the TSO to take advantage of any savings available through substitution.

[1] SEM-14-108

Example: Service A has a required volume of 100 units. Substitution exists between services such that a range of between 75 and 125 units of the service may be procured. 75 units is therefore set as the minimum volume.

ii) Eliminate the possibility for significant market power to be exercised

There are a number of methods for determining market concentration, many of which are illustrated within the paper. These seem overly complex for a new market in which no data exists. TEL believes that the RAs should concentrate on defining a simple metric to eliminate the possibility for significant market power to be exercised.

The UK Office of Fair Trading Merger Assessment Guidelines state that a combined market share of below 40% is unlikely to cause competition concerns[2]. TEL would argue that this is a simple metric to apply and should be adopted in the development of the market for system services. The RAs should not allow any market participant receive term contracts for above a certain threshold for any service across all their assets. This restriction should be up to 40% of the minimum required volume of each service not of the available service volume. This will ensure that early investors are not disadvantaged. This proposal is consistent with the Commission Recommendation on the regulatory framework for electronic communication networks and services[3]:

"…new and emerging markets, in which market power may be found to exist because of 'firstmover' advantages, should not in principle be subject to ex-ante regulation."

Example: During the Auction for Service A, there is a minimum volume required of the service of 75 units. Bids are received from Market Participant X totalling 20 units and from Market Participant Y totalling 40 units. As the minimum required volume is 75 units, the maximum anyone participant can contribute is 30 units (40% of 75), therefore Participant B's bid is capped at 30 units. The total contracts awarded for Service A are 50 units.

iii) Bidders at auction must bid below the regulated tariff

One of the aims of competition is to ensure effective price determination. A competitive auction should result in lower service prices for consumers than the regulated tariff. It should therefore be a requirement for all market participants to submit bids below the relevant regulated tariff for all multiannual contracts. These bids are valid for the entire life of the contract. It is imperative that the regulated tariff for each service is not set too low to enable market participants to build a business case for investment.

Example: The value for Service A (100 units) is determined as €100 resulting in a regulated tariff of €1 per unit of service. All bids at auction for Service A must be <€1 per unit.

This Framework would have the following three results for each service:

a) If minimum required volume is not met: All volumes offered are contracted
b) If only the minimum requirement volume is met: Price will clear at the required volume at a single auction
c) When all volume requirement is met: The remaining volume will be contracted and final price is determined

[2] OFT1254 CC2 (Revised)
[3] 2003/311/EC

a) **If minimum required volume is not met: All volumes offered are contracted**
   Where insufficient bids are received to clear the minimum volume of a service then all volumes offered are contracted. The clearing price at the auction in the absence of full competition is the regulated tariff. The bid prices submitted at auction by the successful bidders are not published. However the bid prices for each service are included in an appendix to the awarded contracts. Awarding contracts for all volumes offered now will incentivise early investment. It will also ensure that the ultimate aim of full competition is arrived at sooner.

   Example: During the Auction for Service A; bids are received from Market Participant X totalling 20 units @ €0.9 and from Market Participant Y totalling 30 units @ €0.85. The total contracts awarded for Service A are 50 units with a clearing price of €1.

b) **If only the minimum requirement volume is met: Price will clear at the required volume at a single auction**

   Where sufficient bids are received to clear the minimum volume of a service in a single auction then the lowest cost bids, taking account of both service price and energy cost required, will be contracted. The clearing price at the auction will be the highest bid that cleared a volume.

   Example: During the Auction for Service A; bids are received from Market Participant X totalling 20 units @ €0.9, from Market Participant Y totalling 30 units @ €0.85 and Market Participant Z totalling 25 units @ €0.93. The total contracts awarded for Service A are 75 units with a clearing price of €0.93.

c) **When all volume requirement is met: The remaining volume will be contracted and final price is determined**

   Where sufficient bids are received to clear the remaining "uncontracted" volume of a service in a single auction the lowest bids will be awarded contracts for the remaining volume. The clearing price at the auction will be the highest bid that cleared a volume across all previous auctions for this service. This price will apply to all contracts that have been executed for that service to date.

   Example: During the first Auction for Service A; bids are received from Market Participant X totalling 20 units @ €0.9 and from Market Participant Y totalling 30 units @ €0.85. The total contracts awarded for Service A are 55 units with a clearing price of €1.

   During the second Auction for Service A; bids are received from Market Participant Z totalling 25 units @ €0.93. A contract is awarded for Service A for 25 units. The total contracts awarded for Service A are now 75 units. The clearing price for all contracts is €0.93.

TEL supports the RAs endeavours to implement competitive procurement arrangements for system services. However, TEL would advise caution with implementing a simplistic competition test. As this is a market for new services which will require significant investment with long lead times it is likely to fail any such test. The result of a failure could in fact delay competition further or undermine the business case for an investment which relies on multiple services to be viable. Segmentation of the market will ultimately undermine the aim of multiannual contracts and result in additional cost for consumers.

SECTION B

Q1. Do you agree with the high level approach set out for identifying and defining the relevant market as set out in section 3?

Please see Section A of the response.

Q2. Do you agree with the use of the proposed metrics for assessing potential market power as set out in section 4?

No, TEL believes that a simpler more practical way of assessing Market Power would be to apply a 40% threshold of the minimum required volume of any one service for a market participant to avail.

Q3. Given that the approach to assessing market power is for the purposes of determining whether a product is auctioned or is paid for under a regulated tariff mechanism, do you agree with the proposed approach to analysing market power for DS3 system services?

Please see Section A. 3. Suggested Competitive Framework above. TEL believes that the premise that there must be a competitive environment prior to an auction being held is self-defeating, as the conditions will not exist until there is a competitive environment which will require investment which will not occur if there is a competition test.

Q4. Respondents are asked to provide views on potential interactions between the system services products.

TEL sees some potential substitutability between FFR and SIR. However with regard to reserve and ramping products TEL does not see any rational substitutionality, for instance SOR is not a substitute for POR.

Q5. Do you agree with the high level proposals for when to apply market power mitigation measures as set out in section 6?

No.TEL believes that the method proposed is self-defeating and will lead to no investment in DS3, which will be followed by increased costs to the consumer. In order to maximise the benefit to the consumer of the high levels of wind on the system, investment must be encouraged. New plant cannot be built and existing plant cannot be upgraded if a long term contract is only available for a fraction of the total services.

Regulated tariffs should be used in conjunction with the auction process to encourage competition. A detailed framework has been included in Section A, of this response,

Q6. Do you agree with the proposals for the types of market power mitigation measures that may be employed as set out in section 6?

Please see Section A of the response.

Q7. Do you think there are alternative market power mitigation measures that could be employed that have not been mentioned in this paper?

Please see Section A of the response.

Q8. Are there any other issues, relating to assessing whether or not a market is competitive, that have been omitted from this paper?

Please see Section A of the response.

TEL urges the RAs to put in place a framework that will support the required investment and enable competition to develop. A suggested competition framework has been included above which we trust will prove helpful in the further deliberations of the RAs. Should you have any queries, please do not hesitate to contact us.

Yours sincerely,

Cormac Daly

Cormac Daly
Risk and Regulatory Manager