

Rationale for determination that SEM

constitutes requisite arrangements

1 November 2007



INTRODUCTION	3
SECTION 1: Basis of Determination	6
Section 1 A Requirements of Paragraph 2	7
Section 1 B General requirement of Paragraph 3	17
Section 1 C Specific requirements of paragraph 3(A)	19
Section 1 D Requirement of Paragraph 3 (B)	38
SECTION 2 Procedural requirements	39

INTRODUCTION

1. As part of our preparations for making a determination whether the Single Electricity Market (SEM) constitutes the requisite arrangements referred to in conditions in Northern Ireland Electricity Licences relating to the cancellation of generating unit agreements entered into at privatisation of the electricity industry (the cancellation condition) we issued a consultation paper on 6 July 2007.
2. In our consultation paper we stated that we were minded to determine prior to the establishment of SEM (“Go Live”) that it constitutes the requisite arrangements referred to in the cancellation condition. The consultation set out our rationale for our opinion that SEM would satisfy the requirements of paragraphs 2 and 3 of the cancellation condition.
3. We received responses to this consultation from:
 - Northern Ireland Electricity PLC
 - ESB International Ltd.
 - ESB Group
 - Friends of the Earth
 - AES Kilroot
 - Consumer Council
4. The vast majority of responses were strongly in favour of the Utility Regulator determining that SEM constituted Requisite Arrangements and met the requirements of paragraph 3 of the cancellation condition and that the consultation process followed in establishing SEM met the requirement of Paragraph 6 of the cancellation condition.

5. The only exception to this was the response received from AES Kilroot. AES Kilroot argued that the the Utility Regulator could not make a determination that SEM constitutes the Requisite Arrangements on several grounds
 - There was no basis for concluding that SEM will facilitate an increase in competition in generation
 - We had not demonstrated that benefits would accrue to Northern Ireland consumers from SEM
 - The requirements of Paragraph 3 in relation to calculation and payment for making capacity available, and adequate incentives sufficient to ensure that all reasonable demands for electricity in Northern Ireland are satisfied are not met by SEM
 - The requirement of Paragraph 3 to ensure that adequate arrangements are in place for the provision by relevant generators of all necessary System Support Services and the proper remuneration of those services was not met by SEM
6. Additionally AES Kilroot argued that the consultation undertaken by the Utility Regulator was not in line with good regulatory practice and was predetermined.
7. Having regard to all relevant information, including that gleaned in the development of the SEM, our knowledge of the legal framework, and the responses of interested parties to the consultation document (including that of AES Kilroot), we have determined the requisite arrangements have been developed for the purposes of the cancellation condition.
8. Our detailed rationale for making this determination is set out in the sections that follow. Section 1 sets out in more detail the basis on which we have made this determination; it also considers the policy and

evidential concerns relating to the requirements of Paragraphs 2 and 3 raised by AES Kilroot and sets out why we do not consider them to be well founded. Section 2 addresses the procedural aspects of the determination including AES Kilroot's concerns both in relation to Paragraph 6 of the cancellation condition and good regulatory practice more generally .

SECTION 1 Basis of Determination

1. This section sets out the basis on which the Utility Regulator determined that SEM satisfies the requirements of paragraphs 2 and 3 of the cancellation condition, entitling us to exercise our powers under paragraph 1 of the condition.
2. The requirements of Paragraph 2, which are general requirements that an electricity trading system which constitutes requisite arrangements meet in relation to competition, are considered in Section 1A.
3. Section 1B considers the general requirements of paragraph 3 in relation to the timing of the establishment of the requisite arrangements, and their binding effect on licensees.
4. Section 1C considers SEM against the specific requirements of paragraph 3(A) in relation to particular aspects the electricity trading must satisfy to constitute requisite arrangements.
5. Section 1 D considers the requirements of the cancellation condition in relation to the granting of supply licences to generators with cancelable Generating Unit Agreements.

Section 1 A Requirements of Paragraph 2

For SEM to constitute Requisite Arrangements it must facilitate an increase in competition in either the generation of electricity available for supply in Northern Ireland or in the supply of electricity in Northern Ireland.

This increase in competition (in either sector) must benefit electricity consumers in Northern Ireland in respect of prices charged; other terms of supply, continuity of supply and quality of electricity supply services.

Consultation Responses:

AES Kilroot hold that despite the policy objective of the SEM to increase competition, this objective is unlikely to be achieved. They also argue that improvements which are “tangible and capable of assessment” are not obvious from the SEM market arrangements.

AES Kilroot argue that any gains increased competition in generation brings will not necessarily be to the benefit of NI customers.

All other responses considered that SEM facilitated an increase in the generation of electricity in Northern Ireland and would benefit electricity consumers.

6. SEM is the first step in the All-island Energy Market Development Framework set out in 2004. It represents a single market for the sale by electricity generators in NI and ROI and PPB to suppliers of electricity

(“wholesale electricity”) in NI and ROI, and measures to ensure effective and co-ordinated regulation of the market.

7. In carrying out our functions to establish the SEM – for example, by modifying licences and designating the Trading and Settlement Code – we did so on the basis that we were meeting our principal objective to:

“protect the interests of consumers of electricity in Northern Ireland and Ireland supplied by authorised persons, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the sale or purchase of electricity through the SEM”. (Article 9(1) of the SEM Order)

8. By complying in this way with our SEM-related duties – to achieve consumer protection by promoting greater competition – we believe that we have established a market that is consistent with and capable of meeting the requirements of paragraph 2 of the cancellation condition. In determining that SEM constitutes requisite arrangements, we have taken fully into account these earlier decisions in relation to the design and legal framework of the SEM.

9. There are many features of the SEM which will facilitate’ (meaning ‘to help bring about’ or ‘make easier’) an increase in the level of competition in generation. Among the most significant are:

- Better and more transparent pricing rules

SEM is significantly more transparent than current arrangements in Northern Ireland. The BST, which sets the benchmark for bi-lateral

contracts, is approved by the Utility Regulator with limited public transparency due to the confidential nature of the GUAs. Other trading is carried out on a bilateral basis among a small number of competitors.

The SEM, by contrast, has a highly visible price formation mechanism. The System Marginal Price is established based on clear rules set out in the Trading and Settlement Code. In addition generators' bids are made publicly available. This high degree of transparency should facilitate potential entrants forming views on the likely evolution of prices. Facilitating market entry underpins competition.

- The wider scope of the Market and better scope for North-South trading.

The removal of barriers to trading in electricity between Northern Ireland and the Republic of Ireland increases competition in generation available for supply in Northern Ireland. These benefits are both static, that is SEM facilitates the scheduling and dispatch of the most economic plant available on the island for meeting Northern Ireland demand, and dynamic in that the wider scope of the market encourages more economic investment decisions.

- Better imbalance pricing – this is particularly important for smaller companies.

Current arrangements impose significant top-up and spill costs for smaller independent generators who have entered into bi-lateral contracts which they are unable to deliver themselves for any reason. The SEM, by virtue of being a gross mandatory pool, removes these

costs. This reduces risk so should facilitate market entry and hence competition.

- Guaranteed market for independent generators and suppliers

Generators are guaranteed a market for all of their generation which is within the merit order. One benefit of this is that it prevents an efficient new entrant from being frozen out of the market by incumbent suppliers with relationships with generators. This means that an efficiently run generation set can be sure of appropriate cash flows.

Independent Suppliers are guaranteed access to energy through the SEM, and cannot be frozen out by dominant generators with ties to competitor suppliers.

By reducing risk we facilitate market entry and so competition.

10. Consequently the new trading arrangements incentivise appropriate investment and operation within the market, reduce barriers to entry or exit, make clear and objectively visible the costs and benefits associated with the production and consumption, of electricity and, from a participant's perspective, schedules and dispatches at the most opportune time and to the optimal capacity in order to maximise profits.

11. Also relevant in this regard are the consultations on development and implementation of the market power mitigation strategy put in place to ensure that the SEM would deliver the benefits of competition in wholesale electricity trading. The market power mitigation strategy is three pronged, it consists of Bidding Principles requiring generators to bid at short run marginal cost (this removes the ability to exercise market power); Directed Contracts to remove the incentive to increase prices and the development

of a market monitoring unit by the Regulatory Authorities (RAs) to assess the market behaviour of participants.

12. AES KILROOT make a number of points in relation to the strategy. These are as follows:

- They do not believe that the SEM arrangements which will come into force include adequate arrangements to counter market power
- In order to constrain the market power of dominant participants, the RAs have designed a structure which is more regulated than that applying in currently in Northern Ireland
- There is considerable uncertainty whether the rules arising out of the strategy will be effective

13. In relation to concerns as to the adequacy of the market power mitigation strategy or the lack of certainty regarding its effectiveness, in our view, AES Kilroot did not provide evidence for their argument. Clearly both of these issues were a major concern in the development of the strategy and we developed the strategy to minimize the risk of failure. A full consideration of the issues can be found in the consultation and decision papers published in the development of the strategy¹.

14. We do not consider the view that SEM comprises significantly more market regulation than currently applies in Northern Ireland is tenable given the small size of independent generation in Northern Ireland, the degree of regulation necessary in North South interconnector auctions, and the regulatory involvement in setting BST, top-up and spill prices in the current arrangements in Northern Ireland.

¹ These can be found on the website www.allislandproject.org

15. AES Kilroot's point that SEM comprises significantly more market regulation than currently applies in Northern Ireland is related to their opinion that the rules governing the submission of technical and commercial offer data do not facilitate competition between generators. They argue that the rules relating to the submission of Technical and Commercial Offer Data will not give generators the opportunity to reflect operating characteristics and behaviour which differentiate performance.
16. The TSC requires that generators submit Technical Offer Data which complies with the Grid Code, and therefore is accurate. The requirement that accurate Technical Offer Data are submitted follows from the High Level Design decision to opt for a central commitment market. The RAs formed the opinion that a central commitment model is somewhat more favourable to potential new entrants because of the reduced volatility of prices relative to the outcomes which could be expected from a self-commitment market.
17. Commercial Offer Data must be submitted in line with generators' licences. This requires adherence to a bidding code of practice which obliges generators to value the cost items making up their bids at opportunity cost. In calculating opportunity cost participants must refer to the price they would pay or receive (after transactions costs) on a generally recognised market (where one exists) in either buying or selling inputs either spot or forward. This allows generators to take into account the commercial environment in which they operate. For example where a generator has bought fuel on a forward market, its opportunity cost is the price at which it could sell that fuel rather than consume it. Hedges, by way of contrast, are purely financial decisions. The Regulatory Authorities have consistently argued that opportunity cost is an appropriate way to measure real resource costs and is consistent with competitive behaviour.

18. It is also important to note that short run marginal cost bidding, while fulfilling an important role in terms of market power mitigation, also serves to prevent double payment for capacity. Moreover, there is nothing necessarily incompatible, as Kilroot suggest, between a competitive market and a large element of regulation. Many competitive markets are highly regulated (e.g. financial services).
19. To support competition in the interests of customers the RAs agreed a strategy for the development of the all island electricity market on 22 March 2007. The new cross-border strategy has *inter alia* the objectives of ensuring effective competition for all electricity customers on the island and that consequently no one company should have greater than 40% market share, and the implementation of the CER -ESB Asset Strategy Agreement to ensure the phased divestment/closure of 1,500 MW of ESB generation by 2010.

Concerns relating to State Backed investment

20. More generally, AES Kilroot argue that the status of several participants as state owned companies undermines competition. They are concerned that the Irish Government will, for political reasons, involve itself in the SEM to enhance the position of companies. They are particularly concerned that the Irish Government “effectively excludes independent and potentially more efficient investment” calling into question the ability of SEM to deliver efficient market entry and exit signals. In support of this contention AES Kilroot cite recent investment decisions by BGE and ESB which required Irish government approval as the shareholder.
21. However, Irish Government support to any company, whether publicly or privately owned, is governed by EU wide rules relating to state aid.

Moreover, the participants which AES Kilroot specifically mention in their response have a commercial mandate.

22. The ownership of a company does not, in itself, mean that it should be presumed not to act in a commercial manner. We expect that ESB and other state owned companies will comply with their commercial mandates. The competent authorities in the Republic of Ireland or the EU will enforce the relevant competition and State Aid rules, and the SEM will itself encourage competitors to ensure that such rules are enforced.

Any increase in competition which does result from SEM will not necessarily benefit consumers

23. AES Kilroot argue that any gains increased competition in generation brings will not necessarily be to the benefit of NI customers, as required for SEM to constitute the requisite arrangements. They point out that regulation at supply level means that wholesale benefits will not necessarily be passed to consumers. This however would only occur either if we are remiss in carrying out our functions as they apply to the regulation of supply or that competition in the electricity supply sector somehow develops in such a way as that it does not benefit consumers. Moreover, any failure to pass on benefits of competition would have to be total (not partial) for consumers in Northern Ireland not to gain at all from SEM. While both outcomes are possible, they are, in our opinion, highly unlikely.

The utility of the NERA report

24. AES Kilroot argue that the NERA estimates of benefits flowing from the SEM (which in part informed the view that the Utility Regulator took at Go-

Active as to the benefits of SEM) are not adequate to support a conclusion that SEM will benefit Northern Ireland consumers.

25. AES Kilroot assert that the NERA report does not properly account for the lost benefits from maintaining the current arrangements, citing in particular the treatment of the cost of carbon credits. However, NERA did compare SEM to the continuation of existing arrangements (indeed an alternative scenario is also presented under which existing arrangements are adapted so as to allow them enable them to meet the requisite arrangements - see executive summary p vii). As a comparator this obviously captures all of the benefits which flow to consumers from the current arrangements.

26. NERA estimate the net present value (NPV) of benefits to consumer of SEM at €70 Million in the Republic and €57.4 in Northern Ireland. AES Kilroot maintain that this benefit to consumers, which they describe as €12.7 Million per annum, is *de minimis* comparing it to total electricity costs of €2.6 billion. However the inferences which AES draw from this do not stand up.

- Benefits are properly compared to the costs of achieving them – the NPV of benefits of SEM is 60% higher than the costs.
- Comparing the NPV of a flow of benefits to a point estimate of market size is not appropriate. Once SEM is established the flow of benefits compared to the total cost of electricity is substantially higher than 0.5%
- Margins in electricity are low and savings should be taken wherever they are found. Achieving a reduction of 0.5% in prices, which AES Kilroot describe as *de minimis*, is, on the contrary, a positive outcome.

27.AES Kilroot questions whether the assumptions in NERA's report regarding improvements in the availability of ESB plant can realistically be achieved. This is based on performance improvements achieved in other markets, and below the high levels of availability currently observed in Northern Ireland.

Section 1 B General requirement of Paragraph 3

General Requirement of paragraph 3: An electricity trading system available for immediate establishment by which the power procurement manager and all licensees will be bound.

28. SEM is an electricity trading system for the wholesale sale and purchase of electricity. It is being established under the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007.
29. Together with the legislation establishing SEM, the documentation and other obligations required to be entered into, imposed or assumed in order to create and implement SEM constitute the electricity trading system. These include *inter alia*: the SEM Trading and Settlement Code (TSC), the Northern Ireland Grid Code electricity licences in Northern Ireland, including subsidiary documents which licencees are obliged to comply with.
30. The Utility Regulator has modified electricity licences to require all licensees to become party to and comply with the SEM Trading and Settlement Code, or, in a number of cases, otherwise comply with the rules of the Trading and Settlement Code².
31. Transitional licence obligations on the SONI, the Transmission System Operator in Northern Ireland applying from the SEM Go-Active decision

² Note: Paragraph 7 of the cancellation condition permits the Authority to relieve a licence holder in question from compliance with the any of the rules of the electricity trading system; or make provision that they are to apply to particular licence holders or classes of licence holder differently from the way or ways in which they apply to other licence holders.

required them to develop a modified grid code suited to the prospective requirements of the Licence under SEM. The modified Grid Code was developed by the SO, after extensive industry consultation and detailed scrutiny by us. We have designated 1 November 2007 as the date on which the provisions of the TSC and enduring licence conditions relating to SEM (including the Grid Code as modified) will come into effect. Consequently, SEM is ready for immediate establishment. All licensees will be bound by SEM with effect from Go-Live.

Section 1 C Specific requirements of paragraph 3(A)

Requirement 1: Proper and adequate arrangements for the trading of electricity, the calculation and settlement of payments due for the provision of available generating capacity the delivery or supply of electricity.

Consultation Responses:

AES Kilroot contend that SEM does not constitute proper and adequate arrangements for the calculation of and payment for the provision of available generating capacity because the calculation of the capacity pot lacks transparency and objectivity.

All other respondents agreed that the SEM met the requirement of this clause.

32. The Market Operator Licence (as granted to SONI), the Trading and Settlement Code (TSC) and the Agreed Procedures as established under the TSC are the relevant industry documents governing the operation of SEM which include provisions regarding trading, settlement and capacity payments.

33. The consultation paper examined in some detail the arrangements set out in the TSC³ for the trading of both energy and capacity.

34. In this we described the central role of the Market Operator (MO) who will be responsible for accepting bids from generators, the calculation and

³ The consultation document referred to the Ex-Post Unconstrained Schedule (EPUS), we wish to clarify that this term, which existed in earlier versions of the TSC, was replaced by the term Unconstrained Unit Commitment (UUC).

settlement of all wholesale energy trades and other charges and payments (e.g. in relation to generation capacity) set out in the TSC. In the period since the 6 July consultation paper, the Market Operator has carried out tests and trials of Central Market Systems, which put into effect the Trading and Settlement Code. Following market trials all participants certified readiness to participate in the SEM from Go-Live.

Trading of and Calculation of Payments for energy

35. No respondents argued either that the mechanism for trading energy through the MO, or the calculation of System Marginal Price - based on generators Commercial and Technical Offer Data⁴ submissions - at which Generators and Suppliers trade with each other was not proper or adequate.

36. Having reviewed the provisions of electricity licences applying under SEM and the Trading and Settlement Code we are satisfied that SEM constitutes proper and adequate arrangements for the trading of electricity.

Calculation of payments for capacity

37. The operation of the Capacity Payment Mechanism (CPM) in the SEM for the calculation and settlement of payments due for the provision of available generating capacity, including the various consultations carried out in its development was set out in the 6 July consultation paper.

38. AES Kilroot make a number of points relating to capacity payments which apply both to this requirement and to the requirement that there are

⁴ AES's concerns relating to the rules governing generators Commercial and Technical Offer Data have already been considered above.

adequate incentives for generators to make available sufficient generation capacity to ensure that all reasonable demands for electricity in Northern Ireland are satisfied. AES Kilroot's points are considered individually below.

- *The smoothing of payments across time periods dampens signals for the need for new capacity*

The degree of smoothing reduces the incentive to game capacity payments by withdrawing capacity but retains sufficient volatility to signal the need for availability during periods of system stress.

- *The deduction of the BNE peaker's likely infra marginal rent in the calculation of the capacity of the pot introduces volatility between years*

Deducting infra-marginal rent is appropriate as the BNE as investors take all revenues into account when assessing the rate of return on an investment.

- *The process of calculation of the capacity pot lacks transparency and objectivity.*

We cannot accept AES's contention that the process of calculation of the capacity pot lacks transparency and/or objectivity. The only data used to calculate the total pot for capacity payments which we did not make public was that which we were unable to release for reasons of commercial confidentiality.

39. We set out our consideration of each of these points in more detail in the section below on the requirement that SEM provides sufficient incentives to meet all reasonable demand for electricity in Northern Ireland.

40. Having reviewed the provisions of electricity licences applying under SEM and the Trading and Settlement Code, and having taken into account the response by AES Kilroot, we are satisfied that SEM constitutes proper and adequate arrangements for the calculation and settlement of payments due for the provision of available generating capacity.

Requirement 2: Adequate arrangements for the provision (by relevant generators) of all necessary System Support Services and the proper remuneration of those services.

Consultation Responses:

AES Kilroot hold that this requirement has not been met as the current arrangements in Northern Ireland were “put in place as part of ‘Interim’ Settlement Arrangements”

All other respondents agreed that this requirement had been met

41. While both RAs have accepted the recommendation from the SOs, that it would be preferable to procure System Support Services on an all Island basis, we also accepted their view that the current arrangements were not incompatible either with each other or with SEM. Our belief that the current arrangements are proper and adequate for SEM is covered by decision paper AIP/SEM/160/06.

42. As part of IME (Internal Market in Electricity) directive implementation, OFREG, as the Utility Regulator was then known, and NIE developed, in an objective manner, the current arrangements for the procurement of System Support Services. They ensure that the SONI acquires all necessary system support services and that generators are properly remunerated for the provision of such services. System support services generally do not interact with the energy market – with the exception of operating reserves and reactive power – consequently the status of settlement arrangements is not directly relevant to the procurement of

system support services. In SEM generating units that are dispatched to provide reserve/reactive power (by being either constrained on or constrained down) are compensated for their foregone infra-marginal rent or receive their offer price for energy. This leaves generators financially neutral as to whether they are dispatched to provide these services.

Requirement 3: Based on a system of despatch which is technically viable (and will not prejudice the security and stability of the total system or any part of it).

Consultation Responses:

AES made no comments on whether this requirement had been met.

All other respondents agreed that this requirement had been met.

43. The SEM arrangements include despatch functions which are the responsibility of the System Operator as provided for within the SO licence(s). These were described in the 6 July consultation, including the high level principles of the despatch system. In setting these principles when making the licence modifications we took into consideration the need for the system to be technically viable.

44. Additionally the modified Grid Code developed by the SO, after extensive industry consultation and detailed scrutiny by us, ensures that the scheduling and despatch arrangements in the Grid Code appropriately reflect licence requirements and obligations and will not prejudice the security and stability of the total system or any part of it.

45. Having reviewed both the SO licences applying under SEM and the grid code developed under them, we are satisfied that this requirement has been met.

Requirement 4: Adequate incentives for generators to make available sufficient generation capacity (to ensure that all reasonable demands for electricity in Northern Ireland are satisfied).

Consultation Responses:

AES argue that it is questionable if there are sufficient incentives to make available sufficient generating capacity in aggregate to satisfy all reasonable demands for electricity in Northern Ireland.

All other respondents agreed that this requirement had been met.

46. The SEM has been designed such that payments in the energy market complement explicit payments to generators for making capacity available (through the CPM). Generators are motivated to provide capacity to the market through the opportunity to earn infra-marginal rents as well as eligibility for capacity payments. Periods of highest demand will require the scheduling and dispatch of the plant with the highest marginal costs, increasing the System Marginal Price, benefiting all generators.

47. The Annual Sum (or Capacity Pot) is calculated as the product of two numbers:

- a Price, determined as the fixed costs of a Best New Entrant (BNE) peaking plant; and
- a Volume, determined as the amount of capacity required to just meet an all island Generation Security Standard (GSS) of 8 hours of lost

load per year (equivalent to, or better than, the existing standard in Northern Ireland).

48. AES Kilroot argue that it is questionable if there are sufficient incentives to make available sufficient generating capacity in aggregate to satisfy all reasonable demands for electricity in Northern Ireland. AES Kilroot's points also go to the propriety or adequacy of the calculation of payments for capacity; our reasons for considering that the CPM, in conjunction with payments for energy, sufficiently incentives generators to make capacity available are relevant to our reasons for determining that SEM meets that requirement.

49. Each of AES Kilroot's points are considered below.

- The smoothing of payments across time periods dampens signals for the need for new capacity

In the extensive consultation on the CPM most generators felt that some smoothing was necessary over the course of a month as it reduced the incentive to game capacity payments by withdrawing capacity but retained sufficient volatility to signal the need for availability during periods of system stress.

- The deduction of the Best New Entrant peaker's likely infra marginal rent in the calculation of the capacity of the pot introduces volatility between years.

The deduction of infra-marginal rent is appropriate as the BNE requires a rate of return on its capital costs. The CPM and the energy market have been designed to complement each other in their operation, and a BNE receiving energy payments which exceeded its opportunity cost of

generation would be receiving some of its required return on capital through these energy payments. The remaining revenues required to pay its cost of capital constitute the basis for the calculation of the Capacity pot. Clearly the energy payments and infra-marginal rent which the BNE would recover can vary as generators enter or exit the market. This type of volatility is a natural consideration in any potential investment decision and does not undermine the raison d'être of the CPM.

- The process of calculation of the capacity pot lacks transparency and objectivity.

We cannot accept the contention that the process of calculation of the capacity pot lacks transparency or objectivity. The expected revenues of the BNE from the energy market are based on modelling of the SEM. All of the input data involved in making our estimates were published except commercially confidential data we received relating to variable operating costs. This means that AES along with all other generators had access to technical data relating to competitors' plants and the estimated fuel prices. Clearly were we also to publish all the actual outcomes of our model we would in so doing have also revealed commercially sensitive information.

50. These points were also considered explicitly in the development of the Capacity Payment Mechanism and detailed consideration to the issues raised can be found in the relevant papers⁵.

⁵ see consultation AIP/SEM/124/06 and decision AIP/SEM/07/14 on capital costs of BNE peaker, consultation AIP/SEM/111/06 and decision AIP/SEM/07/13 on the capacity requirement, consultation AIP/SEM/161/06 and decision AIP/SEM/231/06 on Capacity payment factors, Decision AIP/SEM/07/05 on LOLP, decision AIP/SEM/07/54 on ex ante margin.

51. Having reviewed the mechanisms set out in the TSC, and considered the points raised by AES Kilroot in its consultation response, we are satisfied that the SEM ensures that there are adequate incentives for relevant generators to make available such generation capacity as will in aggregate be at least sufficient to ensure that all reasonable demands for electricity in Northern Ireland are satisfied.

Requirement 5 Generators and suppliers are contractually bound by the Northern Ireland Fuel Security Code.

AES made no comments on whether this requirement had been met

All other respondents agreed that this requirement had been met

52. In the 6 July consultation paper the Utility Regulator set out the opinion that the applicable enduring licence conditions in the SEM ensure that all generators and relevant licensed suppliers are contractually bound to comply with the provisions of the Northern Ireland Fuel Security Code or, to the extent superseded by any other code or arrangement, such other code or arrangement.

53. In the interim period the Northern Ireland Grid Code has been amended such that it now requires all suppliers and generators to comply with the grid code. The relevant sections are:

54. For Suppliers

OC 4.5.1 Each Supplier agrees to comply with the Fuel Security Code to the extent it is expressed to apply to it and with any instructions issued by the TSO pursuant to the Fuel Security Code.

For Generators

CC12.1 Each Generator agrees to comply with the Fuel Security Code to the extent that it is expressed to apply to it and with any instructions from the TSO pursuant to the Fuel Security Code, including in relation to CDGUs, with Dispatch Instructions issued by the TSO

55. The Grid Code is a contractually binding document, and this represents additional grounds for concluding generators and suppliers are contractually bound to comply with the provisions of the Northern Ireland Fuel Security Code or, to the extent superseded by any other code or arrangement, such other code or arrangement.

56. Having reviewed the licences applying to generators and suppliers under SEM and the modifications to the Northern Ireland Grid Code, we are satisfied that this requirement has been met.

Requirement 6 PPB is recompensed for the purchase of electricity under legacy GUAs which have not been cancelled.

Consultation Responses:

AES made no comments on whether this requirement had been met

All other respondents agreed that this requirement had been met

57. Annex 3 of NIE Energy's licence covers how PPB is to calculate the element of the PSO due to it. The formula to be used includes provision for the total payments due to generators under the PPAs, and accounts for the revenues which PPB will receive from the Pool (energy and capacity payments) as well as covering operating and capital expenditure necessary for PPB to carry out its function. NIE PLC will include this in the total charge on suppliers for each MWh of energy delivered, and make payments to PPB for their amount due on a monthly basis.
58. As the total difference between payments under the PPAs and receipts from the pool is unpredictable the formula also allows for under or over recovery in any one year to be carried over to the following year.
59. Having reviewed the arrangements for recovery by PPB which are set out in licence conditions we are satisfied that this test is met by reviewing the arrangements for recovery by PPB which are set out in licence conditions.

Requirement 7: Not in its operation, require any generator to breach the Large Combustion Plants (Control of Emissions) Regulations (Northern Ireland) 1991 in relation to emissions.

Consultation Responses:

AES made no comments on whether this requirement had been met

All other respondents agreed that this requirement had been met

60. In the 6 July consultation we explained why we were of opinion that rules relating to technical offer data in the TSC could not be reasonably interpreted as requiring a generator to declare itself available when to do so would cause it to breach its obligations under legislation.

61. We also explained that the Bidding Code of Practice which is a code prepared by the Authority recognises and addresses issues relating to limitation of generation emissions.

62. Having reviewed the relevant arrangements in relation to despatch and submission of data by market participants (contained in the TSC and the Bidding Code of Practice) we are satisfied itself that this test is met.

Requirement 8 Ensure that a generator who is party to a cancellable generating unit agreement is not in a worse financial position in respect of the operation of clause 7.3.2 of the agreement.

Consultation Responses:

AES made no comments on whether this requirement had been met

All other respondents agreed that this requirement had been met

63. Having reviewed the provisions and operation of Clause 7.3.2, we are satisfied that this test is met. This clause provides that where any one GUA is cancelled or expires, the requirements of Clause 5 in respect of all GUAs no longer apply.

64. The Belfast West GUA has already expired and therefore clause 7.3.2 operates such that clause 5 does not apply with regard to any GUA. Consequently the SEM will not change the operation of clause 7.3.2.

Requirement 9 Costs of Land Bank Business are appropriately shared between and borne by suppliers.

Consultation Responses:

AES made no comments on whether this requirement had been met

All other respondents agreed that this requirement had been met

65. The definition of relevant suppliers in the cancellation condition, and referenced in the Consultation Paper includes relevant exempt self suppliers. This category will no longer exist after the introduction of the SEM, and thus only how licensed suppliers bear the cost of the Land Bank Business is relevant to this determination.

66. Having reviewed the legal provisions relating to land bank costs contained in the licence conditions of NIE's Transmission Owner licence, as modified in accordance with our statutory powers to implement the SEM, we are satisfied that the division of land bank costs between suppliers costs being recovered from suppliers via the PSO agreement is appropriate.

Requirement 10: Not in its operation cause the licensee to be unable to finance the carrying on of the activities it is authorised by its licence to carry on.

Consultation Responses:

AES made no comments on whether this requirement had been met

All other respondents agreed that this requirement had been met

67. A vibrant market can be expected to be characterised by efficient entry and exit, as technology changes and new more innovative competitors emerge. How a licensee chooses to carry out the activities for which it is licensed, and how it responds to the challenges of competition to carry them out is a matter potential investors and lenders will assess when considering licensees' business models and make decisions accordingly¹³

68. The key factors affecting whether licensees are able to finance their activities are the impact of the new trading arrangements on the predictability and riskiness of participants revenue flows. These are directly, but differently affected for different types of participants. In exercising our SEM functions, for example making licence modifications, designating documents etc., we already considered our obligations under Article 9(2)(b) of the SEM Order to secure that authorised persons are able to finance their activities.

¹³ Businesses where a licensee's operations are subject to approval by the Regulatory Authorities or where it is subject to a price control will due to a monopoly or effective monopoly position will

69. Having reviewed the provisions of the Trading and Settlement Code, and the costs imposed on licencees by other elements of the electricity trading system such as Market Operator charges or other services governed by price controls which will apply in the SEM we are of the opinion that the operation of SEM will not require participants to take on unwarranted risk, or create cash flow difficulties and we are satisfied that the SEM will not, in its operation, cause licencees to be unable to finance the carrying on of the activities which they are authorised by their licence to carry on

Section 1 D Requirement of Paragraph 3 (B)

Each generator that has applied for a supply licence which is have effect from the date of its GUA being cancelled shall, subject to certain criteria being met, have been granted a supply licence.

Each such generator that has accordingly applied for a supply licence has been granted a supply licence

SECTION 2 Procedural requirements

Have the procedural requirements of the cancellation condition and the requirements of public law been followed, allowing us to make a determination that SEM constitutes requisite arrangements.

Consultation Responses:

AES Kilroot responded that the 6 July consultation and the consultation process followed in the development of SEM did not meet the requirements of Paragraph 6 of the cancellation condition or our public law obligations.

1. The 6 July consultation paper was issued as as part of our preparations for determining whether the Single Electricity Market (SEM) constitutes requisite arrangements for the purposes of the cancellation condition. This consultation paper made clear that it was additional to, and built upon, those consultations previously undertaken for the purposes of developing SEM and which gave interested parties⁶ the opportunity to make

⁶ The Department and the Consumer Council as well as licensees are specifically mentioned as persons with whom we are to consult in developing the requisite arrangements. We have worked closely with the Department at all stages in the development of SEM. In addition to the wider SEM consultation process the Utility Regulator held several meetings with the Consumer Council to discuss the development of SEM.

representations in relation to SEM at each key stage. The 6 July consultation paper examined decisions made earlier in the development of SEM specifically in the context of the requirements of the cancellation condition.

2. Our determination that the SEM constitutes requisite arrangements takes fully into account our earlier decisions in relation to the design and legal framework of SEM, each of which was calculated to achieve our principal objective of protecting consumers by means of promoting effective competition. By complying in this way with our SEM-related duties, we believe that we have established a market that is consistent with and capable of meeting the requirements of paragraphs 2 and 3 of the cancellation condition.

3. The consultation process involved in developing SEM allowed interested parties the opportunity to comment on whether we were successful in achieving our aims. Taken together, the consultations relating to SEM on the All Island Project website and/or NIAUR's website show that by just prior to Go-Live each of
 - (i) the relevant steps
 - (ii) the relevant documentation and, to the extent relevant,
 - (iii) the relevant obligations

which we believe are required to be taken, entered into, imposed or assumed in order to satisfy paragraph 3 of the cancellation condition (i.e. in order to create and implement the requisite arrangements or SEM), have been consulted upon. These consultations gave interested parties the opportunity to make submissions in relation to the development of SEM and the obligations which would fall on market participants as a

result, such that each person had ample opportunity to make representations on whatever aspects of the relevant steps, documentation and/or obligations they so wished. The Regulatory Authorities published their conclusions (and reasons for those conclusions) on the issues which they consulted upon.

4. AES Kilroot's response to the 6 July consultation paper makes four main points.

(1) The 6 July consultation was premature, and a determination would also be premature. A judgment as to whether SEM constitutes requisite arrangements can only be made after Go-Live when there is empirical evidence of the operation of the new market.

5. The view that the 6 July consultation was premature is inconsistent with the terms of the relevant licence condition. Under the cancellation condition, the requisite arrangements must be 'available for immediate establishment'. It is therefore clear that the licence requires the assessment of those arrangements to be carried out before they have been implemented. Further, the cancellation condition requires the Authority to follow 'the procedural requirements' of paragraph 6, the wording of which, in so far as it is relevant, makes clear that we must carry out a consultation before the requisite arrangements have been implemented.
6. In consequence, a determination made now is not premature, but is consistent with licence requirements.

(2) The consultation was seriously flawed. Its conclusion seemed predetermined, and it failed to set out either the rationale of the Authority for its views or any adequate evidence to support those views.

7. Paragraph 6 of the cancellation condition requires consultation about the legal instruments necessary to give effect to requisite arrangements – in this instance SEM – and it requires this consultation to be carried out during the period when those documents are being developed. In line with this requirement, there has been a long period of consultation in relation to the policy and legal aspects of SEM. This included (among others) consultations on the Trading and Settlement Code, the licence conditions, the new market operator licence and a range of trading and bidding rules in the new market. Therefore, the quality of our consultation cannot be measured solely by reference to the 6 July 2007 consultation paper.
8. AES Kilroot makes a number of specific points in relation to the consultation:

(a) *The 6 July consultation was commenced at the last minute and without warning*

The 6 July consultation paper is a concluding overview, surveying the SEM arrangements and asking if they are requisite arrangements as required by the licence condition. As such, this consultation could take place only once the SEM arrangements were fully defined and could not have occurred earlier.

Further, and as set out above, interested parties have had many opportunities to make representations about SEM.

(b) *Its previous submissions have not fully been taken into account*

In developing SEM the Utility Regulator (in conjunction with CER) took into account all submissions received in response to its consultations, including confidential responses. Detailed consideration of the submissions received can be found in second consultation papers or the decision documents.

(c) *The consultation timetable was short*

As set out above, the wider consultation on SEM took place over a long period. And the individual consultation for the purposes of the cancellation condition allowed twelve weeks, in line with Cabinet Office guidance. The post-consultation six week period for the Authority to consider responses received is lengthy by the standards of many consultations and reflects the detailed consideration given to those responses.

(d) *The consultation had a predetermined outcome*

The 6 July consultation paper sums up work carried out over a period of time in developing SEM. In these circumstances, our consultation indicated that we were minded to make a determination that SEM constituted requisite arrangements. However, in carrying out this consultation, we have been open, and given proper regard, to any representations that express the contrary view.

(e) *We do not give adequate reasons for our conclusions*

This point is addressed below in the context of AES Kilroot's submissions on the basis for concluding that SEM will increase competition and benefit consumers.

(3) The Authority has no reasonable basis for concluding that SEM will increase competition in generation in Northern Ireland. It would therefore be irrational for it to decide that competition will be increased.

9. As set out above, the Authority has already consulted on all legal aspects of the SEM, and put in place all the key aspects of the legal framework. Indeed, most have been in place since Go-Active. When it decided to give effect to the relevant legal changes – such as new licence conditions or the designation of the Trading and Settlement Code – the Authority did so in line with its duties in Article 9 of the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007. These require us –

“...to protect the interest of consumers of electricity in Northern Ireland and Ireland supplied by authorised persons, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the sale or purchase of electricity through the SEM.”

10. In the light of these legal duties, the legal framework that was put in place for the purpose of SEM implementation was based on the conclusion that each of the elements of that framework promoted effective competition and by that means protected consumers, and the 6 July consultation paper builds upon these earlier decisions. The SEM arrangements promote – and thus by definition must facilitate an increase in – competition.

11. The Authority therefore has a firm basis for concluding that SEM will increase competition in Northern Ireland. This is addressed more fully in Section 1A above, in particular at paragraphs 9 to 22.

(4) The Authority has not even addressed its mind to the question of whether SEM will benefit consumers in Northern Ireland. It would therefore be irrational for it to decide that consumers would benefit.

12. This submission does not take into account the lengthy consultation process by means of which we sought to design a legal framework within which consumers would benefit from the SEM. Further, it has no regard to the fact that all of the Authority's previous decisions in relation to that legal framework were based on the duty to protect the interests of consumers. These matters have been foremost in the mind of the Authority over a long period of time.

ANNEX A :

Text of the determination made by the Board of the Northern Ireland Authority for Utility Regulation on 15 October 2007

The Authority, having:

(A) reviewed and considered each of the requirements of the condition titled "Modification of Supply Competition Code and cancellation of contracts" as may be included in any electricity licence (the **cancellation condition**), and

(B) evaluated the electricity trading arrangements which are to be implemented (in whole or in part) under or by virtue of the powers contained in the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 (the **SEM**) against these requirements,

hereby determines, pursuant to paragraph 1 of the cancellation condition in each electricity licence in which it is included, as follows –

- (1) The arrangements which take the form of the SEM are the development of requisite arrangements in accordance with paragraph 2 of the cancellation condition.
- (2) The arrangements which take the form of the SEM satisfy each of the requirements of paragraph 3 of the cancellation condition.
- (3) The decision referred to in paragraph (2) above is subject to the Authority ratifying the decision (Decision A) made by it at its 3 October meeting to designate 00.00 hours on the 1 November 2007 as the SEM Go-Live date and time.

On 23 October 2007 the decision to designate 00.00 hours on the 1 November 2007 as the SEM Go-Live date and time was ratified by the Northern Ireland Authority for Utility Regulation, bringing the determination above into effect.