Consultation on Relevant Considerations in relation to the possible Cancellation of Generating Unit Agreements in Northern Ireland

SONI Response

8th April 2011

SONI welcomes the Northern Ireland Authority for Utility Regulation's ("the Authority") consultation paper on Relevant Considerations in relation to the possible Cancellation of Generating Unit Agreements (GUAs) in Northern Ireland.

SONI is the licensed Transmission System Operator and Market Operator in Northern Ireland[1] and is also part of the wider EirGrid group.

This response has been prepared by SONI on behalf of, and in consultation with, other parts of the EirGrid group. The response makes a number of general observations before addressing the specific views requested and builds on our previous consultation responses in relation to this matter.

GENERAL COMMENTS

Any early cancellation of the GUAs will again require fundamental commercial considerations. SONI fully support the proposed economic analysis, and in particular the likely effect on the PSO charges. However it must be recognised that the appraisal may not capture all of the wider effects and should therefore inform rather than dictate the ultimate decision. It is difficult to incorporate the dynamic nature of the market and how units would respond to being out of contract. SONI would urge the Authority to consider these wider effects when making their decision.

Without prejudice to the results of the analysis our view is that there may be some other benefits in the early cancellation of the GUAs entered into with NIE Energy Power Procurement Business ("PPB"). These benefits would, of course, need to be balanced and evaluated considering any risks or costs associated with early termination.

The benefits would include:-

- Increased transparency, liquidity and competitiveness of the Single Electricity Market ("SEM") as a result of generators operating directly in the market. Cancellation on the Earliest Cancellation Date re-affirms the RAs commitment to the SEM as a gross mandatory pool through which all large generators must physically trade.

- Removal of legacy contractual arrangements and the overhead in their administration and interfacing. For example, the NI Grid Code and the complexities around the provision of Ancillary Services to SONI through PPB as an Intermediary.

- Increased flexibility with the introduction and consistent application of any amended arrangements which would support the SEM and ultimately assist the Authority and the SEM Committee (SEMC) in carrying out their primary duties.

[1] Trading as SEMO under a joint venture with EirGrid.

- Transparency and consistency in how SONI deal with generators and suppliers. The confidential nature of the current arrangements under the GUAs, do not permit the desired level of transparency.

RESPONSE TO VIEWS REQUESTED

The Authority will follow the same process as followed for previous consultations.

SONI broadly support the same process and the basis for the economic analysis as set out in the consultation paper. The modelling should be carried out over the full period from the Earliest Cancellation Date (ECD) to the Contract Expiry Date (CED) to enable the full costs/benefits to be evaluated. The dynamic nature of the market and the wider effect of how units would respond to being out of contract should also be taken into consideration in the modelling.

The total cost of financing the PPB business also needs to be considered as a factor in the overall decision. In addition, as PPB represents a portfolio of generation, there are overheads which should be considered in dealing with an Intermediary in the SEM, with the Authority, and SONI (through the Power Procurement SONI Interface Agreement, PSIA).

How the Authority should take account of the proposed carbon price support mechanism within its analysis.

The offer prices to SEM reflect the variable cost of carbon regardless of the support mechanism in place. If the GUAs were cancelled then the liability for these carbon costs would lie with the generating companies (as with all other generators in the SEM). This would also extend to costs associated with the carbon support mechanism as set out in the recent UK budget, be they through the Climate Change Levy for coal or gas or through a reduction in fuel duties relief for oil products.

As these costs are proportional to the output of the generator unit i.e. they are variable costs, it would seem appropriate to consider these costs in the same manner as the carbon costs were in the previous appraisal on the early cancellation of GUAs.

It should be highlighted that the variable cost of carbon (including any additional costs arising from the new carbon support mechanism) should be considered separately to the issue of 'grandfathered' free carbon allowances.

As the free carbon allowances that legally transferred to PPB conclude in December 2012, the net benefit passed to consumers also ends. So whilst there is a net benefit enjoyed at the moment, this benefit disappears in December 2012.

Additionally, if it is deemed economically viable to cancel some or all of the GUAs early, then there may be additional benefits in aligning the ECD with the expiration of the free carbon allowances to maximise their benefit to NI consumers.

The Policy Considerations which will be taken account of

1. Competition and Liquidity

Promoting more effective competition is a principle objective of both the Authority and the SEM Committee. The cancellation of the GUAs would lead to a more effective market as the physical generators must trade directly with the SEM. This increases transparency and moves the commercial risk associated with participation in the SEM to the owners of the physical generation–those best placed to invest in better performance and more efficient operations.

An integral part of the development of the SEM has been the implementation of a market power mitigation strategy to ensure that the benefits associated with the SEM are not undermined by the abuse of market power. Part of that strategy was to introduce a suite of Directed Contracts (“DCs”), the purpose of which was to remove the incentives on PPB and ESB Power Generation (“ESB PG”) to attempt to profit from the use of market power. The PPB have been obliged to sell Directed Contracts as their market concentration was above what would deemed to be competitive. This concentration, while being significantly lower than that of ESBPG, is a direct consequence of the GUAs.

This concentration has been reduced by the cancellation of the GUAs associated with K1 and K2. However, as the generator units party to the GUAs are now under ownership of a single company, cancelling some or all of the GUAs will increase market concentration in the SEM to the level that PPB originally had prior to the cancellation of GUAs for K1 and K2. These new circumstances place a significant degree of local market power in the hands of AES and it may be appropriate to encourage them to offer sufficient CfDs to the SEM to ensure that a) their market power is reduced and b) to provide Suppliers with an opportunity to manage their pool risk.

On the other hand, cancellation will decrease or eliminate monitoring of the ring-fenced arrangements between PPB and their affiliated generation company.

2. **Security and diversity of supply**

From a security of supply point of view, there are no identifiable transitional or longer term issues regarding early GUA cancellation. (SONI have already seamlessly facilitated the cancellation of two GUAs in respect of Ballylumford ‘B’ station and two in respect of Kilroot units 1 and 2). However, the plant covered by the GUAs is essential for the secure operation of the all-island system and cancellation of the GUAs must not adversely impact plant availability. It is therefore important that the economic analysis should inform any potential financial risk that could be passed to the generating companies that may adversely affect their ability to stay in the SEM.

Although there are now Harmonised Ancillary services arrangements in place, it is currently unclear how the generation companies in Northern Ireland are reconciled for the provision of ancillary services from PPB through the GUAs. It is desirable to have the flexibility to enable such policy instruments to act without recourse to the GUAs.

3. Environmental Sustainability

To the extent that early cancellation of the GUAs would lead to further SEM transparency this may in turn encourage more renewable generation and/ or lower carbon emitting generation to enter the SEM with consequential environmental benefits.

Furthermore, exposing the owners of the physical plant to the cost of carbon places the commercial risks with those who are best placed to mitigate it. This could manifest itself through investment in cleaner technology, co-firing and other innovative measures that would increase the competitiveness of the generator units through a reduction in its carbon intensity.