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19 September 2008

Dear Elena,

DEVELOPMENT OF OUR 5 YEAR CORPORATE STRATEGY – CONSULTATION ON KEY ISSUES

Thank you for the opportunity to comment upon NIAUR's strategy.

Set against the context of volatile wholesale energy markets and its impact for customers, the need for urgent action to mitigate climate change and the inevitable security of supply concern to 'keep the lights on', the next five years will present significant challenges for NIAUR, Northern Ireland and its citizens. These are, and will continue to be, unprecedented times; the present global credit crisis will inevitably place a serious strain on investment decision making.

Given this context, NIAUR's first five year corporate strategy is very timely. The best regulatory response to the unprecedented changes in the energy sector is to ensure a stable and transparent regulatory environment where decisions are made on a rational economic basis.

With the above in mind, we suggest there are three prime objectives that should underpin NIAUR's strategy:

1. Improving Northern Ireland's international competitiveness, by reducing and removing barriers to energy markets.
2. Reducing regulatory risk to attract new investment
3. Enhancing regulatory process to improve transparency and accountability.

Our responses to each of the consultation questions are set out within the attached annex. In summary, the main points we make are as follows:

- **Strategic network planning:** create and implement a strategic network plan, integrated with the Eirgrid Grid Development Strategy (GDS) in the RoI, to connect new generation capacity, especially renewable capacity, to load centres. This is particularly important in the light of UK Government renewable energy targets and it is important that Northern Ireland achieves its share of national targets. Given the small size and rural nature of the network this presents significant challenges. However Northern Ireland has a strong wind resource and access of wind to the grid on economic terms is critical to being able to maximise our contribution to UK targets.
- **Delivering effective competition:** reducing market and industry barriers, including reducing market power and dominance, minimising the electricity and gas price controls in the short term (e.g. removal of 'K' factors), ultimately culminating in their full removal of price controls over the next two/three years.
- **All-island market:** maximising the benefits for Northern Ireland consumers by delivering more efficient all-island gas network tariffs through CAG, and enhancing the transparency and efficiency of the SEM committee.
- **Stable Investment signals:** The cost of future strategic investment in new generation technologies will be lowered if clear stable signals can be given to investors. An example would be a more stable capacity mechanism in the SEM.
- **Regulatory and market transparency:** this is of increasing concern and requires relatively simple action to ensure the market has access to data and information. It also requires timely, easy to access, comprehensive, and well thought out market communication systems. An SEM appeals mechanism would increase accountability and provide a more secure basis for investor confidence. An enhancement of the market monitoring process would also be welcome (see appendix for suggestions).

Please do not hesitate to contact us if we can elaborate further on any of the points we make.

Yours sincerely



Garrett Blaney
Head of Regulation

ANNEX

Response to Consultation Questions

1. We would welcome views as to whether there are other significant challenges which we ought to have reflected here.

RESPONSE: *we do not underestimate the challenges covering: sustainability, environmental, social policy, security of supply, and the challenges associated with the “small scale of the Northern Ireland Market”. We would also add the following:*

- *The challenge in supporting the overall UK energy policy objectives. For example, it is clear from a reading of the BERR’s June 2008 consultation on the UK Renewable Energy Strategy, that Northern Ireland is expected to play its part in helping ‘UK plc’ achieve its overall EU energy policy obligations.*
- *Enhancing the SEM market monitoring processes, especially given the early bidding teething problems (see appendix). We should not underestimate the effort that will be required to ensure good governance.*
- *Improving the transparency and timeliness of SEMC decisions.*
- *Meeting European policy objectives, especially the 3rd liberalisation package, although we note this is picked up later in the consultation.*
- *Improving overall market and regulatory transparency.*

2. We would welcome views as to whether there are other significant opportunities which we ought to have reflected here.

RESPONSE: *we wholeheartedly agree with the identified opportunities, noting in particular the economies of scale that can be achieved on an all-island basis, and the preparations necessary to ensure that Northern Ireland is thus able to engage within the wider European market context in the years ahead.*

We also agree that, given NIAUR’s limited resources and subject to our point on adequacy, it is critical it makes best use of these resources through its research and investigation into best market practices across other jurisdictions. Smart metering is an excellent example whereby, a number of other markets including Ireland, already have, or are already embarking upon smart metering technology trials and customer research. It would not make sense for NIAUR to duplicate this work and so tie up its precious resources. It would be better to continue building on its collaborative regulatory

approach, and to learn from the experiences of others, and how these might be tailored for the Northern Ireland market.

3. We would welcome views as to whether there are additional significant “context” issues which we ought to have reflected in this chapter but have omitted.

RESPONSE: *the contextual backdrop has been well covered, with the possible exception of the role that Northern Ireland is expected to play in helping ‘UK plc’ in meeting the overarching UK energy policy objectives, e.g. renewables.*

4. We would welcome views as to whether there are significant issues within the context issues already identified we should have noted.

RESPONSE: *these have been well captured, albeit we would also add market and regulatory transparency as key issues moving forward.*

5. We would welcome views as to whether there are other significant “wholesale” issues which we ought to have reflected here.

RESPONSE: *these have been captured, and we look forward to improvements under SEM, particularly strengthening its governance via an effective Appeals mechanism.*

6. We would welcome views as to whether there are significant network issues which we ought to have reflected here.

RESPONSE: *these are well covered. However, we would like greater emphasis on maximising NIAUR’s wider all-island “network” brief. This will be important if Northern Ireland is to improve its security of supply exposure. Factors to consider include:*

- *Whether further mutualisation works against its longer term interests for consumers by effectively ‘locking out’ further integration with other markets, and could act as a barrier to efficient grid development.*
- *Effective network planning, securing a robust, efficient and transparent strategic network plan that maximises the all-island security of supply objective, particular with regard to the all-island grid study and the need to secure new generation connections.*
- *Resolving cross jurisdictional issues, to maximise benefits evolving from the Common Arrangements for Gas (CAG), especially with regards to transmission tariffs.*

7. We would welcome views as to whether there are other significant “retail” issues which we ought to have reflected here.

RESPONSE: *please refer to our previous responses following NIAUR’s consultation on gas and electricity retail market issues (response 15 July 2008).*

We also note NIAUR’s reference that, “..our preferred policy position in this may not take us towards a model that mirrors the utility markets in GB (for example in terms of high churn rates)..”

We are puzzled by this statement. In principle, we probably agree that alignment with GB is not necessarily a good thing (albeit there are some best practices worthy of investigation). However, the logical extension to market structures that do not, at the very least, facilitate high churn rates, is to suggest that customers will ultimately be denied choice, particularly within the wider all-island market context. We would appreciate further clarification on this point.

8. The Utility Regulator has limited resources, both as a whole and also within each operational Directorate, to deliver priorities in the coming 5 year period. We would welcome early views from respondents on the urgency, importance and thus prioritisation of strategic goals and work priorities.

RESPONSE: *compromising on any of the significant energy policy objectives could have serious consequences in the years ahead. This is not about fitting the strategy to the available resources, but about determining the ‘right’ strategy and ‘right’ priorities, and then assessing whether NIAUR has the resources and the means to deliver against it. For example, is it better to focus on price regulation to minimise pricing effects on customers, or developing incentives that secure much greater investment, to help deliver against security of supply objectives. That said, we highlight the following strategic imperatives:*

- **Strategic network planning:** create and implement a strategic network plan, integrated with the Eirgrid Grid Development Strategy (GDS) in the RoI, to connect new generation capacity, especially renewable capacity, to load centres. This is particularly important in the light of UK Government renewable energy targets and it is important that Northern Ireland achieves its share of national targets. Given the small size and rural nature of the network this presents significant challenges. However Northern Ireland has a strong wind resource and access of wind to the grid on economic terms is critical to being able to maximise our contribution to UK targets.
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controls in the short term (e.g. removal of 'K' factors), ultimately culminating in their full removal of price controls over the next two/three years.

- **All-island market:** maximising the benefits for Northern Ireland consumers by delivering more efficient all-island gas network tariffs through CAG, and enhancing the transparency and efficiency of the SEM committee.
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Appendix

NIAUR Implementation of Market Monitoring Function - Suggestions

Suggested Market Monitoring Competencies

VPE has taken a neutral position on whether the market monitor function is best performed by the independent system operator as is the standard in the US, or whether a dedicated regulatory function can more adequately deliver this function as decided by the RAs as part of the SEM design. We can see merit in the debate from both sides but recognise that the quality of the staff and systems engaged in delivering the market monitoring function is probably the single largest factor in determining how efficiently the function performs.

However, given the potentially critical nature of the market monitor function, it is important that the role carried out by the individuals appointed are dedicated to monitoring the market and is not used as an additional resource within either the RAs or the system operator to perform non-market monitor roles.

The high degree of market concentration with state owned companies in the SEM significantly complicates the task of a market monitor in the SEM. The licence condition to bid Short Run Marginal Cost (SRMC) however, while it can be viewed as limiting the competitive dynamic in the market, makes the task of a market monitor much easier. The primary role of the market monitor in the SEM is thus not to analyse the competitive dynamic in the market, simply to assess whether the generator is complying with their licence requirements to bid SRMC.

VPE suggest that there are a number of key areas of competency that would significantly enhance the delivery of a market monitoring function, including:

- An understanding of generation technology types and the challenge of mapping the technology characteristics to Commercial and Technical Offers (CO and TO). This understanding should extend into the operation and maintenance principles of different power generation technologies and the influence of maintenance activities on CO and TO.
- A commercial appreciation of fuel markets and fuel delivery processes and how these commodities are priced in the short-term and how long term contracts can be renegotiated to the benefit of fuel suppliers and fuel offtakers, without affecting SRMC.
- An appreciation of emission limitations to fossil fuel fired generators and how emission limits can restrict the operating flexibility of generators.
- A comprehensive understanding of grid dispatch processes and particularly the unit commitment decision making of the market (MSP) and the system operator (SCUC). The restrictions of grid system operation and the importance of ancillary services would also be useful. The influence of pumped storage and interconnection on the all-island market is particularly important.

- The effect of renewable generators, particularly wind, on the demand profile and contingent dispatch in the market.

Because of the restrictive nature of the latitude that is afforded to generators because of the BCOP, the following normal market monitor skills are not needed:

- Game theory and the competitive dynamic in a competitive market
- The influence of market power on market bids
- The interaction of start-up costs and running costs (in the SEM market these are based on costs and should not be as a result of competitive dynamic or dispatch considerations).

Suggested Market Monitor Outputs

The expected outputs of the MM would be significantly enhanced if they clearly defined and adhered to.

Reporting:

- To achieve a goal of a market that is 'self policed', transparency is key. The market monitor function should publish weekly reports on participant bidding behaviours benchmarked against the MM view of SRMC.
- Explanatory notes of departure of behaviour from SRMC should be included in the report.

Response:

- Complaints should be acted upon quickly. Given the potential financial consequence of market abuse, the resolution time from initial complaint to publication of MM findings should be no more than 1 month.
- A defined resolution timetable is needed to set expectations of both the MM and the participants under investigation.
- Following a determination by the RAs, participants should be monitored closely. If no change to the behaviour is evident within 1 week, the participant should be subject to action by the MM. The methodology used to produce these bids should be based on a process such as that employed by KEMA and NERA in their analysis of SEM market data.