

**REGISTERED MAIL**

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cc. 1. The Single Electricity Market Committee;  
2. Office of Gas and Electricity Markets

17 December 2014

Dear Garrett and Jenny,

**Re.: Proposed Modifications to the Trading and Settlement Code: Mod 09 14 and  
Mod 10 14 (Make Whole Payments)**

We are writing to you in connection with the abovementioned proposed modifications to the Single Electricity Market Trading and Settlement Code (the "**TSC**"), which have been raised jointly by the Commission for Energy Regulation and the Utility Regulator (together the "**Regulatory Authorities**" or "**RAs**"). While these proposed Modifications (the "**Proposed Modifications**") are still under consideration by the Code Modification Committee, we feel the need to write to you now to urge you to withdraw the Proposed Modifications as a matter of urgency.

The Proposed Modifications concern altering the pricing structure (for interconnector users only) in the Single Electricity Market to discourage exports of power into the neighbouring market, Great Britain.

Electroroute Energy Trading Limited ("**ElectroRoute**") is one of the largest exporters of power from the island of Ireland into Great Britain and would be directly affected by the Proposed Modifications should they be adopted. We are concerned that:

1. the Proposed Modifications will have the effect of severely discouraging interconnector flows in the direction SEM-to-Great Britain, at a time when (i) Ireland has identified exports of renewable energy as a national priority<sup>1</sup> and (ii) there is an acknowledged capacity shortage in Great Britain<sup>2</sup>;

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<sup>1</sup> See for example the Memorandum of Understanding between the governments of Ireland and the United Kingdom signed on 24 January 2013, available here: <http://www.dcenr.gov.ie/Press+Releases/2013/Irish+and+UK+Energy+MOU.htm>

<sup>2</sup> See <http://www2.nationalgrid.com/mediacentral/uk-press-releases/2014/national-grid-tenders-for-balancing-reserve-services-to-meet-market-changes/>

2. the Proposed Modifications appear to discriminate directly against one class of market participant (namely interconnector users), and have been raised without sufficient regard for the impact this will have on the forward positions that market participants have already taken, including interconnector capacity holdings and Levy Exemption Certificate transactions;
3. the Proposed Modifications will have the effect of eroding the integration of national markets which the internal market in electricity requires, whilst at the same time imposing a quantitative restriction upon exports from the island of Ireland, in direct contravention of Article 35 of the TFEU; and
4. the Regulatory Authorities may not have considered the regulatory aspects of the Proposed Modifications on the other end of the interconnector cables. It is not clear to us that the Proposed Modifications would not invalidate or jeopardise various exemptions and approvals which the interconnector operators have previously obtained from the regulator in Great Britain.

While we understand, and are supportive of, the motivation behind the Proposed Modifications, Mod\_09\_14 and Mod\_10\_14 have been drafted with little apparent consideration of their consequences or even their lawfulness. This not only amounts to a serious procedural deficiency, but also raises substantive issues given that even the most cursory consideration of the proposed Modifications raises serious questions in this regard. The fact that the Regulatory Authorities proposed two alternative Modifications rather than forming a considered view as to the appropriate course of action is indicative of the lack of consideration that this appears to have been given.

Further to our presentation on 4 December 2014 which we have previously provided to you and other market participants, we set out in this letter a more detailed description of the issues raised by the Proposed Modifications.

This letter has been copied to the Office of Gas and Electricity Markets in light of the cross-border aspects of the Proposed Modifications.

### **Motivation for modifications**

It may be convenient to recall first the issues that the Proposed Modifications, as we understand them, seek to address.

According to the Modification Proposal Form, the purpose of Proposed Mod\_09\_14 is to “*amend the Code so that Interconnector Users receive Make Whole Payments based on their aggregate position across all gate windows (EA1, EA2 & WD1) in which they have traded...*”. This is justified by the need to avoid those situations where an Interconnector User with a net flow of 0 MW receives a Make Whole Payment (“**MWP**”) depending on the gates that it has used, and how it has used them, in circumstances where this has resulted in a significant increase in MWP. The Modification Proposal Form also records that the Regulatory Authorities do not believe that “*the current situation in the Code is a necessary pre-requisite for efficient trading between SEM and BETTA and therefore does not believe that [Mod\_09\_14] will distort efficient cross border trade*”.

Under the second Regulatory Authorities’ proposal, Proposed Mod\_10\_14, no participant would be allowed to receive MWP in respect of their Interconnector Units. This proposal is made “*as an alternative to [Mod\_09\_14]*” in the context of a “*potential concern around the effectiveness*” of the latter. In other words, the purpose of the second proposal is to make sure that current levels of MWPs to interconnector units should not be allowed to continue and need to be stopped in any event if netting a participant’s trades across the interconnector does not suffice to reduce MWPs.

ElectroRoute agrees that the fact that MWPs may be made to a participant which has overall taken no position on the interconnector (taking into account all gates in the relevant period) is an anomaly in the TSC that should be addressed. Simultaneous exports and imports by a single participant should not place a cost on the MWP mechanism.

ElectroRoute would be happy to support and work with the Regulatory Authorities in developing an appropriate Modification to the TSC to resolve this issue. Indeed, ElectroRoute has recently proposed two separate Modifications to seek to address this issue, although having since obtained legal advice in relation to the proposed Modifications, we are concerned that further analysis may be required to confirm that they do not also fall foul of the legal issues outlined below.

ElectroRoute believes that the proposed Modifications should be immediately withdrawn for policy, procedural and legal reasons. These include:

## **1. Policy Considerations**

ElectroRoute fundamentally disagrees with the Regulatory Authorities' suggestion that any increase in MWPs to interconnector units is necessarily inappropriate and should be done away with. MWPs are a fundamental part of the design of the SEM and are critical to enable market participants to manage their exposure between the Trading Day and subsequent settlement periods in which market prices may have moved dramatically.

While we acknowledge that the extent of MWPs to interconnector units is in part due to the netted volume anomaly in the TSC and we agree that this should be addressed, the recent increase in MWPs to interconnector units is primarily due to the increase in exports over the interconnector. It is a direct effect of the pricing mechanism in the SEM, in particular the disjoint between pricing and scheduling in the SEM, and the relationship between the SEM and BETTA, in the context of an increase in export. It is not possible to just do away with increases of MWPs which found their reasons in the workings of the SEM without altering the latter's fundamental cost recovery and pricing principles.

As the Regulatory Authorities know well, the interconnector units, in order to allow exports to take place, have their volumes fixed in the ex-ante timeframe and they agree export dispatches on the basis of the shadow price: yet the SEM works in such a way that there may be a significant disjoint between the shadow price and the SMP. In the light of the SEM pricing mechanism, the SMP tends to spike much more severely upwards than downwards in a manner that is impossible to predict and unless interconnector units are protected appropriately against this significant commercial risk, export trade will be severely restricted. During 2012 and 2014 the mean absolute value of the half hourly SMP price changes between EA1 (where most volumes are dispatched) and EP2 (where volumes are priced) was €15.50/MWh (between January 2013 and October 2014): a near unprecedented systematic pricing risk in the electricity sector which biases volumes away from export trading. MWPs correct any overcharge arising from the SEM pricing mechanism and they are accordingly a fundamental aspect of cross-border trading.

Promotion of cross border trade is at the heart of the internal market in electricity. Promotion of exports reduced constraints and curtailment in the SEM, benefits consumers, facilitates development of renewables, contributes to the costs of interconnector owners thereby reducing the burden on electricity consumers and brings potentially hundreds of millions of revenues and associated taxation into Ireland. It is likely that the negative implications of abolishing MWPs for interconnector units will far outweigh any benefits. Implementing a measure which will impede or

eliminate private sector trade in electricity to BETTA is inconsistent with the most fundamental policy objectives of the SEM.

## **2. Procedural Considerations**

As is noted above, no adequate analysis has been done of the proposed Modifications. The minutes of the Code Modification Committee indicate that an Impact Assessment has been made in respect of the proposed Modifications, but a review of Code Modification Committee minutes reveals that the only assessment that has been made is of the systems cost implications of implementing the Modifications. No analysis has been undertaken of the impact on exports, constraints, curtailment, interconnector capacity revenues, electricity revenues and/or taxation. It is impossible to assess whether or not the proposed Modifications can be justified in the absence of this analysis.

## **3. Legal Considerations**

There are a number of reasons why it is unlawful to implement the Modifications. At the outset, the Regulatory Authorities have not made clear pursuant to what power or duty they have proposed the Modifications. One infers from the drafting of the proposed Modifications that the rationale is to reduce costs for consumers, however the absence of any or any adequate Impact Assessment means that any suggestion that consumers are benefitted by the proposed Modifications is at best speculation and at worst ultra vires the Regulatory Authorities.

Secondly, the proposed Modifications are overtly and unduly discriminatory. The proposed Modifications do not purport to eliminate MWPs for any group of market participants other than interconnector users. All participants in the SEM are rightly protected against losses arising from the workings of the SEM by a number of mechanisms including constraint payments and MWPs. If this were not the case, participation would be severely restricted. This is particularly obvious in the case of demand side units which rely on MWPs in precisely the same manner as exporting interconnector units, however there is no proposal to remove MWPs in respect of demand side units or justification for treating such units differently. This alone renders the proposed Modification unlawful. Furthermore, other generator units are kept whole between costs incurred within day and SMP through constraint payments. There is no reasonable basis for eliminating any market mechanism which hedges variations between shadow prices and SMP, let alone eliminating it in respect of one class of participants only.

Finally, any Modification cannot have, as its effect or indeed object, restrictions of export trade over the interconnector. Removing MWPs will have a chilling effect upon export trades because it will remove the sole pricing certainty mechanism available to traders. Removing such a protection in respect of interconnector units will severely restrict exports. As such it is impermissible because it discriminates against interconnector units, contrary to statutory requirements, and because it severely restricts exports, contrary the objective of market opening embedded in the Third Energy package and the Treaty on the Functioning of the European Union ("TFEU"). In particular, we are advised by our legal advisers that such a measure would fall squarely within the realm of State measures prohibited under Article 35 TFEU as having an effect equivalent to a quantitative restriction on exports.

For these reasons, Mod\_10\_14 is clearly inappropriate and unlawful. While Mod\_09\_14 seeks simply to address the netted volume anomaly in the TSC and make sure that MWPs for interconnector units are calculated on the netted volumes of a participant's trade over all gates, in practice it will have the same effect as Mod\_10\_14 and will work in effect to prevent MWPs to interconnector units. This is because Mod\_09\_14 does not properly take into account the fact

that interconnector units work on a "*bid to flow*" basis rather than "*bid at cost*" insofar as import trades are concerned. "*Bid to flow*" has the practical effect of overstating the level of infra-marginal rent for the purpose of the MWP calculation very significantly. This results in a malfunctioning of the MWP calculation mechanism and an under-compensation of export trades in respect of out-of-money bids. Combining all gates into one MWP calculation as proposed in Mod\_09\_14 will magnify this effect and, contaminating all MWP calculation with wildly incorrect values, will have the effect in practice that MWPs are not available to interconnector units.

The specific effect of Mod\_09\_14 being identical to Mod\_10\_14's, it is unlawful for the same reasons as Mod\_10\_14.

## **Way Forward**

In the light of this analysis, and severe restriction on exports that these Modifications in practice imply, we have, as you know, suggested alternative Modifications. If the principal objective of the Modifications proposed by the Regulatory Authorities is to address the netted volume anomaly in the TSC, then it would be sufficient, as set out in Mod\_12\_14, to remove the periods of simultaneous import and export within a participant's account from the MWP calculations entirely. Mod\_12\_14 would do so by forcing an interconnector participant to decide whether it wants to import or export in respect of a trading period on an interconnector. Participants would use different ex ante gates to schedule import and export and the TSC would be amended to allow identify when a participant is both importing and exporting so that these periods would be removed from the MWP calculation.

If, however, the Regulatory Authorities' proposals have a wider ambit than simply addressing the netted volume anomaly, then what needs to be addressed is the fact that the current SEM pricing structure gives rise, at times, to disjointed price signals allowing simultaneous imports and exports over the interconnector. Mod\_11\_14 proposes to move all interconnector units to a *pay (be paid) as bid* principle. While this may be implemented relatively quickly, such a change would have far more reaching implications. We believe that Mod\_11\_14 would represent a helpful starting point to a fundamental review or re-design of the import/export space and consideration of fundamental issues arising in this context including in terms of dispatch principles, pricing, bidding practices etc. But we do not believe that it would be prudent and consistent with good regulatory practice to amend the TSC in such a way without first conducting a thorough impact assessment where consideration is given to how to price exports in the context of the SEM.

We anticipate that (providing no measure is taken that would make this impossible) there will be a significant increase of exports over the interconnector over the next three years that is worth hundreds of millions euros of trade. Assessing MWPs only in terms of their numerical increase or decrease fails to recognise the fundamental role that they play in allowing exports to occur in the first place; analogously the security of constraint payments means that generation by less efficient units can occur in an orderly manner. An increase in exports is a very positive development from a regulatory and trading perspective that should be supported, not hindered, as would result from the Regulatory Authorities' proposed Modifications. As demonstrated by the Modifications proposed by ElectroRoute and consistent with the position that we expressed to the Regulatory Authorities over 16 months ago, we would be supportive of a review of the pricing mechanisms that govern imports and exports. However, this is a complex task that requires careful consideration of the issues involved so as to ensure that trade is facilitated, not discouraged.

We would welcome the opportunity to meet with you and discuss these issues and answer any queries that you may have. In the meantime, all of ElectroRoute's rights in respect of this matter are strictly reserved.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Ronan Doherty', with a horizontal line underneath the name.

Ronan Doherty  
Chief Executive Officer

cc.      1. The Single Electricity Market Committee; and  
          2. Office of Gas and Electricity Markets