Irish Wind Energy Association

Sycamore House,
Millennium Park,
Osberstown, Naas,
Co. Kildare. W91 D627

Thursday, 11th January 2018

Public Consultation on Electricity Support Schemes: Transitioning to I-SEM Arrangements
Electricity Policy Division
Department of Communications, Climate Action and Environment
29-31 Adelaide Road
Dublin D02X285

Submitted by email to:

## Re: IWEA Response to REFIT in I-SEM Consultation

To whom it may concern,

The Irish Wind Energy Association welcomes the opportunity to make a submission in respect of the "Electricity Support Schemes: Transitioning to I-SEM Arrangements Consultation" from the Department of Communications, Climate Action & Environment.

IWEA is the leading renewable energy representative body in Ireland and as such has an active interest in the potential and capacity for renewable energy development, and in particular wind energy, in Ireland. Approximately 120 organisations are members of IWEA across all areas of the wind industry including community engagement, planning, grid development, market design, health & safety, and asset management. IWEA hosts two of Ireland's largest energy conferences each year and regularly engages with key stakeholders across policy, regulation, industry, and research. IWEA works in a proactive and engaging manner with all stakeholders and as such feels it is both appropriate and important to make this submission, which is attached to this cover letter.

Yours Sincerely,

Head of Policy

IWEA
Irish Wind Energy Association

Sycamore House, Millennium Park
Osberstown, Naas, Co. Kildare
Phone:
Email: office@iwea.com

# IWEA Response to DCCAE Consultation "Electricity Support Schemes: Transitioning to I-SEM Arrangements Proposed Decision Paper"

11th January 2018

# Contents

# 1 Introduction

This paper is IWEA's response to the recent consultation from the Department of Communications, Climate Action, and Environment (DCCAE) entitled "Electricity Support Schemes: Transitioning to I-SEM Arrangements Proposed Decision Paper".

# 2 REFIT Is a Guarantee

REFIT is a minimum price guarantee given by the Minister to participating generators for the duration of the applicable REFIT scheme. Numerous representations have been made to industry that under REFIT they would be entitled to rely on a guaranteed level of support (see Section 8 of this response). The price guarantee is one of the fundamental aspects of REFIT because it removes variable price risk from renewable energy investments. The stable price commitment has been essential in attracting investors and lenders to the renewable energy sector and to commit the capital necessary to help Ireland to achieve its 2020 renewable energy targets.

IWEA acknowledges that the current electricity market in Ireland is changing and supports the principle that electricity generators, including renewable electricity generators, should be balance responsible. However, IWEA also believes that it is essential that these changes should not be detrimental to the arrangements put in place under REFIT, under which investment has been made since 2006, and which has been upheld and supported consistently since. IWEA also believes it is important that changes should not negatively impact on how investors view policy and regulatory risk for investments in low carbon infrastructure in Ireland, where Ireland's record (so far) of policy consistency has been key to attracting ever increasing volumes of inward investment at ever lower costs of capital in recent years. In introducing balance responsibility, it is essential that the REFIT commitments which underpin existing investment cases, including the REFIT floor price and the principle of price stability, are maintained.

IWEA accepts that the introduction of balance responsibility for renewable generators represents the direction of developing EU electricity market policy, however would like to highlight that there is no obligation on the Irish government or the regulatory authorities to retrospectively introduce balance responsibility. Balance responsibility is referenced in the EU State Aid Guidelines 2014-2020, however these guidelines:

- Only apply from 1 January 2016 whereas REFIT 2 was granted State aid approval in 2011.

- Even for a new aid scheme, beneficiaries are only subject to balancing responsibilities if a liquid intra-day market exists. With no implementation date for XBID in I-SEM and serious concerns about liquidity levels in the I-SEM Intraday market, the EU direction of travel is that beneficiaries in Ireland should not be subject to balance responsibility.

This is also evident from the original text of the EU's Clean Energy Package, where Article 4(2)(c) of the proposed new regulation on the *Internal Market for Electricity* as drafted in 2016 provides that;

> *"Member States may provide for derogation from balance responsibility in respect of.... installations benefiting from support approved by the EU Commission under Union State aid rules"*
>
> and
>
> *"Member States may, subject to Union State aid rules, incentivize market participants which are fully or partly exempted from balancing responsibility to accept full balancing responsibility against appropriate compensation."*

Rather than imposing balancing costs, it is clear that EU direction is to explicitly allow Member States to incentivise market participants benefitting from State Aid support to be balance responsible through appropriate compensation.

# 3 The Day Ahead Market Approach represents a significant erosion of REFIT

As outlined in IWEA's submission to the DCCAE on 30th June 2017, IWEA believes that the Day Ahead Market Approach is incompatible with Irish and EU policy and constitutes a damaging and unnecessary change to an express guarantee from the Irish government. Further detail is given in IWEA's previous submission.

Of the three options presented in the Proposed Decision Paper, the Day Ahead Approach is the most onerous for industry in that it offers no recognition that balancing costs will be borne by REFIT generators in I-SEM. As a result, it represents a deliberate erosion of the REFIT guarantee in two ways:

- Firstly, the REFIT guaranteed price is certain to be reduced by each generator's cost of balancing
- Secondly, given the balancing cost is unknown, will vary from year to year, and is to a large degree outside of the control of the generator, it represents a breach of the REFIT commitment to provide price stability

IWEA believes the Day Ahead Approach represents the most serious erosion of REFIT and recommends in the strongest terms that the DCCAE does not consider it as a viable option for its decision-making process.

# 4 Blended Approach results in an arbitrary REFIT top-up and unquantifiable price risk

IWEA acknowledge that the Blended Approach attempts to recognise the forecast error of wind generation and so balancing costs, however believes that it does not do so in a reasonable or accurate way. IWEA has concerns about the proposed Blended Approach because it:

- Does not relate to Balancing Costs and so results in an arbitrary REFIT top-up
- Risks unintended consequences
- Includes uncertainty about how the REFIT top-up will compensate for balancing costs

These are elaborated upon below.

## 4.1 Does not relate to Balancing Costs and so results in an arbitrary REFIT top-up

The Blended Approach only takes account of prices in the day-ahead market (DAM) and balancing market (BM). It does not take account of the volumes of wind energy transacting at those prices and so, fundamentally does not relate to balancing costs. The deemed reference price under the Blended Approach does not reflect prices achieved by REFIT generators and therefore results in an arbitrary REFIT top-up. This is the crucial weakness of the Blended Approach and its risks and consequences should be considered in detail by the DCCAE in reaching their decision.

## 4.2 Risks unintended consequences

As there is no link between the REFIT top-up and balancing costs as outlined above, there is a higher risk of unintended consequences associated with the Blended Approach.

For example, in day to day trading, there is a potential for participants to exploit the lack of a relationship. If participants believe the system will outturn BM prices above DAM prices then they can withhold generation from the DAM to gain from both higher BM prices and a higher REFIT top-up, calculated against 100% of the DAM price. While there would be a risk that BM prices outturn lower

than DAM, this risk would be mitigated under the Blended Approach by a more favourable REFIT reference price (80%:20% blend). The asymmetric risk under the Blended Approach could result in unintended consequences from distorted incentives to be balance responsible and disrupt the efficient operation of I-SEM.

## 4.3 Uncertainty about how the REFIT top-up will compensate for balancing costs

Many factors other than wind imbalance costs can impact upon balancing market prices such as thermal bidding strategies, generator and interconnector outages and system operators reserve planning to name but a few. Under the Blended Approach these factors, even though they are unrelated to wind imbalances, would affect BM prices and so the REFIT top-up. Under the Blended Approach, neither the DCCAE nor REFIT Generators can anticipate how the REFIT top-up will compensate for balancing costs.

For REFIT generators this means they would be exposed to a new risk where system events, outside of their control, could result in imbalance costs which would be inadequately compensated through REFIT. This new exposure is incompatible with the fundamental premise of REFIT to provide price stability. It may also impact projects lending arrangements in the short-term because the compensation for balancing costs is unquantifiable under the Blended Approach. As a result, lenders may apply worst case scenarios to their models, which in extreme cases could cause projects to unnecessarily breach debt covenants for forward debt service coverage ratios. Banking defaults associated with the transition of REFIT into I-SEM would negatively impact on how investors view policy and regulatory risk for investments in low carbon infrastructure in Ireland.

IWEA believes the DCCAE should also be concerned about the uncertainty with how the REFIT top-up will compensate for balancing costs. Under the Blended Approach, the DCCAE cannot be certain that the total REFIT top-up, when added to the market revenues earned by all REFIT generators on the system, will not result in total remuneration above the REFIT floor. This is particularly relevant given the EirGrid modelling (presented later in ) shows the costs of the Blended Approach to be close to the average system imbalance cost (i.e. the Dutch Option).

IWEA believes the uncertainty about how REFIT will compensate for balancing costs is undesirable for both the DCCAE and REFIT generators and therefore cautions against the Blended Approach.

# 5 The Dutch Option is the least onerous option

It is essential to note that the Dutch Option represents a significant erosion of the REFIT guarantee in that it relinquishes the principle of a guaranteed price for every unit of electricity to be replaced by a variable market price. Price certainty remains a major consideration for investors into REFIT projects and so this change negatively impacts upon investment cases by introducing a new variability into revenue streams. However, of the three options presented in the Proposed Decision Paper, IWEA believes the Dutch Option is the least onerous because it:

- Provides more certainty about how REFIT will compensate for balancing costs
- Better maintains investor confidence
- Has sharper market incentives and will result in lower system imbalance costs
- Has a similar administrative procedure as the blended approach
- Is better placed to receive State Aid approval

Again, these are elaborated upon below.

## 5.1 Provides more certainty about how REFIT will compensate for balancing costs

As outlined in section , under the Blended Approach REFIT generators cannot be assured that the REFIT top-up will compensate for balancing costs. It is possible that system events, outside of their control, could result in imbalance costs which would be inadequately compensated through REFIT. This new exposure is incompatible with the fundamental premise of REFIT to provide price stability.

However, this is not the case with the Dutch Option where system events that cause balancing costs to be higher will result in appropriately higher compensation through the REFIT top-up. Although REFIT generators are still exposed to variable prices under the Dutch Option, it offers greater certainty that REFIT will compensate for system wide events outside of the generators control.

IWEA believes that the Dutch Option should also be attractive to the PSO. Should the market operate effectively and result in lower balancing costs, the impact on the PSO will be equally reduced. It is arguably the case that balancing costs will trend downwards in the long-term due to improved forecasting and so IWEA believes the Dutch Option offers the PSO greater protection, particularly over the long-term.

### 5.2 Better maintains investor confidence

The Dutch Option endeavours to maintain, in a manner that is reasonable and practical, the original commitment of REFIT to provide a stable price for every unit of electricity. IWEA members believe it would better maintain investor confidence in policy and regulatory risk for investments in low carbon infrastructure in Ireland, compared to the other proposed options.

### 5.3 Has sharper market incentives and will result in lower system imbalance costs

The Dutch Option is a fully market based approach where participants are exposed to the downside costs and upside reward of their forecast accuracy and trading behaviour. Under this mechanism participants are only compensated for the system average imbalance cost and therefore are strongly incentivised to reduce their balancing costs below this level. The Dutch Option creates a competitive environment where market participants will continually strive to improve forecast accuracy and reduce balancing costs. In this way, the DCCAE can be assured that the market will work in the most efficient manner to the benefit of the PSO and electricity consumer.

### 5.4 Further comments – Ease of Administration and State-Aid Approval

IWEA disagrees with the DCCAE view that the Dutch Option is administratively complex. The additional overhead is simply to engage a third-party consultant to calculate the system imbalance costs for each trading period and apply this to the DAM price. In our view, this process is not complex. Furthermore, if preferred by the DCCAE the Dutch Option can be implemented by way of a simple formula calculated on a trading period basis in a manner that is administratively similar to the Blended Approach.

The Dutch Option is already working successfully in the Netherlands and has been granted State-aid approval. Therefore, IWEA believes that the Dutch Option is better placed to obtain State-Aid approval than the Blended Approach which is not a proven concept in the EU.

## 6 Cost Comparison – Dutch Option and Blended Approach

### 6.1 Costs are similar for Blended Approach and Dutch Option

The EirGrid modelling underpinning the proposed decision paper (see shows that costs for both the Blended Approach and the Dutch Option are similar in the DAM 100% and DAM 80% trading scenarios.

## COST COMPARISON – DUTCH OPTION AND BLENDED APPROACH

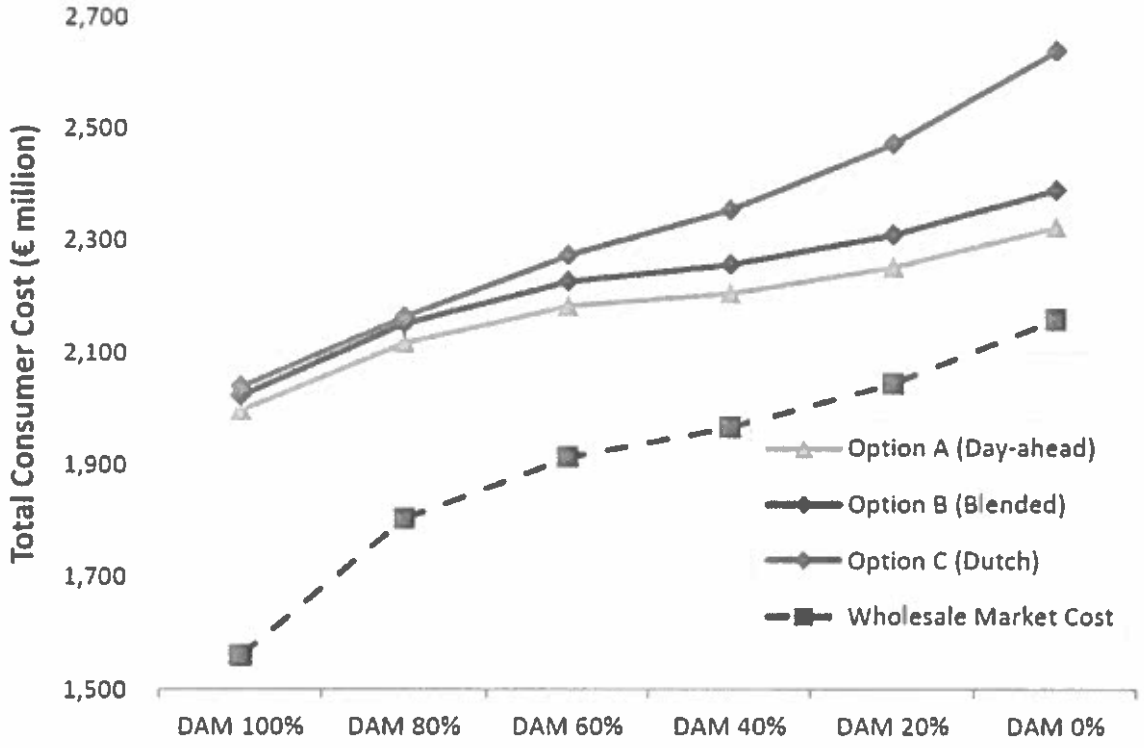


*Figure 1: Total consumer costs (i.e. combined DAM costs and PSO levy costs) from the EirGrid modelling in the consultation for each the 3 options proposed. The graph shows how the combined costs vary with wind trading strategy and with the option selected for implementing REFIT in I-SEM. The dashed red line shows the DAM market cost on its own for reference.*

IWEA note that the DCCAE may have considered results from EirGrid when large volumes of wind are withheld from the DAM (i.e. DAM 60% to DAM 0%), where the Dutch Option has higher costs than the Blended Approach. However, IWEA would like to emphasise two points to outline why this should not be a consideration for the DCCAE in reaching a decision.

Firstly, IWEA stresses that the EirGrid model does not take account of arbitrage trading by market participants i.e. if there is a sustained difference in prices between the DAM and BM caused by wind trading in the BM, then EirGrid incorrectly assumes this will not be traded away by the market. This market arbitrage can ultimately happen in two ways:

- Where wind noticeably stays out of the DAM but subsequently sells into the BM, demand could choose not to purchase in the more expensive DAM on the basis that they know the wind will ultimately appear in the BM. This could be achieved through some observation of market trends and basic wind forecasting. This should have the effect of lowering the DAM price and moving up the BM price resulting in an outcome closer to price equalisation between the two timeframes.

- Assetless traders could observe systematically low volumes of wind trading in the DAM with a resultant significant spill into the BM. They could opt to sell a non-asset backed volume in the DAM and then buy it back later in the IDM or BM. This should have the effect of lowering the DAM price and moving up the BM price resulting in an outcome closer to price equalisation between the two timeframes.

It is implausible that large and sustained differences between DAM and BM prices will not be arbitraged and so the higher balancing costs modelled by EirGrid in the DAM 60% to DAM 0% scenarios would not arise in reality. It is essential that this point is fully understood when analysing the EirGrid results and therefore only the results for DAM 100% to DAM 80% trading scenarios should be used to inform decision making.

Secondly, and notwithstanding the above, if the DCCAE's concern is irrational market behaviour, then the best way of avoiding such an outcome is to design a market with the sharpest possible incentives. The Dutch Option, where the exposure to both downside costs and upside reward means participants will compete to maximise accuracy and minimise balancing costs, so it has the clearest incentives and is the best means of ensuring rational market behaviour. In effect, a properly functioning market with strong, transparent market incentives such as the Dutch Option inherently protects the PSO Customer from extreme balancing costs.

## 6.2 Given comparable costs between options, other factors should influence DCCAE decision

Given the comparable costs between the Blended Approach and the Dutch Option outlined above, IWEA believes other factors should be used by the DCCAE to reach a decision. These factors include those outlined in sections and such as market incentives, investor confidence and risks of over-compensation. IWEA believes that for the Blended Approach marginal cost gains would be outweighed by the risks of distorting market behaviour, compromising regulatory certainty associated with investment in Ireland and over-compensating all REFIT generators on the system.

# 7 IWEA Requests Clarifications

## 7.1 Clarification on competition concerns with the Dutch Option

IWEA is concerned with the statement in the proposed decision paper that REFIT generators might *"agree to trade all of their output in the balancing market in order to increase average balancing costs and in turn aggregate remuneration via the PSO levy"*.

IWEA find the suggestion that REFIT generators might collude to engage in anti-competitive practices to illegally manipulate market prices to be concerning. It would be entirely inappropriate for the DCCAE to take this into account in the decision-making process.

IWEA requests clarification whether the above competition concerns were indeed a factor in the decision-making process.

## 7.2 Clarification on formulae for the Blended Approach and Dutch Option

IWEA is basing the views expressed in this response on certain assumptions about the Blended Approach and the Dutch Option such as, the reference price is wind-weighted and balancing costs are calculated at individual wind farm level. Misunderstandings could significantly alter IWEA's views on the Options considered by the DCCAE and therefore it is essential there are no misunderstandings or misinterpretations when implementing the decision on how REFIT will transition into I-SEM.

For example, under the Blended Approach IWEA believes clarity would be required that the 'period' defining the reference price is a discrete trading period in the DAM.

Similarly, under the Dutch Option clarity would be required as to how the balancing cost is to be calculated, either by a third-party consultant or within a simple formula.

IWEA therefore requests that when making their proposed decision that the DCCAE include an appendix outlining the exact formula to be implemented by the CRU.

## 7.3 Change of Suppliers due to activation of PPA market change and REFIT change clauses

The introduction of I-SEM will be a possible trigger for the activation of market change and REFIT change clauses in some generator PPAs. When these clauses are activated, generators and suppliers will enter into commercial negotiations to determine how costs associated with the introduction of I-

SEM will be allocated. REFIT generators have a general concern that without the ability to easily switch suppliers, they would be in a weaker negotiation position relative to suppliers.

IWEA believes it is also in the interests of DCCAE and the CRU to ensure that the transition to I-SEM is as seamless as possible and that all parties are exposed to financial incentives to operate in a responsible manner in the new market. As a result, IWEA recommends that for the transition to I-SEM the DCCAE and the CRU increase flexibility in its administrative procedures to facilitate fair negotiations between suppliers and generators.

Some examples of how the DCCAE and CRU could introduce flexibility into the processes would be:

- DCCAE should instruct the CRU to accept newly notified PPAs up to mid-August 2018 for changes in PPA off-taker for the upcoming PSO Year (October 2018 to September 2019)
- Consent to change should not be sought by the DCCAE from old suppliers
- The change to I-SEM in itself is an exceptional circumstance so there should not be a need to demonstrate exceptional circumstances during the transition period

## 7.4 Clarification on additional de-risking for smaller wind farms in Option C

The DCCAE recognise in the Proposed Decision Paper that smaller wind farms "may be less able to manage forecasting and market interactions" and as a result under the Blended Approach, created a 70/30 blend to provide further de-risking for De minimis generation, defined as wind farms below 5 MW. IWEA propose that a similar de-risking is provided in Option C for smaller wind farms.

# 8 Legal Comments

IWEA believes there are a number of legal considerations relevant to the proposed decision paper including:

- The imposition of balancing costs is in breach of the PSO Order and the Electricity Regulation Act 1999
- The Blended Approach is an unreasonable exercise of discretionary powers
- REFIT generators have legitimate expectation of substantive benefit

Each of these is described in more detail in this section.

## 8.1 The imposition of balancing costs is in breach of the PSO Order and the Electricity Regulation Act 1999

Article 6D(1) of the PSO Order imposes a public service obligation on certain licensed suppliers to purchase electricity from certain generators under REFIT PPAs. The PSO Order is required to provide for the recovery, by way of a levy on customers, of the additional costs incurred by suppliers in complying with the PSO Order.

Section 39 of the Electricity Regulation Act, pursuant to which the PSO Order is made, provides at subsection 5(a) that "an order under this section shall provide for the recovery, by way of a levy on final customers, of the additional costs ..... in complying with an order under this section including costs incurred after the variation or revocation of such an order". It is therefore a statutory requirement of the Act that the PSO provides for the recovery of "additional costs" of parties complying with the public service obligation to purchase power under a REFIT PPA.

Article 2(3C)(a) of the PSO Order provides that "'additional costs' includes costs incurred by a supplier in complying with its obligations under Article 6D either before or after the coming into operation of this paragraph and which are not otherwise recovered". Reading the Act and the PSO Order together, it is therefore clear that a supplier shall recover costs incurred in purchasing electricity under a REFIT PPA which are not otherwise recovered. This is not an entitlement in respect of which the Minister has any discretion, it is an express legal requirement.

Furthermore, notifications to the EU Commission for REFIT schemes clearly provide that additional costs include costs of balancing non-dispatchable electricity.

As a result of the above, REFIT suppliers entered into fixed price contracts with renewable generators on the clear understanding and expectation that their additional costs of balancing would be

recovered by REFIT. As outlined above the Day Ahead Approach and the Blended Approach do not relate to the additional costs which suppliers will suffer by participating in the I-SEM balancing market. Accordingly their adoption would be in breach of the PSO Order and the Electricity Regulation Act 1999.

## 8.2 The Blended Approach is an unreasonable exercise of discretionary powers

As stated previously in section . under the Blended Approach there is no direct link between the REFIT reference price and balancing costs and so it proposes to calculate the REFIT top-up by reference to an arbitrary price. Because this approach does not take into account the balancing costs of a REFIT generator in a meaningful way, a decision to adopt the Blended Approach would be a flagrant disregard of reason, particularly when viewed alongside alternative reasonable and practical mechanisms such as the Dutch Option.

## 8.3 REFIT generators have legitimate expectation of substantive benefit

Numerous representations have been made to industry that under REFIT, they would be entitled to rely on a guaranteed level of support. Examples of these representations include:

- Paragraph 3.1 of the REFIT 2 and 3 Terms and Conditions provides that *"REFIT is a feed-in-tariff support scheme that operates by guaranteeing new renewable generation a minimum price for electricity exported to the grid over a 15-year period."*
- Paragraph 3.1 of the REFIT 1 Terms and Conditions provides that *"Each applicant declared successful in REFIT will receive a "letter of offer". The "letter of offer" will confirm to any licensed electricity supplier that in return for entering into a PPA to purchase the output from the proposed renewable energy powered plant, for 15 years, the supplier will, when these terms and conditions provide for it, be entitled to receive a REFIT payment, calculated in accordance with these terms and conditions."*
- In the REFIT 2 State Aid approval at paragraph 58 and the REFIT 3 State Aid approval at paragraph 73 the European Commission expressly approved REFIT 2 and REFIT 3 as a *"guaranteed level of support"*.
- REFIT 1 Letters of Offer appended an information note for retail suppliers participating in the REFIT programme. The Letter of Offer stated that this was enclosed *"following discussions with electricity suppliers"* and should be delivered to suppliers by the REFIT generator. Under the heading *"Reimbursement of additional costs to participating suppliers"* the information note

confirmed that *"The published terms and conditions of REFIT make ex ante provision for suppliers to recover net additional costs incurred by participating in REFIT"*.

- The Department's 2006 REFIT clarifications state that *"The undertaking to suppliers participating in REFIT is that such suppliers will be compensated for the net additional costs which the Department is satisfied have been incurred by a typical supplier participating in the scheme. This undertaking applies for the duration of the programme. There is insufficient detailed information on a future SEM to decide the detailed nature of proportionate compensation in the future SEM. However the broad undertaking to compensate for net additional costs will continue to apply in accordance with all other published terms and conditions."*

On the basis of these representations and undertakings, REFIT suppliers and generators have a legitimate expectation that they will continue to be reimbursed for the *"net additional costs incurred"* of entering into REFIT PPAs following implementation of the I-SEM. The adoption of the options in the Proposed Decision Paper, and in particular the Day Ahead Market Approach and the Blended Approach, would breach this legitimate expectation in a manner that is incompatible with the fundamental premise of REFIT to provide stable market prices.