



Electricity Market Reform Project
Department of Energy & Climate Change
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3 Whitehall Place
London
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Dear Sir or Madam

Electricity Market Reform Consultation Document (EMR)

Thank you for the opportunity to comment on the above consultation.

The Utility Regulator is a non-ministerial government department responsible for regulating the electricity and gas industries and water and sewerage services in Northern Ireland, to promote the short and long-term interests of consumers. We make sure that the utility industries in Northern Ireland are regulated and developed within Ministerial policy as set out in our statutory duties.

We carry out our work in line with statutory duties set out in the Energy (Northern Ireland) Order 2003 and the Water and Sewerage Services (Northern Ireland) Order 2006. The Utility Regulator has three main objectives:

- to protect the interests of electricity consumers with regard to price and quality of service, where appropriate by promoting competition in the generation and supply of electricity;
- to promote the development and maintenance of an economic and co-ordinated gas industry and to protect the interests of gas consumers with regard to price and quality of service;
- to protect the interests of water and sewerage consumers, where appropriate by promoting competition, by promoting a robust and efficient industry delivering high quality services.

The EMR package as a whole is intended to:

- 1) Increase security of supply
- 2) Help tackle climate change by promoting low carbon energy in the UK.
- 3) Maintain affordability.

We note that the four elements of the EMR package (carbon floor price, FIT with CFD, capacity payments, emissions performance standard) have been analysed by DECC in the GB context and that DECC have not carried out any Northern Ireland-specific analysis of the package. Some elements of the package will not apply directly to Northern Ireland, due to the fact that energy is a devolved matter. However the Carbon Floor Price as a taxation matter will apply directly to Northern Ireland and the other elements of the package will have significant consequences for Northern Ireland. Therefore we are disappointed that no Northern Ireland-specific analysis has been carried out by DECC and we are concerned that the overall effect in Northern Ireland would be likely to be the opposite of that intended. Our high level concerns are noted below and we are happy to work with DECC to provide further detailed analysis as required.

The Northern Ireland market differs significantly from that in GB; before outlining our concerns it is worth while giving a very high level overview of the Single Electricity Market (SEM) on the island of Ireland. The SEM is an unconstrained wholesale market operating across the island of Ireland. It operates on the basis of a gross mandatory pool. All electricity generated (from installations above 10MW installed capacity) must be bid into the pool on a cost reflective basis. Bids into the pool are used to determine merit order and dispatch and also to determine the system marginal price (SMP). All suppliers across the island of Ireland purchase from the pool at the SMP.

Taking each element of the EMR package in turn:

Carbon Floor Price

While we have already responded to Treasury on this matter we feel our points are worth restating. Our initial analysis suggests that the carbon floor price would have the following unintended impacts on Northern Ireland which are the opposite of those intended by the EMR package as a whole:

1) Increased Security of Supply

- a) The CFP will increase costs to Northern Ireland generators thus creating a distortion and disadvantage for Northern Ireland generators as compared to their

Republic of Ireland counterparts. If Northern Ireland generators bid the increase in costs into the pool they will fall down the merit order and thus run less often. If Northern Ireland generators do not bid the CFP cost into the pool there will be an adverse impact on returns to Northern Ireland generators as compared to their Republic of Ireland counterparts. Both of these scenarios provide an incentive for non renewable generation to locate in the Republic of Ireland rather than Northern Ireland.

- b) The CFP may provide an advantage to Republic of Ireland generators thus providing windfall gains.
- c) While the SEM is an unconstrained wholesale market there are physical constraints on interconnection between Northern Ireland and the Republic of Ireland. The consequences outlined above would almost certainly feed through into a knock-on effect on constraint costs. This is due to a security of supply requirement to run generation in Northern Ireland when they are not in schedule.
- d) Due to the small size of Northern Ireland and the amount of interconnection available any shifting of base load generation from Northern Ireland to the Republic of Ireland would have serious consequences for security of supply in Northern Ireland.

2) Helping to tackle climate change - Low Carbon Generation (Including Renewable and Nuclear)

- a) Due to the size of Northern Ireland, nuclear is unlikely to be a possibility in the near future.
- b) Due to the unconstrained nature of the wholesale market on the island of Ireland, the CFP signal to renewable generators would be diluted across the island as a whole. If the CFP is fed through into the SMP the benefit in increase revenue to renewable generators would be the same whether they locate in Northern Ireland or the Republic of Ireland.

3) Maintaining affordability

- a) Northern Ireland has the highest rates of fuel poverty in the UK, currently 44%. Any increase in costs passed on to Northern Ireland consumers will exacerbate the situation.
- b) Northern Ireland customers spend more than twice as much of their disposable income on energy than households in London and around 60% more than the UK average, thus the impact on customers would be greater in Northern Ireland than in the rest of the UK.

For the above reasons we strongly believe that the CFP should not be implemented in Northern Ireland as it would have the opposite effect to the stated policy intention.

Replacing the RO with a FIT with CFD

Energy policy is devolved to Northern Ireland and thus Northern Ireland does not necessarily need to follow the GB model for renewable support. However energy policy though out UK has so far been to socialize the cost of supporting renewable energy across the UK as a whole. This policy is a sensible one because it reflects the fact that the UK as a whole has a renewable energy target and each region within the UK will play some part in meeting that target.

Within the UK some regions will be rich in renewable resources while others will not. Socializing the cost of renewable energy support across the UK as a whole allows regions rich in renewable resources to exploit that resource to the full benefit of the UK, without overburdening or penalizing customers who happen to live in that area.

Northern Ireland is an area rich in renewable resource which wishes to play its full part in meeting the overall UK target for renewable energy. The Northern Ireland executive has set an ambitious NI specific target of 40% of electricity to come from renewable sources by 2020. This will be an important contribution to the overall UK target, but it will be difficult for Northern Ireland to meet this target unless we can continue to operate a support mechanism which takes advantage of the UK acting together.

Therefore we consider that any renewable support mechanism which replaces the RO should continue to allow for the cost of supporting renewable generation to be spread across the UK as a whole.

Customers, suppliers and generators (both renewable and conventional) require a support mechanism that delivers on the following;

- simplicity,
- transparency,
- reduced risk
- reduced cost

Although the proposals in the DECC consultation may not be followed in Northern Ireland, the Utility Regulator has reviewed the lead option FIT with CFD to see how it stacks up against the above in the GB context, we have then looked at potential consequences for Northern Ireland.

Simplicity

FIT with CFD appears overly complex. CFDs in particular are complex financial instruments which could we believe come under the Markets in Financial instruments Directive, and Financial Services and Market Act (FSMA). We are concerned that many of the potential investors in renewables could be put off by complexity.

Transparency

We are concerned that there are a number of points around the proposed CFD with FIT mechanism which are unclear. These include how the CFD strike price will be set, what

market index will be used to measure the CFD against, how often the CFD strike price will be adjusted and for which generators and how the funding for the CFD will be raised. We suggest that an auction is the most transparent way of setting strike prices. However the design of any such auction in GB would need to be carefully considered and also the duration of the CFD. We note that should any similar approach be considered in the Northern Ireland context the SEM market price would be appropriate for settlement, we also note that in Northern Ireland the market structure is so different from that in GB that it would be vital to ensure that there are no distortions, opportunities for gaming or unforeseen consequences.

Reduced Risk

Certainty is important to both suppliers and generators as risk equals cost. Renewable generators will want to see certainty of revenue over the course of the investment typically 20 years.

Customers will want to see some stability in terms of tariffs and domestic customers in particular like tariff periods that allow them to budget over the course of the year. Suppliers will want to see certainty in terms of ensuring that there are no adverse consequences in relation to their cash flow or their ability to compete. Therefore we suggest that any levy on suppliers to fund the CFD should be set on a transparent basis and announced for at least one year in advance. We also consider that a potential method for collecting the means to fund the CFD in GB could be via a Public Service Obligation (PSO).

However at very high levels of renewable penetration we are concerned about the practicality of determining the funding required for the CFD a year in advance. Over the course of a year unforeseen shocks to the market price would have severe consequences in cash flow terms for any agency set up to act as counterparty to the CFD. Therefore we would suggest that any agency set up to act as counterparty to the CFD would require access to high levels of reserve funding.

We are further concerned about dispatch and scheduling signals within the proposed mechanism. The consultation states that the proposed mechanism will encourage renewable generators to dispatch efficiently. However wind generators in particular will be divorced from such signals and will wish to run when they can.

Reduced cost

We are concerned that the CFD with FIT option has not been modelled in a SEM type market. In the SEM the CFD with FIT is similar to a fixed FIT. We have recently modelled the option of a fixed FIT against the NIRO and found that the NIRO in its current form to be more cost effective.

Consequences for Northern Ireland

As stated above energy policy is devolved to Northern Ireland so that theoretically Northern Ireland could continue to operate the Northern Ireland Renewable Obligation (NIRO). However in practical terms it would be impossible for Northern Ireland to

operate the NIRO without being part of the wider GB Renewable Obligation. This is mainly due to the fact that Northern Ireland is a small renewable rich region of the UK which typically tries to punch above its weight in terms of renewable generation.

Northern Ireland has carried out modelling on the cost of the NIRO compared to other support mechanisms and found that the NIRO in its current form is the most cost effective mechanism for getting Northern Ireland to its target of 40% of electricity from renewable sources by 2020. When the cost of support plus the cost of energy is assessed, customers in NI cumulatively pay around £2 per MWh more than GB customers for renewable generation¹. Removing Northern Ireland's ability to retain its position within the UK RO as currently structured could seriously adversely affect Northern Ireland's ability to afford its target of 40% of energy from renewable sources.

We are also concerned about the complex nature of the proposed changes and the level of uncertainty that this will cause in Northern Ireland. This is particularly important in Northern Ireland which retains the NIRO as the method of support for small scale renewable generation. Small scale generators in particular may be less willing to deal in complex financial instruments such as CFDs. Such high levels of complexity and uncertainty run the risk of an investment hiatus in renewable energy.

Our main concern with the CFD proposal relates to Northern Ireland's ability to continue to operate the NIRO as currently structured within the wider UK Renewable Obligation. As stated above any changes to the current structure could endanger Northern Ireland's ability to meet its renewable electricity target and would also have adverse consequences for energy affordability here. Energy affordability is particularly important in Northern Ireland due to the high levels of fuel poverty as noted above, and also due to energy costs here.

Finally we would note our disappointment that the analysis which has been carried out for this proposal did not include Northern Ireland. As noted above the SEM market operates entirely differently from the UK market and has different wholesale energy prices.

Capacity Mechanism

It is our understanding that the capacity mechanism will not apply in Northern Ireland, since Northern Ireland as part of the Single electricity market already has an established capacity mechanism. It would be helpful if this could be confirmed. Any impact of a capacity mechanism on the GB price will have an effect on the interconnector trades between the two regions.

Emissions Performance Standard

It is not clear if this is to apply in Northern Ireland. It would be helpful if this could be confirmed. Would this place a limit on the current carbon emission elements of the current plants with Northern Ireland and involve any additional retrofitting. This standard

¹ Source CEPA modeling

would also have implications on certain new build technologies within Northern Ireland unless these builds are accompanied by carbon capture and storage. It should be noted that the effect of an EPS would be most likely to increase the price of electricity to consumers compared to prices paid today further increasing the fuel poverty in Northern Ireland.

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