

Dr Andrew Murrison
Chair
Northern Ireland Affairs Committee
House of Commons
LONDON
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1 June 2018

Dear Dr Murrison

ELECTRICITY IN NORTHERN IRELAND: FOLLOW-UP

Thank you for your letter of 16 May 2018 which followed the opportunity, which we welcomed, to provide evidence to the Committee in relation to the outcome of the ISEM CRM Auction, on 14 March.

I have addressed the follow up questions in your letter in the order which they were posed.

1. On what basis will the Utility Regulator decide on the request for derogation made by AES regarding the early closure of generating units at Kilroot and Ballylumford?

The decision falls to be made within a clear legal framework defined by statute, the licences and the Northern Ireland Grid Code.

The starting point is that the AES companies¹ are required under their generation licences to comply with the Grid Code².

As the Committee is aware, the Grid Code in turn obliges generators which want to close (or to withdraw from service) any plant with capacity of 50MW or more to provide SONI with at least 36 months' notice of their intention to do so³. The UR can enforce this requirement, and there are statutory sanctions which may be imposed if it is breached.

¹ AES Ballylumford Ltd (**ABL**) and AES Kilroot Ltd (**KPL**) – while the Committee's letter understandably refers to AES as a corporate group, there are in fact two relevant AES legal entities which hold separate licences and have made separate derogation requests.

² Condition 4(1) of the [ABL Licence](#) and of the [KPL Licence](#).

³ [PC6.1.6](#) of the Grid Code.

However, the generation licence also gives the UR the power to issue a direction relieving the generator of any obligation under the Grid Code⁴.

These directions are informally known as 'derogations'. The UR publishes guidance indicating the procedure it will adopt before issuing a derogation⁵. In very simple terms, this says that any generator which seeks a derogation must make a formal request to the UR, providing all the information on which it wishes to rely. The UR will then assess and determine the request, aiming to do so within a specified timescale. Under the licence, the UR must consult with both SONI and NIE Networks before making its determination.

This is the process in which the UR is currently engaged, following receipt of valid requests from both ABL and KPL for derogations from the 36 month notification requirement.

In this process we expect the company to demonstrate why it should have a derogation. All other things being equal, unless it can do so, the requirements of the Grid Code will continue to apply as normal.

The UR determines any request on a quasi-judicial basis, deciding whether or not to grant the derogation on the basis of the evidence available to it, and all relevant circumstances that apply at the time at which the decision is made. The criteria against which it determines any request are those which are set out in statute in the form of the UR's principal objective and general duties⁶. The UR does not maintain obligations on a company unnecessarily, but only where they serve a statutory purpose in line with the objective and duties.

The particular purpose of the obligation to provide notification of plant closures is to ensure an orderly exit by generators from the market without compromising system security or stability. Therefore, on any request for a derogation from that obligation, the UR will give very careful consideration to any system impact of an early exit, whether it has the potential to have an adverse impact on consumers, and whether there are any mitigating steps that can be taken by the generator or the system operator.

In making this assessment, the evidence provided by SONI, as NI system operator, is likely to be of particular importance. The AES companies will be consulted in relation to that evidence before any final decision is reached.

⁴ Condition 4(2)(a) of the ABL Licence and KPL Licence.

⁵ [Derogations from Network Codes and Grid Codes – Guidance Document](#), February 2017.

⁶ Article 12 of the Energy (Northern Ireland) Order 2003.

As the Committee is aware, the UR is currently in the process of gathering and assessing the evidence necessary for it to reach a determination on the ABL and KPL derogation requests, and will shortly be consulting again with the AES companies for that purpose.

Given that this is a formal legal determination made within a statutory framework, and that it is important to ensure that due process is followed prior to the decision, I hope the Committee will understand that it is not possible to say much more about the determination at the present time.

a. For what reason were you unable to make a decision on AES's request, and what further information have you sought to inform this decision.

A complicating feature of this process is that there is no single AES derogation request. Instead there are separate requests made by ABL and KPL. Within the AES group structure, these are the separate legal entities holding generation licences at the Ballylumford and Kilroot sites respectively. Each company has, quite properly, submitted requests made in its own name and for the purposes of its own licence.

In accordance with the UR's published guidance, any derogation request is first considered by the UR for validity, i.e. is it complete and containing all the information set out in the guidance as being necessary for the request to be processed?

With regard to the KPL request in relation to the K1 and K2 units at Kilroot, the UR wrote to the company on 5 February 2018 to indicate that this was being treated as a valid derogation request from that date. We then commenced the process of considering the request, including by engaging with SONI to seek its assessment of the likely system impacts of any derogation being granted.

With regard to the ABL requests in relation to the B4 and B5 units at Ballylumford, the UR did not receive all of the information it required until 18 April 2018. We then wrote to ABL to indicate that we were treating the ABL requests as valid with effect from that date, and would proceed to consider them, again engaging with SONI for that purpose.

The UR took the view that this raised a question as to the most appropriate way to proceed, in particular given that in this case the two companies, while separate legal entities, are part of the same corporate group. On 23 April 2018, we wrote to both AES companies and described the issue that arose in these terms –

"The current position is that there are now valid derogation requests for each of K1, K2, B4 and B5. The requests in respect of all four units relate to the same provision of the SONI Grid Code and, while different derogation start dates have

been sought, the periods of derogation that are requested would overlap to a significant extent.

In these circumstances, it is clear that the derogation requests may have a bearing on each other. Put simply – and entirely without prejudice to any conclusions the UR might reach in the light of the information and evidence submitted to it – it is at least possible that if a derogation were granted in respect of one or more units it would be less likely that a derogation could be granted in respect of one or more other units.

In the light of this, the UR has considered again the process by which the derogation requests are to be assessed and determined.

In broad terms, there are two ways in which the requests could be determined. The first is to determine them in sequence, beginning with the first valid requests to be received. On this approach, a determination would be made in respect of the earlier requests without taking into account the later ones. When the later requests came to be determined, the earlier determinations would be an established fact that would be taken into account as part of the factual context in which those later determinations were made.

The second approach is to determine all of the requests at the same time, taking into account the potential interactions between them, with a view to determining the most appropriate overall outcome in respect of the four units as a whole."

The letter suggested that the second of these approaches was to be preferred, since it would allow the UR to make a holistic assessment of the requests and determine the most optimal overall outcome. However, the letter also described this as a 'minded to' position, and invited both ABL and KPL to raise any objections they had to it.

In a reply dated 27 April 2018 from Ian Luney of AES, writing on behalf of both companies, ABL and KPL agreed that the second approach was the best way forward – *"We believe that taking such a holistic approach is in line with the UR's principal objective and duties and would allow the UR to assess the best solution in light of the best overall economic value, taking into account the impact on security and diversity of supply, system support services and energy prices overall."*

For completeness I should note that Mr Luney also said that the UR should have adopted this procedure from the outset. However, I also note that AES had not previously proposed or asked for this approach to be taken, and indeed has routinely stressed that

ABL and KPL are separate legal entities acting independently⁷. In any event, the question could not arise until both sets of requests had been assessed as being validly made.

In consequence, the UR has now asked SONI to assess the position in respect of the K1, K2, B4 and B5 units taken as a whole and in relation to each other, and SONI is in the course of preparing its analysis.

While this assessment is necessarily more complex, and so requires more time to be carried out, both we and AES are satisfied that it is likely to lead to a better outcome overall.

b. What assessment have you made of delaying this decision, given that AES has requested to close units at Kilroot power station at the end of May?

The derogation request received from KPL was to allow it to close the K1 and K2 units with effect from the I-SEM Go-Live date.

At the time when the request was first made, that date was expected to be 23 May 2018. The Committee is of course aware that it is now scheduled to be 1 October 2018.

Given the change in the I-SEM Go-Live date, the UR still expects to be in a position to make a decision on the K1 and K2 derogations before the date by which they were requested to have effect. Since the rationale for the derogation request was framed in terms of I-SEM (notably the outcome of the capacity auction) coming into effect, and since the previous arrangements under the SEM continue in force until the new Go-Live date, we do not consider that the delay is inconsistent with the derogation that has been sought or the reasons given for it.

In any event, the UR will continue to process each of the derogation requests as expeditiously as it can, consistently with the need to ensure that the requirements of due process are met and that it is fully informed as to all relevant matters before making its final determination.

⁷ Including in the 27 April 2018 letter – *"However, we wish to reiterate that the individual entities which have made the derogation requests have done so independently and are separate legal entities."*

2. If generating units at Kilroot and Ballylumford are closed this year:

a. How can the Utility Regulator ensure Northern Ireland's security of supply?

This question is one that the process for considering derogation requests is designed to allow us to resolve so that security of supply is not compromised.

As I explain more fully in answer to question 6 below, the requirement for 36 months' notice of plant closure is the default position which is designed to ensure system security and stability, and therefore security of supply. The notice period is capable of being relaxed (by derogation) on the application of the generator. But a derogation is only likely to be given if the UR can be satisfied that early closure will not have an adverse impact on consumers by compromising the security of supply to which they are entitled, or that mitigating measures will be in place to avoid any adverse impact that would otherwise occur.

The legal framework therefore requires us to approach the question from the opposite angle to the one implied by the Committee's question. Early closure will be permitted only if the UR can first be satisfied that the security question has been adequately addressed. We will place particular weight on the assessment of SONI in reaching any conclusion on this issue.

The Committee can be assured that there is no question of there being a situation in which early closure is permitted and the consequences of that closure are only then considered as if they were secondary issues. This is precisely the kind of outcome that the rules are designed to prevent.

b. What impact will there be on the price of electricity for customers in Northern Ireland?

Any economic implications that may impact on the price of electricity for Northern Ireland customers will be considered as part of the derogation process.

For example, this may include considerations such as the cost of compliance with the Grid Code requirements by ABL and KPL if derogations are not granted, as compared to the cost to SONI, other system users and consumers of granting a derogation.

At this time, when the UR is still in the process of gathering and assessing evidence as part of the formal process I have described above, it is not possible to comment in any more detail on these implications. However, all relevant matters will of course be fully considered as part of our determination of the derogation requests.

3. What would the Utility Regulator's view be of the sale of Kilroot and/or Ballylumford power stations to a new operator?

The UR adopts a neutral position in relation to any potential sale.

If the sale took place by way of a sale of shares in ABL and/or KPL, then it would not affect the regulatory position. The UR would expect to continue to regulate each of those companies under their generation licences in the same way that it does now, regardless of the identity of their shareholders.

If anything in the circumstances arising from the new ownership required it to do so, the UR would of course consider whether any conditions of the relevant licence ought to be modified. However, this would be unusual; generation licence conditions take a standard form for most operators, and we have no reason to expect this to change.

As a regulator, we have no specific powers in relation to any change in control of ABL or KPL. Some relevant powers rest with the Department⁸. But at most the UR would be a consultee of the Department before it exercised those powers. Our response if consulted would depend on the identity of the purchaser and all the other surrounding circumstances, and it is impossible to speculate about those issues at this time in relation to a purely hypothetical sale.

If the sale was an asset sale of one or more units at Ballylumford or Kilroot, any new owner would need either to hold an existing generation licence which allowed it to generate at those sites, or to apply to the UR for a licence authorising it to do so.

In either case, the regulatory position ought to be unaffected. An existing licence holder would be subject to the usual conditions of its licence, and again there would be no reason to expect these to change unless there were specific reasons to do so relevant to that operator. If any new licence application had to be made, the UR would consider it in the same way as it would consider any other application, and would assess whether the applicant was a suitable person to hold a generation licence.

a. Have you had any discussions with AES about this possibility?

The UR is aware that certain parties have expressed interest in the purchase of assets owned by the AES companies. While this possibility may have been mentioned in general

⁸ Schedule 1, paragraph 1(f) to the generation licence of each company.

terms as part of wider discussions with AES, the UR has not had any detailed discussions with AES, or indeed with any other party, on this matter.

As set out above, the UR adopts a neutral position in relation to any potential sale.

- 4. What implications will the delay to the go-live date for the I-SEM have on the all-island electricity market, security of supply for Northern Ireland, and the request by AES to close generating units at Kilroot and Ballylumford this year?**

The UR does not consider the delay to have any material impact on the security of supply for Northern Ireland. I have outlined the impact of the delay on the derogation process in my response to question 1(b) above.

- 5. What other assessment has the Utility Regulator made of how the CRM auctions and other I-SEM market systems will affect the financial viability of electricity generators in Northern Ireland, and what implications could this have for security of supply in Northern Ireland?**

The I-SEM market arrangements (including the CRM) have been developed following a very extensive series of consultations and industry engagement exercises. In particular, this includes the I-SEM High Level Design Decision⁹ which incorporated a comprehensive impact assessment.

Subsequent decisions on the detailed design of the various market arrangements have been made on the basis of the SEM Committee's statutory duties, and relied on clear assessment criteria which took into account the financial health of the market – for instance, ensuring that the trading arrangements promote competition between participants; incentivising appropriate investment and operation within the market; and not inhibiting efficient entry or exit.

The SEM Committee also monitors the financial performance of electricity generators on a regular basis, including by engaging external expertise to produce detailed market analyses¹⁰. This work will continue as part of the operation of the I-SEM.

⁹ [I-SEM High Level Design Decision](#), September 2014.

¹⁰ For example, the [CEPA Generator Financial Performance Report](#), December 2016.

a. What action could be taken to make the transition to the I-SEM more smooth and stable for Northern Ireland's businesses?

The UR recognises that the move to the I-SEM market arrangement, which introduces a more competitive dynamic, will inevitably create certain challenges for some electricity generators. However, consumers should ultimately benefit from the increased competition.

In developing these arrangements, a number of measures have been taken that will help aid this transition. For example, the CRM includes a mechanism that ensures a minimum level of generation is selected for capacity reasons in Northern Ireland as well as the for the all-island requirement.

In addition, we consider – as I explain more fully in answer to question 6 below – that the rules relating to for plant closure are appropriately designed to provide protection to Northern Ireland consumers and businesses should a generator seek to exit the market.

The UR also expects that, over time, the market will continue to evolve and improve – the SEM Committee, for example, is already consulting on the parameters that should apply for future capacity auctions¹¹.

6. To what extent does AES's requested derogation to close generating units at Kilroot power station raise wider questions about the rules for plant closures?

In broad terms, our view is that the request demonstrates rules that are working appropriately, as they are designed to do.

The rules are intended to be consistent with our principal objective and general duties. These are of course complex and require us to take many things into consideration. But in particular (and simplifying somewhat) they privilege a requirement to protect the interests of consumers in Northern Ireland, and in doing so oblige us to have particular regard to the need to ensure security of supply and to secure the financeability of licence holders.

In giving effect to these statutory requirements, the UR needs to strike various balances, and the rules in relation to plant closure are designed to do this.

¹¹ [Capacity Remuneration Mechanism – Parameters for T-4 2022/23 Capacity Auction – Consultation Paper](#), May 2018

On the one hand, the obligation on generators to provide 36 months' notice of any proposed closure allows for there to be a managed exit from the market, and in particular gives time to SONI to take any necessary mitigating actions to avoid the adverse effects that would occur if major generating units were taken off the system overnight.

On the other hand, the right of a generator to request a derogation from this obligation allows for the duty to be relaxed in any case in which the full notice period is not needed and system security and stability, and therefore security of supply in general, are able to be maintained (or any risks to them mitigated) if the closure occurs in a shorter timeframe.

One way of looking at this is that it entails striking an appropriate balance between the interests of the market as a whole and the interests of the individual company seeking to exit the market. As the Committee will no doubt appreciate, no *ex ante* rule could be written which would make suitable provision for all cases that might arise in the future. The determination of the correct approach in any given case will always be sensitive to the facts of that particular situation. The best that can be expected of any rules is that they establish a procedure under which this determination can be made when those facts are known.

This is exactly what the rules do, as reflected in the legal process in which the UR is currently engaged. They start from the default position of protecting consumers and ensuring system security and stability (the 36 month rule), but then allow generators the opportunity to show that the default position does not need to be insisted on in the individual circumstances of each case (the derogation request). The effect of this overall is to allow the UR, as regulatory authority for Northern Ireland, the power to determine the appropriate outcome in each case, giving effect to the principal objective and duties afforded to it by statute.

a. Is there a need to review industry rules about power station closures in order to avoid similar issues in the future?

The UR, in discussion with SONI, will keep the operation of the rules under review with a view to considering whether they can be improved in any way.

In particular, after the current derogation requests have been determined, the UR will review how the process worked and consider whether any changes need to be made to it for future cases.

However, while all processes are capable of improvement and refinement over time, we think it highly likely – for the reasons I have just given – that it will continue to be necessary to have in place arrangements broadly equivalent to the existing ones.

In other words, any rules that could be conceived of will need to continue to strike a balance between competing interests, and establish a framework in which an appropriate decision can be made by a suitable person when all the facts of each individual case are known.

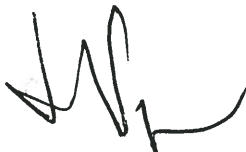
In any case in which a major generator wants to exit the market quickly, 'similar issues' to the ones raised by the present derogation requests may well arise, and that is almost certainly an unavoidable reality of the industry.

The question for us as Northern Ireland regulator is how those issues can best be addressed, appropriately respecting the interests of all parties, while ensuring that our principal objective and general duties operate to provide the legal framework for determining the best outcome in each case.

The UR will of course take into account in particular any suggestions that the Committee may have for improving the process. However, as I have said, any future arrangements are likely to have to bear a considerable resemblance to the existing ones.

I hope the information I have provided is of value to the Committee and I am of course happy to provide any further assistance you may require.

Yours sincerely



JENNY PYPER
Chief Executive