EP UK Investments Response to SEM-24-027 CMC Modifications Workshop 36 Consultation Paper

EP UK Investments (**EPUKI**) welcomes the opportunity to respond to this consultation paper. Each of the modifications considered in the consultation are discussed below.

CMC_02_24: Modification to Performance Security Requirement

EPUKI recognises the merit in the principles of this modification. Specifically, resolving barriers to entry for New Capacity which act to limit Security of Supply, and reflecting the duration of capacity contracts in Performance Securities and Termination Charges. EPUKI also acknowledges the questions raised at Capacity Workshop 36, specifically in terms of what is a reasonable level of reduction which should be applied to a one-year contract. EPUKI supports this modification in principle and believes that further consideration should be given to the details of its implementation.

CMC_03_24: Enduring Mechanism for Indexation Based on GB Model

EPUKI strongly supports this modification proposal and is disappointed in the SEM Committee's (**SEMC**) minded-to position. The only justification provided for this position is that it would represent a substantial change to current policy. However, EPUKI notes that this policy has failed to date to secure and deliver New Capacity at the scale required by the Irish market. Additionally, the issue of inflation risk was identified by industry over two years ago. Given the criticality of this challenge EPUKI would expect current policy to have been updated or at the very least reviewed within this timeframe.

The current policy framework which governs the Capacity Market places too great a burden of risk on developers of New Capacity. Inflation in 2022 demonstrated the impact that external global events can have on project costs and ability to deliver. While the 2028/2029 Capacity Auction parameters includes an increased price cap, failure to protect against inflation rates over the lifetime of a contract means that significant risk exposure still exists at the time of the Capacity Auction.

EPUKI first raised a modification on indexation in June 2022. This modification was raised following the Russian invasion of Ukraine and global re-opening following COVID-19 lockdowns. These events resulted in spikes to inflation, particularly related to costs of materials and equipment, which threatened the feasibility of Awarded New Capacity projects.

In February 2023, the SEMC consulted on introducing an indexation mechanism to address unforeseen inflation (SEM-23-014). Within this consultation, the SEMC stated that they may consider moving from the existing system where projects are based on fixed nominal prices to a system where capacity contracts are indexed over the lifetime of the project.

In September 2023, Energia raised a modification to introduce indexation for future capacity projects. EPUKI was supportive of the high-level principle of this modification but opposed to certain elements of its implementation (such as application to New Capacity from a certain date onwards only). The SEMC consulted on this modification and indicated a minded-to reject position, based on the fact that this modification would represent a "*substantial change to current policy"* (SEM-23-084). As part of this consultation the SEMC indicated that they would consider prioritising a review of an enduring indexation mechanism in 2023/2024.

The SEMC has now stated that it has not included this review on its workstream and is minded-to reject the proposed modification on the basis of substantial policy change. This is an irrelevant consideration and not a justifiable reason for rejecting the proposed modification. This issue has been on the radar of the SEMC for almost two years and the impact of high inflation on participants' ability to raise funds and invest in New Capacity is material. This contributed to the failure of the T-4

2027/2028 which resulted in less than 80MW of new gas turbine capacity bidding into the auction, despite the fact that over 3GW was qualified. It is irrational that the SEMC would reach this conclusion on the matter given the demonstrable impact on the efficacy of the CRM that inflation risk poses, and the extended timeline over which this issue has been known.

EPUKI would highlight that this issue has been directly addressed by Government departments within a number of renewable energy procurement processes on the island of Ireland:

- In November 2022, the Department for Energy, Climate, and Communication (**DECC**) consulted on the Terms and Conditions for the Renewable Energy Support Scheme (**RESS**) 3 auction. This included the introduction of indexation to the Strike Price, which was announced in May 2023. The indexation provision was retained for the February 2024 consultation on Terms and Conditions for RESS 4, where it was noted that such provision "*should reduce the risk and therefore offer prices".*

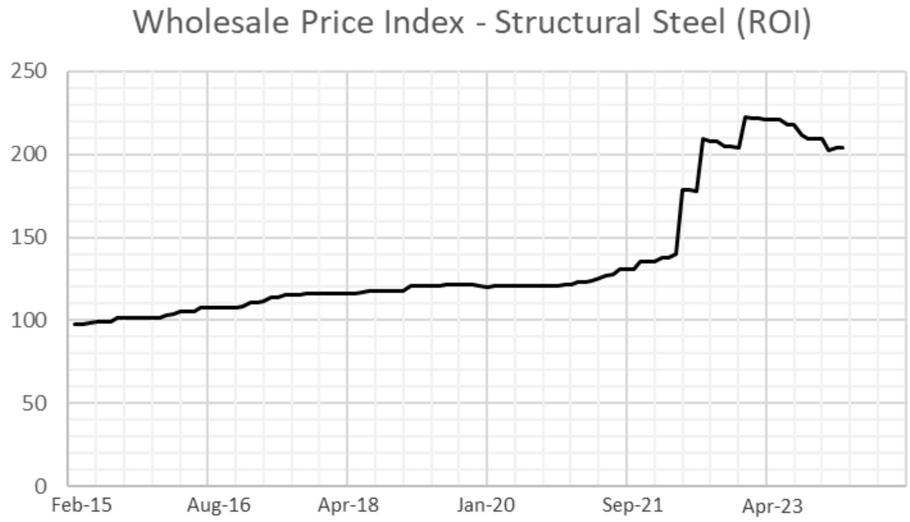
- In April 2023, DECC announced the Terms and Conditions for the Offshore Renewable Energy Support Scheme (**O-RESS**) which included a provision for indexation. In January 2024 it was announced that this provision would be maintained for O-RESS 2.

- In February 2024, the Department for the Economy consulted on design considerations for the introduction of a renewable energy support scheme in Northern Ireland. This paper identified the fact that indexation mechanisms offered benefits to consumers. Additionally, it was noted that the inclusion of an indexation mechanism supports investor confidence to increase participation in the support scheme.

- In March 2024, Eurelectric provided feedback to the European Commission on non-price criteria which could be applied to renewable support schemes. This report noted that the best way to incentivise timely project delivery is to make it attractive to build by addressing financial uncertainties that companies are facing. This report notes that CPI-linked indexation is now commonplace for support schemes throughout Europe.

The benefits of indexation mechanisms to reduce investment risk and consequently reduce costs for consumers has been well established and accepted within other sectors of the energy market. Additionally, the examples listed above demonstrate a clear ability for governing bodies and Departments to respond to challenging economic environments and address obstacles and to ensure continued investment in necessary energy generation. It is thus without sound reason for the SEMC to indicate that they will not introduce an enduring indexation mechanism after two years of discussion and modifications on the issue. Industry participants have dedicated time and resources to working with the SEMC to develop a necessary solution to a problem that the SEMC is able to, and indeed required to, address under its statutory and regulatory mandate, but is failing to do discharge its duties in this respect.

A key driver of capital expenditure for developers of thermal capacity is the cost of manufacture of components. As a benchmark, the wholesale price index for structural steel is included below:



It is clear from the above graph that the cost of steel, which is the main material required to construct a thermal generator was relatively stable from the inception of the new Single Electricity Market (**SEM**) arrangements and the Capacity Market up until March 2022. This has changed since the beginning of the Russia – Ukraine war and there is no evidence to suggest that economic conditions will revert back to previous conditions. Further, recent tension in the Middle East has resulted in material disruption to logistics and trade routes for key equipment and materials, and higher pricing and inflation persists.

EPUKI believes that it is necessary to reflect these prevailing economic conditions in the Capacity Market if the SEMC seeks to procure New Capacity to address the adequacy deficit which has been forecasted in both jurisdictions of the SEM. Failure to update policy to reflect this risk will undermine investor confidence. Based on the examples above, EPUKI believes it is feasible to address this through policy changes in a manner which is swift and efficient to ensure there is no further delay to new build capacity coming online via the Capacity Market. The SEMC should seek to implement this modification proposal in time for the T-4 2028/2029 Capacity Auction in November 2024. The urgent need to procure New Capacity through this auction has previously been identified by EPUKI and indicated to the SEMC in response to the consultation on parameters for the T-3 2027/2028 Capacity Auction and T-4 2028/2029 Capacity Auction. In January 2024, EirGrid at the Joint Committee on Environment and Climate Action identified the enduring problem of the failure of the Capacity Market as one which needed to be "*resolved as a matter of urgency".*

Failure to procure adequate capacity though this auction will represent a significant risk to Security of Supply, as well as a negative impact for consumers. The consumer in Republic of Ireland is expected to incur costs of almost €1bn by the end of 2024 through the external procurement of Temporary Emergency Generation. This is a distortional cost for consumers, particularly when considering the duration of this capacity compared to New Capacity procured through the Capacity Market (approximately 15 times higher than the 2027/2028 T-4 Auction Price Cap on a per MW basis), as well as the environmental impact of more carbon intensive generation. The costs for consumers associated with introducing an enduring indexation mechanism is fractional compared to further out-of-market capacity procurement which represents a possible breach of European Union State Aid law absent State Aid Approval.

In terms of the mechanics of the modification itself, EPUKI welcomes the amendments which have been applied from previous modifications seeking to address inflation risk (07_22 and CMC_22_23).

EPUKI is strongly supportive of this modification given its benefit to Security of Supply, consumers, and its alignment with the Capacity Market Code objectives.

CMC_04_24: Recovery of Net Present Value Lost as a Result of No-Fault Delays to New Capacity Projects

EPUKI is disappointed by the SEMC's minded-to position to reject this modification. This modification was raised to increase the likelihood of Awarded New Capacity delivering in the Capacity Market and to mitigate against risks outside the control of the participant. As outlined above, the risk to Security of Supply and cost to consumer of not delivering New Capacity is significant. Based on this, EPUKI believes that the SEMC should take steps to ensure that the feasibility of New Capacity is not threatened by external circumstances which participants have no means to address.

The current arrangements under the Capacity Market represents an inappropriate balance of risk, in which developers of New Capacity projects are burdened with the potential downsides of State agencies failing to deliver. Developers are already tasked with permitting and constructing a power station within the relevant timeline of the Capacity Auction. EPUKI considers it reasonable to expect a third-party to deliver a gas and/or grid connection in this timeframe. However, the current arrangements offer no incentive for third parties to execute their functions in a timely manner. If they cannot deliver on time, then the investor in New Capacity should not suffer the consequences.

In the consultation paper the SEMC raise concerns about the term "*No-Fault Delay Costs*" and specifically how fault would be attributed. EPUKI notes that the mechanism available under this modification proposal would only be available where an extension under Section J.5.6, J.5.7, or J.5.8 has been received by a participant with respect to a relevant New Capacity project. These extensions are approved by the Regulatory Authorities which confirms the validity of an extension. This means that an assessment of whether or not a delay is the fault of a participant has already been made. EPUKI believes that this should address concerns that the SEMC has identified with respect to attribution of fault. Notwithstanding this, the term "*No-Fault Delay Costs*" does not seek to attribute fault to any third-party, but rather should be adopted when a delay can be demonstrated to not be the fault of a participant.

The SEMC also raises concerns around the calculation of this term and the perceived impact on incentives for timely delivery. EPUKI believes that the calculation of the time value impact is straightforward. The only variable inputs to this calculation would be the Weighted Average Cost of Capital (**WACC**), and the length of a delay incurred. The length of the delay will have already been considered and approved as per the pre-requisite for extension approval identified above, which means that the WACC is the only new variable associated with this modification. In the interest of simplicity and objectivity, EPUKI recommends that the SEMC establish a single WACC for each Capacity Auction, based on prevailing economic conditions, and applies it with respect to all projects in that auction. We further consider that the risk appetite for generation investment needs to reflect properly and that the beta and related settings for the calculation should be consulted and opined upon in time for the T-4 2028/2029 Capacity Market Auction.

The other element proposed in this modification was related to construction cost increases incurred due to the need to retain or redeploy third-party contractors in the event that a delay is incurred. EPUKI notes that these costs will not be relevant in many cases and largely depend on what stage a New Capacity project is at when a delay is incurred. For example, if a team of contractors is on-site to carry out pre-connection testing or first-fire and a delay is incurred to the electricity or grid connection date, the project will incur costs associated with lost-time and retention of crews on site. EPUKI believes that these costs would be easily verifiable and would be included in contracts with third parties which could be demonstrated to the SEMC where incurred.

This approach significantly reduces the perceived complexity of this modification. In addition, it provides greater transparency to participants, and ensures equal and objective treatment of all projects awarded contracts in a given Capacity Auction.

EPUKI strongly refutes that this modification would have any impact on incentives for timely delivery. As outlined above and in the modification proposal, the proposed cost recovery mechanism would only be available to projects which have received an extension under a relevant section of the Capacity Market Code. This means that the delay itself will have already been incurred by a project and remedial actions to address that delay will have already been approved by the SEMC.

This modification only seeks to address the cost impact of postponing the Capacity Payments which have been offset by the delay. For example, if a New Capacity project incurs a three-month delay due to an unsuccessful third-party planning challenge and is subsequently granted a three-month extension by the SEMC, this modification will cover the difference in value of three months of payments in October 2028 compared to three months of payments in October 2038. As set out above, this value will be calculated based on a WACC approved by the SEMC.

This modification would therefore not be expected to have any impact on delivery timelines, nor on a participant's incentive to deliver in a timely manner. Rather, it is a straightforward correction mechanism to ensure that participants are made whole where they have incurred a delay outside their control.

This modification is strongly aligned with the objectives of the Capacity Market Code as set out in Section A.1.2.1. This modification, if approved, would increase the likelihood of New Capacity participating in future Capacity Auctions, and increase the likelihood of Awarded New Capacity delivering. EPUKI once again highlights the urgent need to secure and deliver New Capacity through the T-4 2028/2029 Capacity Auction. This modification aligns with the objective to ensure Security of Supply and also aligns with the consumer interest.