

NORTHERN IRELAND ELECTRICITY plc

**Single Electricity Market
Fixed Cost of a New Entrant
Peaking Plant for the CPM**

**Decision and Further
Consultation Paper**

**NIE's Response to
AIP/SEM/07/14**

13 March 2007.



Executive Summary

Provision needs to be made for the recovery of the cost of gas capacity. However, under the RAs' proposals recovery is excluded from the cpm, and on the basis of the proposed bidding principles it appears that it may also be excluded from the energy price. The paper seems to have overlooked the fact that the postalisised arrangements for charging for gas infrastructure in NI are not based on the concept of booking capacity on a day ahead basis. In NIE's view, gas capacity represents a fixed cost which should be recoverable under the cpm.

The application of the RoI rates for ancillary services and corporation tax understate the value of capacity and will tend to bias the outcome against new build in NI. Given the scheduled plant closures in NI, we are concerned that this approach may give rise to security of supply issues, at least in the period before enhanced interconnection is established.

The way in which other factors, such as inframarginal rents and the omission of the cost of fuel stocking, are applied to the BNE calculation would tend to understate the value of capacity, thus undermining the incentives for generation investment.

The proposal for annual resetting of the cpm parameters risks creating a regime that lacks stability

Introduction

There are common elements in the RAs' consultation papers on the "Fixed Cost of a New Entrant Peaking Plant for the CPM" and the "Loss of Load Probability Curve for the SEM" and in NIE's responses to both papers.

This response does not repeat all our previous comments on the CPM but concentrates on a few areas, particularly where we have obviously not made our points clearly enough and the RAs have not understood them. In this consultation, this particularly relates to the nature of energy credits for peaking plants and the failure to include the cost of gas transportation capacity. Other general comments are made in the final section of this response.

Peaking plant energy credits

The RAs' assumption that a new peaking plant will have net energy credits which can be deducted from the capital cost implies the existence of other less efficient peaking plant. This will be either because there is an assumption of technical progress or physical degradation (and so new plant is more efficient than old plant) or because there is smaller scale less efficient peaking plant.

If there is technical progress this should be allowed for in assessing the cost of capital and so raise the cost estimate in other ways but, in their response to NIE's comments (p44), the RAs say, "there is little evidence to suggest that the cost of peaking plants will decrease over time or that efficiencies will dramatically increase." If so, this source of energy credits is excluded¹.

If there are smaller less efficient peaking plant in place this suggests that the increment being considered by the RAs is too large, significant disadvantages of size are being ignored and the capital costs are understated (rather than that it is legitimate to deduct an energy credit). NIE has argued this in previous responses and remains of this view. It may be possible to argue that it was efficient to install smaller, more expensive plant when the systems were separated and before the SEM but that the larger scale is now appropriate. However, the argument is not very persuasive and, even if valid, implies only a transitional impact.

There remains only the argument that a new peaking plant would derive energy credits from bidding lower than an old peaking plant whose efficiency has degraded. The assumed new efficiency is 36.3% and the lifetime efficiency 35.6%. Given an assumption of how often old peaking plants were at the margin, it would be possible to calculate simply the net present value of the declining lifetime energy credits from this factor and turn that present value into an annuity to deduct from the annual capital cost. The sum is unlikely to be large.

¹ Nevertheless, the risk of loss is present. The RAs' response on page 30 to the ESBPG comment clearly states that improvement in performance and changes in capital cost will be captured in future BNE calculations.

NIE remains of the view that it is not appropriate to deduct an estimate of net energy credits from the annual cost of peaking capacity.

Gas Capacity

On page 12, in the section on cost assumptions, it is said that gas capacity is not a fixed cost and should be excluded from the cost of the OCCT. This assumes there is liquidity in the market for gas transportation capacity which does not exist at present. Similarly, it is difficult to identify whether a plant could be financed at a low WACC if it doesn't have gas transportation capacity to enable it to run when it is actually needed.

In any event, if a peaking plant is to be "available" each day and declares itself available, it must have the gas capacity available to support that declaration: otherwise it is making a fraudulent declaration (probably in breach of the Grid Code). Hence on a daily day ahead basis (and for the duration of the trading day) it needs to have the gas capacity regardless of whether it is actually called upon by the System Operator to run. Hence gas transportation capacity is a sunk/fixed cost.

Moreover, the SRMC bids do not recognise gas capacity costs as a legitimate marginal cost and hence the RAs proposals effectively exclude the recovery of fixed gas transportation costs in the market.

The issue is also relevant on page 21 where the cost of gas capacity is omitted.

Other comments

1. NI/RoI differences: Ancillary service credits, tax etc.

In section 3(a), "Revenue Assumptions", the proposal is to use RoI ancillary service rates. This will disadvantage NI generation since they are receiving lower ancillary service payments than is assumed in the derivation of the CPM prices. Similarly, the use of the lower RoI corporate tax rate means that, even if the other items in the WACC calculation were correct, the cost would be based on a cost of capital lower than is available in Northern Ireland.

The RAs counter (p14) that costs are such that new peaking plant would site in RoI and so that it is at present appropriate to use RoI costs. However, the CPM should be generic and not imply such a degree of regulatory intervention. There are capacity closures planned in N. Ireland over the next 4-5 years and prior to the increase in the transmission capability between NI and RoI, replacement mid-merit / peaking plant will be required in N. Ireland. On the basis of the current capacity pricing signal, such capacity will not be properly remunerated which will result in a security of supply issue for N. Ireland customers.

The suggestion that future BNE prices might be based on siting in N. Ireland highlights our concerns about uncertainty, volatility and regulatory risk.

2. Fuel Stocking

The derivation of the BNE costs in Section VI of the paper makes no reference to the capital cost of constructing fuel storage and handling facilities. There is also no reference to the capital cost of actually holding backup fuel stocks. These costs should be included.