



Energy for
generations

ESB Generation and Trading's Response to Best New Entrant Net Cost of New Entry (BNE Net CONE) Consultation Paper

(SEM-22-076)

30/11/2022



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1. INTRODUCTION

ESB Generation and Trading (ESB GT) welcomes the opportunity to respond to the Best New Entrant Net Cost of New Entry Consultation Paper (SEM-22-076). The purpose of this Consultation Paper is to provide comments on the review of BNE carried out by CEPA and Ramboll (SEM-22-076a).

ESB GT's response is broken into four sections; the first is an executive summary of ESB GT's response to the Consultation Paper. The second section outlines ESB GT's support for the EAI consultation response and Frontier Economics' expert review on BNE Net CONE. The third section provides ESB GT's comments on specific aspects of the CEPA/Ramboll BNE Net CONE report. The fourth and final section provides comments on the purpose of BNE Net CONE within the CRM, and how this purpose can be best achieved in the market and political context both today and into the future.

2. EXECUTIVE SUMMARY

The BNE Net CONE is an integral part of the I-SEM CRM Auctions as it sets the Auction Price Cap, Existing Capacity Price Cap and New Capacity Investment Threshold. ESB GT has called for this review over the past few years and welcomes the fact that a consultation has been brought forward on this topic, however, serious concerns exist over several features of this process and its proposals. For example, several issues around the governance processes in this Consultation paper have made it difficult for industry to effectively engage with the proposals. These issues namely relate to the publication of this Consultation Paper after the T-4 parameters consultation (SEM-22-015) and the T-1 parameters consultation (SEM-22-064) earlier this year. ESB GT also believes that from a governance perspective, publishing a substantial reduction in the BNE Net CONE, which has a foreclosing impact through the Auction Price Caps, has sent an alarming signal to the market that the necessary investment in New and Existing Capacity should not be made during a time when the TSOs¹ and CRU's² are identifying system adequacy shortages.

ESB GT believes that the CEPA report upon which the RAs proposals are based have serious shortcomings which ultimately produce a BNE Net CONE estimate which is not credible and works against the current needs of the SEM. The assumptions underlying IMR, DS3 and cost of capital are some of the main issues which ESB GT has identified. Many other issues with the assumptions and

¹ https://www.eirgridgroup.com/site-files/library/EirGrid/EirGrid_SONI_Ireland_Capacity_Outlook_2022-2031.pdf

² <https://www.cru.ie/wp-content/uploads/2022/06/CRU202264-Electricity-Security-of-Supply-Programme-of-Work-Update.pdf>

methodology used by CEPA have been highlighted in an expert review done by Frontier Economics, which has been submitted with the EAI's response and which ESB GT fully endorses.

This Consultation Paper thus far represents a missed opportunity for the RAs to engage with industry on the role of the BNE Net CONE, and how it can best support the objectives of the CRM. We are now faced with a context of the security of supply crisis, the rapidly changing market landscape, as well as the urgent need for the electricity sector in Ireland to lead on the country's decarbonisation pathway. ESB GT believes that in the face of these issues, the CRM has an evolving objective not just to secure the cheapest possible capacity, but to secure a diverse, resilient and low carbon ready portfolio which is best suited to ensuring that Ireland's RES targets are met securely.

Recommended approach:

1. Withdraw consultation: ESB GT believes this Consultation Paper should be withdrawn and instead used as a steppingstone from which the RAs can work together with industry to find interim (for the upcoming T-4) and enduring frameworks which will allow the BNE Net CONE to evolve alongside the CRM such that it continues to support its objectives.
2. Move to ex-post review (GB solution): To allow the next auction round to be effective and prevent time being used currently to find an "ideal" alternative for the future (such as carbon budget management) a GB style approach may be right for an immediate but effective steppingstone to secure the island's security of supply. If this is not possible, the minimum should be for the RAs to at least reflect the assumptions captured in the EAI response in the BNE calculation. **This is ESB GT's preferred solution.**
3. Revise BNE parameters to reflect all relevant assumptions: As an alternative to the ex-post review proposal, ESB GT would support adoption of a revised BNE, which reflects all relevant assumptions captured by FE (provide) details
4. Clarify timing: Publish a decision and corresponding timetable clearly setting out pathway to T-4 auction

3. EAI RESPONSE

The Electricity Association of Ireland (EAI) has submitted a response to this Consultation Paper on behalf of a significant part of the energy industry that it represents. As part of that response, Frontier Economics has carried out an expert review of the CEPA/Ramboll report for the EAI. Frontier Economics' findings are presented in a report which is appended to the EAI response.

The key findings of the Frontier Economics review are as follows:

5. The proposed reduction in BNE Net CONE risks undermining the success of the CRM;
6. The increased uncertainty facing a CCGT through substantial reliance on energy market revenues has been recognised in CEPA's report but not incorporated into the approach taken;
7. Insufficient detail has been provided to allow for stakeholders to fulsomely comment;
8. There are a number of issues with individual parameter estimates and assumptions in CEPA's report;
9. The SEM Committee should consider how BNE Net CONE is applied, to ensure that the objectives of the CRM are met.

ESB GT endorses the EAI response and the expert review from Frontier Economics and requests that the SEM Committee consider the EAI response in conjunction with this response.

4. CONCERNS WITH THE CONSULTATION AND REPORT

ESB GT has a number of concerns with this consultation, from the governance procedures followed by the RAs, to the methodology and assumptions employed by CEPA in several areas in their report (SEM-22-75a). That the RAs have now brought forth this Consultation paper which works against the current needs of the SEM (in the form of an urgent need for capacity) by lowering the BNE Net CONE so substantially sends an alarming signal to the market. ESB GT believes the best course now is an immediate pause and re-examination of how the BNE Net CONE can best support the objectives of the CRM.

4.1 Governance

ESB GT would like to express its concern with the governance procedures and overall process followed during this BNE Net CONE consultation. Hitherto this point, several decisions have been taken by the RAs which have made it difficult for industry participants to engage effectively with the regulatory process. Some decisions which ESB GT note in particular include:

10. Publishing the BNE review and consultation after the auction parameters consultation;
11. A relatively short consultation period to deal with what is a very significant reduction in BNE, which has large potential ramifications for the market;
12. A serious dearth of detail and supporting data and assumptions, without which meaningful analysis and scrutiny from industry is impossible.

Without sufficient time and transparent supporting evidence and detail, it is not possible for industry participants to sufficiently analyse and consider the proposals being made. Whilst ESB GT recognises that the BNE QA Exercise (SEM-22-087) was published with the intention of clarifying assumptions and methodological decisions, the timeframe which industry was given was not sufficient to ask the required questions of a complex quantitative exercise such as this one. In addition, the date by which CEPA replied to industry questions was insufficient to allow industry to properly consider and incorporate the answers into their consultation responses.

With respect to SEM-22-087, ESB GT notes with concern that when asked why it was not possible to commission specific model runs for IMR, CEPA responded that its '*analysis was constrained by the time and resources available prior to the consultation*'. Below ESB GT details the main concerns with the approach taken on IMR, but would note that the IMR results appear to be badly misaligned with reality, yet the IMR results for a CCGT lead to its selection as the BNE plant. ESB GT is alarmed that the RAs have put forward results based on analysis which was so lacking in time and resources, which have the potential to foreclose on investments in New and Existing Capacity.

ESB GT would like to express its concern that by setting a BNE significantly lower than the current level, the RAs are effectively signalling to the market that they do not want investment in new or existing capacity, despite the clear need for both which has been articulated by DECC, the CRU and the TSOs. Using the current APC and ECPC multiples, the proposed BNE Net CONE of €58,310/MW/year proposed by the RAs would not just likely foreclose on New Capacity bidding into the SEM, but also prevent Existing Capacity from making upgrades to their assets which would extend their life and operation in an efficient way. This would constitute a failure of the CRM to deliver on its objectives and represent a material waste of SEM customer money as assets exit the market earlier than is necessary.

This signal is highlighted in Figure 1 below, which shows capacity-weighted clear prices of new and existing capacity in recent auctions³, against the new BNE net CONE combined with the current APC and EPC multipliers.

³ SEMO data does not explicitly provide for New and Existing Capacity. ESB GT analysis uses contract duration as a proxy in this case, discounting any 1 year contracts with clear prices above €80k.

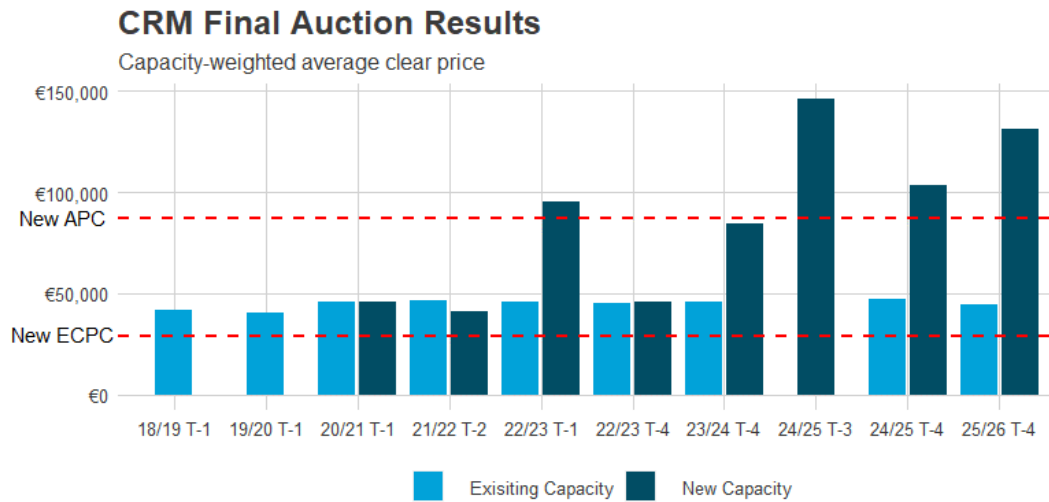


FIGURE 1

ESB GT would also like to express alarm at the signal being sent to the market at this time. Today, the SEM is facing an acute adequacy problem, with amber alerts and the risk of possible backouts expected for several winters ahead⁴. The need for new generation to solve this problem is made clear in EirGrid/SONI’s Generation Capacity Statement 2022-2031⁵, which states the need for ‘*delivery, through the all-island capacity auctions, of over 2,000 MW of enduring flexible gas-fired generation capacity, which is renewable gas ready, by 2030*’. This ambition is being supported and delivered as part of the CRU’s Electricity Supply Programme of Work⁶. The signal being sent by the RAs in this current BNE Net CONE Consultation Paper is at odds with both the TSO’s articulation of SEM needs and the CRU’s urgent work programme, ultimately sending a signal which risks deepening the current adequacy crisis.

Additionally, the current BNE methodology makes no provision for new plant being renewable-gas ready. In ESB GT’s view, this decision will set the SEM up for failure to deliver on the promise of Ireland’s low carbon future, locking in unabated plant today which will be incompatible with Ireland and Northern Ireland’s 2030 targets and beyond. There are clear risks to ultimately wasting SEM customers’ money if plants being delivered in 2026/2027 are not fit for a decarbonised system post-2030. This is

⁴ https://www.eirgridgroup.com/site-files/library/EirGrid/EirGrid_SONI_Ireland_Capacity_Outlook_2022-2031.pdf

⁵ https://www.eirgridgroup.com/site-files/library/EirGrid/EirGrid_SONI_Ireland_Capacity_Outlook_2022-2031.pdf

⁶ <https://www.cru.ie/wp-content/uploads/2022/06/CRU202264-Electricity-Security-of-Supply-Programme-of-Work-Update.pdf>

a significant item that should be considered when determining a BNE methodology as it is not just the BNE for 26/27 that needs to be considered it is the future portfolio required for net zero.

4.2 Revenues

When examining the CEPA/Ramboll report, ESB GT is very concerned about the assumptions used in calculating expected revenues for the BNE plant. These concerns apply to both infra-marginal rents (IMR) in the energy market and system services revenues (DS3) and can broadly be placed into one of two categories:

- i. Compatibility of assumptions with current market evidence and regulatory signals;
- ii. Rigor of assumptions relating to future market expectations.

Below ESB GT sets out the main concerns with each revenue stream, primarily focusing on CCGT revenues as this is identified by CEPA as the BNE plant and relies most heavily on the revenue assumptions made.

4.2.1 IMR

IMR refers to the revenues which can be earned by selling electricity into the market. The rent opportunity arises because the SEM operates a marginal pricing merit order system. This means that in any given hour, plant are dispatched in ascending order of marginal costs, and the plant with the highest marginal cost of supplying electricity sets the price for all plant which are in the market. Any plant which dispatches ahead of the marginal plant will earn the difference between their marginal costs as IMR.

The ability of a BNE plant to earn IMR therefore depends on their position in the merit order, their annual run hours, and the marginal price setting plant in each year considered. The original CEPA report has a dearth of details on nearly all of these factors, making meaningful comment on their IMR calculations very difficult. However, ESB GT would like to call attention to several apparent assumptions.

First, the assumed load factor assumed for 2026/2027 (which is then carried forward for 10 years) is 65%. Without providing any detail on the modelling done, it is not possible for ESB GT to accurately assess what CEPA have done, however this load factor does appear to be significantly higher compared to estimates from other sources engaged in SEM modelling. Evidence from ESB GT's own internal modelling suggests a load factor for a CCGT of ~40% in 2026/2027, which is close to independent modelling contained in Frontier Economics' expert review.

Second, CEPA have assumed that IMR remains constant over the period of the capacity contract, though it is not clear how this is approached for the full plant lifetime. In any case, ESB GT believes this is a flawed approach. A constant IMR implies that the BNE plant (a CCGT) is either:

- iii. maintaining the same efficiency differential to the marginal plant and the same run hours in all years considered; or
- iv. running for fewer hours but achieving an even larger efficiency differential compared to the marginal plant.

As Ireland's electricity system decarbonises and as new low-carbon generation comes online in the coming decade, it seems that either of the above is a rather dubious assumption. By 2030, according to government targets and TSO forecasts, Ireland will have reached 80% RES generation and 95% SNSP capacity. So long as the BNE Net CONE methodology does not provide for renewable gas readiness or carbon capture technology in its capex assumptions, it is unclear how an unabated⁷ CCGT would expect to maintain its position in the merit order and running hours as we move into this 2030 world and beyond. It is equally unclear why such a plant would expect to earn rents high enough to compensate for declining running hours as its position in the merit order deteriorates. This fact is indeed recognised by CEPA in their own report, who speak to the fact that *'it may be appropriate to apply some form of reduction to the CCGT infra-marginal rent figures to reflect lower rents in the later years'*. Whilst CEPA/Ramboll do present a sensitivity to this effect which show revenues which are ~80% lower than the base case, this figure does not actually feature in the final BNE Net CONE.

4.2.2 DS3

DS3 revenues make up a meaningful portion of the total expected revenues for a BNE CCGT plant, meaning the assumptions made about DS3 revenues are materially important to the final BNE Net CONE. However, it is ESB GT's view that the assumptions underpinning DS3 revenues are misaligned with the current signals being sent by the RAs.

CEPA have assumed that DS3 tariffs are reduced by 20% compared to current rates, however a recent EirGrid/SONI Consultation Paper⁸ has proposed significantly deeper cuts to DS3 revenues. ESB notes that no final decision has been taken, but that suggestions indicate some form of:

- i. 25-35% cuts which would apply from Q1 2023; and

⁷ ESB GT assumes that the CCGT is unabated as there is no provision made for renewable gas readiness or CCUS retrofitting.

⁸ <https://www.eirgridgroup.com/site-files/library/EirGrid/DS3-System-Services-Consultation-16-Sept-2022.pdf>

- ii. further reductions of 7-10% for each additional 100 MW of fast acting services procured following Procurement Gate 7;
- iii. a combination of lower cuts from (a) and (b) above with reduced scalars.

The above proposals also follows a 10% reduction to tariffs last year. The lack of alignment between this Consultation Paper and the recent publications from the TSOs reduces the credibility of the DS3 assumptions made by CEPA. Additionally, CEPA have applied an uplift to the 20% DS3 discount, however given that DS3 tariffs are not indexed to inflation. Whilst ESB GT believes the value of system services should be reflected and the total expenditure on system services should increase in the future as we reach a 95% SNSP limit in 2030, considering the RAs comments in the latest DS3 workshop that unit prices should decrease in an oversupplied market, ESB GT doesn't understand how CEPA have applied this approach on behalf of the SEMC.

As in the IMR assumptions, DS3 revenue estimates also rely on the BNE plant maintaining its already high annual run hours for the duration of the capacity contract. For the reasons already given above in the IMR section, ESB GT finds this assumption to be problematic.

Finally, ESB GT would like to note its continued concern with the inclusion of DS3 revenues in the first place. Through the inclusion of DS3 revenues in the BNE Net CONE methodology / USPC process removes any incentive for participants to invest in DS3 products. ESB GT believes the design of I-SEM (DS3, energy markets and CRM) must be approached in a holistic way. ESB GT is of the view that the current procedures for the calculation of the BNE Net CONE strips away the incentive to provide additional system services when the DS3 commercial advantage is removed from the potential capacity payment. If the net sum position of a plant's "allowable" cost recovery, due to BMPCOP, NIV tagging in the Balancing Market and BNE Net Cone/USPC less DS3 revenue is zero, the incentive to invest in other services no longer exists.

The cost based regulation approach applied to I-SEM, DS3 and CRM means any DS3 investment decisions results in a zero sum game as any impact on revenues from a DS3 investment is offset in the CRM IMR bid determination. ESB GT believes a more holistic value based approach must be applied I-SEM, CRM and DS3 in order to ensure customers get the full benefits of I-SEM.

For the reasons described above, ESB GT believes the proposed BNE Net CONE needs to be revised to ensure investment in much needed DS3 products is encouraged.

4.3 Cost of Capital

The net present value of any project is influenced heavily by the cost of capital which is used to discount expected future costs and revenues. Whilst deferring to Frontier Economics' expert analysis on the cost of capital and its individual parameters, ESB GT would like to highlight two major conceptual issues with the approach taken by CEPA in assigning a cost of capital.

The first and foremost of these issues is in the decision to apply one single cost of capital across all technologies considered, differentiating only by region. The problem with this approach is that it fails to recognise the fundamental impact which uncertainty has on a project's hurdle rate. This is the underlying principal of risk and reward. As described in the CEPA report, the ultimate Net CONE for a CCGT relies significantly on expected energy market revenues, which come primarily from IMR and DS3. As discussed above in this response, and as acknowledged by CEPA in their report and by the RA's in the accompanying consultation paper, there is a very large degree of uncertainty surrounding the potential IMR and DS3 revenues which will be available to a best new entrant over the life of a plant. This is in contrast to an OCGT (the gas plant type which has dominated in recent capacity auctions in the SEM), where nearly all revenue comes from capacity payments and so is far more predictable and less risky.

The current approach to cost of capital fails to account for the divergence in risk profiles when considering a CCGT versus an OCGT. Presented with the same nominal returns, a rational investor is unlikely to accept the significantly higher risk undertaken when building a CCGT.

The second issue with the cost of capital as calculated by CEPA relates to the final point estimates for Ireland and Northern Ireland as compared to Pöyry's 2018 estimate. At a high level ESB GT believes it is unreasonable to conclude that the cost of capital has decreased since 2018. At that time, interest rates had spent years at historic lows, meaning record low debt costs and a record low risk free rate. Since that time however, and particularly in 2022, the macroeconomic context has changed dramatically. War and decades high inflation have precipitated one of the most aggressive monetary tightening cycles in living memory, with huge ramifications for the cost of capital. Despite this, CEPA's analysis has shown the cost of capital moving downward. ESB GT believes that this fact alone warrants a complete re-examination of how the cost of capital has been calculated.

5. OBJECTIVES OF BNE NET CONE IN THE CRM

With this Consultation Paper, the RAs have proposed a very substantial reduction in the BNE Net CONE, which has serious implications for the Auction Price Caps and Demand Curve, and by extension the CRM itself. In their current form, these proposals would feed through the entire SEM and have

ramifications for years to come. ESB GT notes that the RAs have brought forth this substantially reduced estimate of BNE Net CONE at a time of extremely challenging circumstances for the market, namely in the shape of:

- i. A security of supply crisis, high inflation and rapidly rising interest rates in the immediate term;
- ii. Changing demands on the electricity sector in the form of the BAT, increased CAP targets, and other sector developments, and
- iii. A pressing need to rapidly decarbonise the SEM in the face of significant demand growth in the medium term.

In the face of the above challenges, ESB GT is of the view that this Consultation Paper and the proposals therein are completely misaligned with the now urgent needs of the market, which are:

- i. Securing 2000 MW of flexible gas-fired generation by 2030;
- ii. Securing a mix of dispatchable assets which will contribute to a low carbon system which is resilient to the challenges which will come with increasing RES penetration;
- iii. Securing value for money for SEM customers through efficient investment in New and Existing capacity that is fit for a low carbon 2030 and beyond.

ESB GT believes that this consultation should be withdrawn, and instead this should act as a stepping stone to a wider discussion of how the CRM is delivering on its objectives, and whether the BNE Net CONE and Auction Price Caps contribute to this delivery. If this is not possible, in the interim, the minimum should be for the RAs to at least reflect the assumptions captured in the EAI response in the BNE calculation.

As stated in this Consultation Response, ESB GT does not believe that the BNE Net CONE has been correctly estimated, and has instead produced a result which could foreclose on investment in New assets through the APC. In addition the estimate, if adopted, could also significantly increase the administrative burden on both generators and RAs for Existing assets which would need to apply for USPCs in significantly greater numbers. However, it must also now be considered whether even a 'correctly' calibrated BNE Net CONE (as it is currently defined) can contribute positively to the urgent issues in the SEM. Below, ESB GT offers some comments on how BNE Net CONE interacts with the CRM and how this can be best optimised for today and into the future.

5.1 Purpose of the BNE Net CONE in the CRM

The 'missing money' problem arises when a generator's expected market returns alone cannot cover their costs. The objective of the CRM is to solve this 'missing money' problem such that there is sufficient capacity in the SEM. In this context, sufficient capacity refers to the capacity level required meet the agreed upon reliability standard, which is currently set at 8 hours Loss of Load Expectation (LOLE) in the SEM.

The CRM operates a competitive auction format to meet its objective of procuring sufficient capacity at least cost to customers. The BNE Net CONE is envisaged as a tool which can support this objective through the construction of Auction Price Caps. The Auction Price Caps are set at multiples of the BNE Net CONE. Currently, these multiples are:

- i. 1.5x BNE Net CONE for the Auction Price Cap (APC) for New Capacity;
- ii. 0.5x BNE Net CONE for the Existing Capacity Price Cap (ECPC)

Correctly calibrated, these Auction Price Caps have previously had the potential to protect against market power manifesting through excessive bid prices, whilst still ensuring that sufficient capacity is procured. However, ESB GT believes that the balance of risk between constraining potential market power and foreclosing on legitimate capacity bids has now shifted such that the BNE Net CONE must be reconsidered and adapted to the current context.

5.2 BNE Net CONE in the Current Context

As described above, the original objective of the CRM is to solve the 'missing money' problem such that there is sufficient capacity in the SEM. This must evolve however, as there is now a need not just to secure the cheapest capacity available, but the right mix of capacity which is fit for the future. In practice, this means the CRM must evolve in two key ways:

- First, the CRM must procure a diverse mix of technologies which can contribute to a high-RES system in different ways – for instance, peaking plants to support during shorter periods of high net demand, efficient baseload power to support during longer periods of low wind (i.e. 'Dunkelflaute'), and batteries to manage demand peaks.
- Second, the CRM should encourage capacity which is fit for a low carbon environment, such as gas fired plant which are ready for renewable gas or carbon capture technology. Existing capacity must be incentivised to make low carbon upgrades so that maximum value for money for SEM customers is achieved.

In its current form, the BNE Net CONE works against these objectives. By estimating the Net CONE of the cheapest capacity, only the lowest cost capacity will bid into the market, preventing a diverse portfolio of assets from qualifying, clearing and providing the resilience that the SEM needs as it continues to decarbonise. Assets are also dissuaded from being renewable gas / carbon abatement ready, meaning that SEM customer money is wasted procuring capacity which is unlikely to be able to contribute meaningfully to a post-2030 power system. ESB GT notes that the issues described here apply to a theoretically 'correct' BNE in its current form. The BNE assumptions presented as part of this consultation are not credible or correct and so further exacerbate the issues described here.

5.3 Options available

ESB GT recognises the needs for safeguards against the exercising of market power in the CRM. The current BNE Net CONE and approach to the Auction Price Caps is designed to meet this objective, but has several limiting features which have existed since its original design. These features include:

- The risk of under-investment in New and Existing Capacity if the BNE Net CONE is too low;
- The inability to procure a diverse portfolio beyond the absolute minimum cost capacity;

For the reasons described above, ESB GT believes that these limitations have become too costly, and that regulatory prudence now suggests a new enduring approach. ESB GT believes that there are several options here which could be explored.

ESB GT supports the findings of the recent EY Review of the Performance of the SEM Capacity Remuneration Mechanism⁹ with respect to the ECPC, which states that:

While [the ECPC and USPC] are important mitigants against market power, an adverse effect of these rules has to been to limit the potential for price discovery and to increase the risk that existing plants are unable to recover their ongoing fixed costs through the auction. This could ultimately lead to plant seeking to shut sooner than they would otherwise do even where they require less remuneration than alternative new build.

A more proportionate approach to mitigating market power – i.e. that does not foreclose potential for price discovery among existing plants – would seek to focus bidding restrictions on exceptional cases. This could be achieved through either raising the ECPC or through making USPC applications approved by default except where there is material evidence to support intervention.

⁹ <https://www.semcommittee.com/sites/semc/files/media-files/SEM-22-054A%20Performance%20of%20the%20SEM%20CRM.pdf>

ESB GT believes that this thinking can be extended to the Auction Price Cap, where an ex-post approach may better balance the needs for new and diverse low carbon capacity against risks of participants exercising market power. This sort of ex-post thinking could be combined with other options such as a 'third-best new entrant' which would allow for the necessary portfolio diversity to develop.

ESB GT would hope to see a consultation put forward on this topic in due course which will allow the RAs and industry stakeholders to come to an enduring solution which benefits the SEM for years to come.