Endesa Ireland response to SEM/09/023
Fixed Costs of a Best New Entrant Peaking Plant
Calculation Methodology

Endesa Ireland Ltd. welcomes the consultation paper on the calculation methodology for determining the fixed costs of a best new entrant peaking plant (BNE). The fixed costs of the BNE are used to determine the capacity payments in the SEM, which are a significant portion of operator income. The variability in these costs year-on-year results in significant uncertainty in operator income. This uncertainty makes it difficult to assess profitability for new projects, creating difficulties in obtaining finance and, most importantly, making the investment in new generation that is necessary for system stability and security uneconomic.

Endesa Ireland supports the objective of decreasing volatility in the capacity payments by defining a transparent, predictable and simple to administer mechanism that guarantees system security and attracts new investment at a reasonable cost.

Following are Endesa Ireland Ltd.'s views on the consultation points set out in SEM/09/023:

1. *Comments on methods that would significantly improve the method used by the RAs to determine BNE costs, without imposing considerable costs to customers*

Endesa Ireland does not consider that the RAs should include infra-marginal rents and ancillary service revenues in the calculation of BNEFC.

The experience of Endesa Ireland is that peaking plant are the marginal plant in the SEM or are dispatched in the secondary market. As such, the units are pay-as-bid, which ensures recovery of fixed costs but does not generate additional profit. The inclusion of infra-marginal rents in this calculation suggests that the BNE will not be the marginal plant on the system, which is contrary to Endesa Ireland's experience. The revenues for infra-marginal rent included in this consultation paper are, on average, zero. However, these rents should be removed from the calculation entirely.

In addition, ancillary service revenues are uncertain. Endesa Ireland considers that these revenues should not be included in the calculation of the BNEFC unless these revenues can be guaranteed by the RAs. If the RAs wish to reduce the BNEFC, they may consider it worthwhile to direct the TSOs to enter into a 10-year ancillary service contract with new peaking plant commissioned on the island. If this security is not provided, the ancillary service revenue estimates should not be included in the BNEFC calculations.

Although not the subject of this consultation, Endesa Ireland considers that the technology selected for the BNE should be reconsidered. The BNE selected by the Regulatory Authorities to date has been a distillate-fired gas turbine. Endesa Ireland considers that this discourages investment in more efficient and environmentally sustainable peaking plant fired with natural gas, as the cost of the gas connection is not considered.

The argument presented in the July 2008 decision for choosing distillate over a gas-fired plant is the reduced start-up and run-down times for these units, and the associated costs. Endesa Ireland considers that the additional costs associated with carbon emissions of distillate, even though considered variable costs, must be taken into account when selecting the applicable technology. In addition to the cost of carbon, the contribution towards Ireland and Northern Ireland's 2020 targets for reduced emissions should be taken into account.

Endesa Ireland would suggest that the Regulatory Authorities signal that investments in efficient, environmentally sustainable peaking plant are encouraged. Therefore, the cost for a standard connection to the gas transmission network should be included in the BNEFC. This would not impose considerable costs to customers, as it would be offset by reduced costs of carbon emissions, more efficient plant and long-term environmental benefits.

2. Other options to be considered in order to reduce the perceived volatility of the BNEFC

Endesa Ireland considers that a floor-price for the CPM should be set by the RAs, applicable for at least 5 years. Setting a floor price will significantly reduce perceived volatility and will increase investor certainty in the ability to recover fixed costs.

Another option would be to allow existing market participants to fully recover their fixed costs. The SEM is a regulated market, with separate mechanisms for the recovery of fixed and variable costs. The market rules ensure that if units are dispatched the operators are able to fully recover their variable costs. Similarly, operators should be able to fully recover their fixed costs.

The SEMC may wish to consider changing the CMP to have individual pots (or individual floors) for each existing market participant to enable them to fully recover fixed costs, profiled to incentivise short-term availability. These costs can be audited to ensure operators are not over-recovering.

3. *Option 1: Current method of calculating BNEFC with all component costs recalculated annually*

Endesa Ireland considers that the current method for calculating BNEFC is too volatile. As stated in the consultation paper, the primary cost component of the BNE, EPC costs, has shown significant variance over the past ten years. When calculating the BNEFC, the RAs include the EPC costs for that year. This can result in significant under-recovery for investments that were made when the EPC costs were made at the height of the cost curve.

Using the current methodology, capacity payments for 2010 are likely to be decreased. This will arise from the projected reduction in demand, leading to a reduced capacity requirement and reduced EPC costs that are utilised in the calculation of BNEFC. If capacity payments decrease significantly, peaking plant commissioned prior to 2010 may be unable to fully recover their fixed costs. This will be of greater significance to market participants that do not have a diverse portfolio of plant.

For example, the adjusted annualised fixed cost included in the 2007 BNE calculation was €67.73/kw; in 2009 these costs had increased to €87.12/kw. If, based on capacity requirements in 2009, an investor commissioned a 168MW peaking plant in 2009, they would need to recover annual fixed costs of €87.12/kw. If, in 2010, the adjusted annualised BNEFC return to 2007 levels, the investor could face an annual loss of approximately €4 million (without taking into account further losses due to a possible reduction in the capacity requirement).

This volatility is a serious deterrent to investment in the SEM. Fixed costs must be recovered over the lifetime of the plant. The CPM must ensure that investments made during times of capacity shortfalls to meet the island's generation adequacy requirements are not penalised in times of excess capacity.

4. *Option 2: Calculate BNEFC annually with some component costs constant for a number of years*

Endesa Ireland supports this proposal. Fixing some components of the BNEFC for a number of years will reduce volatility, giving investors increased certainty. However, Endesa Ireland considers that this option should also include a price floor, further reducing the level of uncertainty. In addition, the technology employed during the fixed period should be reviewed to ensure it can support the island's 2020 targets.

Endesa Ireland suggests that this option be introduced for existing market participants, with a ten-year CPM (Option 6) designed for new entrants.

5. Most appropriate method of indexing

Endesa Ireland considers that the PCCI (excluding nuclear) is the most appropriate index to be used in the annual indexation of investment capital costs. As stated in the consultation paper, this index most closely follows the annual changes in costs for procuring generation technology and services and is a more accurate reflection of operator costs.

The RAs have indicated that using various indices for the indexation of different cost components may worsen regulatory uncertainty, as it would require the discretion of the RAs. Endesa Ireland considers that the RAs should specifically consult on the indices that are to be used for each cost component; these should then be constant for at least 5 years. This would minimise the discretion of the RAs and would improve regulatory certainty.

6. Options 3/4: Calculate BNEFC annually and apply a smoothing effect / calculate BNEFC annually with some costs remaining constant and applying a smoothing effect.

Endesa Ireland does not consider that the application of a smoothing effect is appropriate. These proposals reduce transparency without significantly reducing volatility.

7. *Option 5: Calculate the BNEFC and keep it in place for a multiple year period*

Endesa Ireland agrees with the proposal that a 5-year BNEFC, indexed annually (as per point 5 above) would significantly reduce volatility and would improve operator cash-flow projections, provided the BNEFC are set so that investments made prior to 2010 are able to recover their fixed costs.

Endesa Ireland supports this option for existing market participants, but strongly recommends that Option 6 be implemented for new market entrants.

8. Option 6: Fixed price for new entrants

Endesa Ireland **strongly supports** the RAs proposal to secure a fixed price capacity payment for new entrants. One of the reasons for offering capacity payments is to ensure long-term security of supply. In order to incentivise new investment, the RAs must provide sufficient surety for investors, particularly in the current economic climate. A fixed-price capacity payment for new entrants over a 10-year period will provide the necessary incentives and certainty to ensure the island of Ireland meets its generation adequacy requirements.

The capacity payment for new entrants should reflect the capacity needs on the island of Ireland for the given year. This need will vary from year to year, depending on capacity requirements as advised by the TSOs and may be zero in some years, when there is sufficient capacity to meet projected demand requirements.

Endesa Ireland suggests two means for allocating capacity payments to new entrants:

a. Capacity Payment Auction
   The RAs could hold an auction when it is determined that new entry is required (as per the TSOs). Investors looking to provide this capacity can bid in a price at which they will be willing to provide this capacity, payable over ten years (from COD). The winner will be the investor offering to provide capacity at the lowest price. Winners should be required to sign a connection offer within 90 days of the close of the auction and must commission their plant within 2-3 years of the connection offer signing date.

   The RAs could also utilise this mechanism to ensure capacity is built in the most advantageous locations, as determined by the TSOs.

b. Allocation of the fixed capacity pot
   The regulatory authorities could set a fixed capacity payment for ten years (from COD) that will be allocated to plant that sign a connection agreement during that year, with the condition that they are fully commissioned within 2-3 years of signing their connection agreement.

These options would allow the capacity mechanism to more accurately reflect the capacity needs of the island of Ireland.