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6th April 2009
Kevin O' Neill and Priti Dave-Stack,
Northern Ireland Authority for Utility Regulation,
Queen House, Queens Street,
Belfast BT1 6ER

Ref: AIP/SEM/09/023 BNE Peaking Plant 2009

Dear Kevin and Priti,

I attach ESB International (ESBI) response to the above consultation

Kind regards

Claire Kierans
Market Strategy Manager,
Independent Generation,
ESB International

ESBI RESPONSE
Fixed Cost of a Best NEW ENTRANT PEAKING Plant
Calculation Methodology
SEM/09/23

A CONSULTATION PAPER

1. Introduction

ESBI appreciates the opportunity to comment on these important regulatory parameters. We have no objection to all or part of it being published by the Regulatory Authorities (RAs).

This response comments on the current review of the CPM calculation and responds to the specific questions posed in this Consultation.

2. Review of the Capacity Payment Mechanism

Comments on Objectives of the paper

ESBI strongly supports the statement…"The SEMC is also of the view that at this early stage of the SEM it may not be appropriate to significantly alter the design, calculation or operation of the Capacity Payment Mechanism particularly as there is no evidence to strongly suggest that a significant change in the design and the calculation of the BNEFC and ACPS is required at this juncture".

We do not understand the statement; "The first phase focusing on the possibility of reducing volatility in the capacity payments pot.....". Capacity payments reflect market costs and have risen in line with these costs in a predictable manner.

We note the BNEFC has increased from €64.73/kW/yr in 2007 to €87.12 kW/Yr in 2009. This indicates there has been a significant increase in key capital costs which is in line with ESBI experience in its generation investment and international consulting business. We agree that customers are best served with the provision of competitive wholesale pricing signals that will deliver suitable generation margin over the investment cycle and year on year variations in price are not inconsistent with this. As the SEM has been in operation for a very short time period (18 months) we agree that it is too soon to revise arrangements. The revised arrangements as suggested by this Consultation could increase the perception of regulatory risk by potential investors who will be considering the stability of the trading and regulatory arrangements as part of their investment appraisal. The key issues in the calculation of BNEFC are that it is transparent and delivers a methodology for the calculation of generation fixed costs on which to base Capacity Payment. The overall design of SEM and regulatory requirements, specifically SRMC bidding principles, must show existing generators and new entrants that the CPM provides an accurate reflection of input costs.

Consultation Point 1: The RAs welcome comments from participants in relation to approaches that would significantly improve the method used by the RAs of determining the BNE costs without considerable cost to the customers.

ESBI believes that the current method of establishing peaker costs should be retained – that is, independent consultant reports should be commissioned to advise on appropriate input values for calculating BNEFC.

A considerable number of peaker projects have been announced. The Market Monitoring Unit could poll applicants as to the type/manufacture of peaking plant that they intend connecting together with their projections of capital and O&M costs. This could give a more accurate reflection of 'real world' costs and could assist in the calculation of CPM.

Consultation Point 2: The RAs welcome comments from participants on whether there are other options that should be considered in order to reduce the volatility of the BNEFC.

"The RAs have considered the options to reduce the perceived volatility in the BNEFC". We strongly oppose this statement as we do not consider that the BNEFC calculation has proved to be volatile. Capital costs have increased, as have the fixed costs of existing generators. This cannot be regarded as volatility and is a function of global supply and demand in the electricity generation sector and exchange rate fluctuations. The revised arrangements as suggested by this Consultation introduce a degree of regulatory uncertainty for potential investors who will be considering the stability of the trading and regulatory arrangements as part of their investment appraisal. It is this uncertainty that should be reduced thereby improving year-on-year predictability by stakeholders. Transparency and consistency of approach is required in calculation of CPM.

With the increasing difficulty of attracting investment into Ireland in the current uncertain economic climate, the emphasis should be on providing a stable regulatory environment to maintain investor appetite for the electricity sector.

Consultation Point 3: The RAs welcome comments from participants on the materiality of any adverse effects of the current method of calculation (i.e. Option 1) - Current methodology

ESBI considers that Option 1, i.e. the current approach, is the acceptable approach for the reasons outlined in Consultation Point 2.

Consultation Point 4: Taking the worked example and indexing options into account, The RAs welcome comments from participants on the proposed method for <u>Option 2</u> including any additional options that may help to reduce the perceived volatility.

We have already commented on the RAs perception of volatility and do not agree that this is an issue.

The use of the indices mentioned in the Consultation is not appropriate to the generation industry in Ireland. The main components of generation cost are EPC contract prices in Ireland, which are driven by international and local market conditions and exchange rates; operation and maintenance costs, which partly reflect EPC contract prices and local wages; insurance, which is market driven; Rates which are determined by local authorities and transmission use of system charges which are determined by regulation.

The year-on-year changes in these costs are best determined by appropriate independent consultants.

ESBI considers that Option 2, smoothing of input data is an unacceptable approach. The input smoothing within Option 2 presents the scenario of over or under recovery. If inputs to BNEFC had been fixed in autumn 2007 for three years ahead then generators would have forgone recent higher rewards. Similarly fixing costs in summer 2008 for three years ahead may lock in higher costs, disadvantaging customers.

ESBI is concerned that over / under recovery issue within Option 2 will result in strong external pressure on the RAs to claw back perceived "windfall gains" from generators and to disallow recovery of generator revenue shortfalls in circumstances where smoothing has resulted in such shortfalls.

Consultation Point 5: The RAs have four indexing options; RPI, CPI, HICP, PCCI. The RAs welcome views on which would be the most appropriate method of indexing.

As stated, ESBI believes that BNEFC costs should be established by independent consultants. None of the indices listed reflect the major cost variations to which generators are exposed in Ireland.

Consultation Point 6: The RAs welcome views on

1. **Is smoothing a suitable tool to reduce the perceived stability of the BNEFC**
2. **If so what timeframe should be smoothing occur?**
3. **Should a simple or weighted arithmetic average be considered?**
4. **If a weighted average is to be used, what values should be used for each of the weights?**

As stated, ESBI considers smoothing to be inappropriate and will lead to over- or under-recovery of costs by generators and will expose generators to regulatory risk.

However, if smoothing is adopted by the Regulatory Authorities, a simple arithmetic average would appear reasonable, as a weighted average is unnecessary complex. Consequently, Option 3 would be the most acceptable, subject to assurances that the detailed approach to output smoothing ensures that the full value of BNEFC from year to is captured as per Consultation Point 7.

Consultation Point 7: The RAs welcome comments from participants on the proposed "legacy" measure and the options for implementing this.

Should smoothing be adopted, ESBI would prefer that the arrangements are forward looking (Option A) rather than historical to reduce the complexity of adjusting historic payments.

Consultation Point 8: The RAs welcome comments from participants on the proposed Option 4 and the merits of implementing this

Option 4 builds on Option 2 and is therefore also an unacceptable approach.

Consultation Point 9: The RAs welcome comments from participants on the proposed Option 5 and the merits of implementing this

Option 5 uses the same methodology as Option 2 with the addition of keeping the variables constant for 3 to 5 years. Therefore Option 5 also an unacceptable approach.

Consultation Point 10: The RAs welcome comments from participants on the proposed Option 6 and the merits of this implementation

The RAs also welcome comments on whether this option should be considered as part of the second phase of the CPM review.

ESBI does not support the approach outlined in Option 6 – Fixed price for new entrants. This approach provides no incentive for new investors to see competitive wholesale pricing signals that will deliver suitable generation margin over the investment cycle. It could also be said that this approach removes the risk from potential new generators and is transferring this risk onto customers. This approach is directly in opposition to the basis of SEM design. The RAs should comment on this in the decision document.

Summary

ESBI do not believe that the current method of calculation of BNEFC leads to price volatility and we are very concerned at any proposals to change the method of calculation at such a short time after the opening of the SEM. Furthermore we do not believe that this paper SEM-09-23 provides any evidence of volatility. Increased capital and other costs have led directly to a higher BNEFC in a transparent way. The CPM is the means of recovery of some generator fixed cost that cannot be recovered through bids into the energy market and it is imperative that the CPM calculation is simple, fair, and offers efficient price signals as stated by RAs in page 8 of the Consultation.

This does not require more measures to reduce “perceived volatility” but should allow future and existing entrants to make their own estimates of their costs, confident that the methodology is stable, fair, transparent and impartial.