Response to

Single Electricity Market Consultation Paper

Fixed Cost of best New Entrant Peaking Plant
Calculation Methodology
SEM-09-023

prepared by

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for and on behalf of

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31 March 2009

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1. Introduction

Premier Power Limited welcomes the opportunity to respond to the consultation paper SEM-09-023 Fixed Cost of best New Entrant Peaking Plant - Calculation Methodology.

2. Premier Power Limited

Premier Power Limited (PPL) is a wholly owned subsidiary of BG Group plc. The company owns and operates Ballylumford Power Station, the largest power station in Northern Ireland.

3. Response

General

The discussion on how to smooth the Capacity Payment Mechanism (CPM) is helpful and will make it easier for market participants to plan their businesses from year to year but it does nothing to reduce the overall risk to generating plant investors. This is because investors evaluate new investment options over the expected life of the plant usually around 25 years. A two or three year smoothing mechanism will not change the fact that investors cannot forecast the CPM more than a few years forward and have no control to mitigate a falling CPM should it happen.

Economists would respond that this is how competitive markets work and that high cost participants should exit if lower cost entrants come in. They would argue that this is how other markets work and they would be correct. The element that economic theory misses is that the power industry is inherently different than other industries in two significant ways. First electricity cannot be stored and thus a real spot price for electricity should be the most volatile price on the planet. Of course this is not the case because of the second fundamental difference between the power market and other markets. The power industry is so important to any economy and receives so much public scrutiny that market participants are either directly regulated or are significantly influenced to ensure “low cost reliable supplies”.

In the SEM, market designers have worked to suppress price volatility. Indeed one of the RAs’ stated criteria for the CPM is to reduce price volatility. Thus the SEM is not a truly competitive market but is one that is managed to ensure what is effectively a regulated price. If the price is going to be regulated then investor returns will be effectively regulated (i.e. capped) which is what consumers and their advocates routinely call for. If market returns are going to be capped on the upside then they should also receive regulatory protection from the downside and thus if investors cannot protect against a falling CPM then the RAs should.

The paper notes that one of the factors that “can dictate the outcome” of the Best New Entrant Fixed Cost (BNEFC) is the WACC. The most important component that drives the WACC is the risk investors face because the more risk investors face the higher return they and their financiers will demand. This is the same issue as raised above but reducing investment risk only garners a small mention in the RAs’ criteria for the CPM development under the Simplicity heading. Reducing investment risk should in itself be one of the criteria for the CPM.

PPL has always maintained that some form of long-term contract would be better to reduce investor risk and thus reduce the BNEFC. PPL believes that Option 6 – Fixed Price for New Entrants is not at all radical and should be seriously considered. It would significantly reduce investor risk and would therefore reduce the WACC and BNEFC. This will then lower the cost overall to consumer.

<u>BNEFC Evaluation</u>
The evaluation of BNE cost is and will always be a hypothetical exercise. Actual plant investments can vary widely due to a range of factors including the creditworthiness of the buyer. For example, EPC vendors will charge more for a plant when it is being built for an owner who may not pay on a timely basis.

Furthermore there are no real databases of plant costs as suggested in the paper. Generic plant costs are often quoted in various studies and by industry publications but these are usually custom developed for a specific purpose and are not useful for anything as important as setting the BNE price. PPL and its parent company would only use this generic information as a screening tool but anytime a key decision is required specific cost estimates would be developed.

The only thing that might be more accurate but would be more costly to develop is to select an actual site and pay for EPC contractors to develop actual priced quotes. This is often used in the oil and gas industry as a way to better define plant costs before expending significant sums on plant development. As well, the WACC estimation needs to realistically reflect the risk inherent in the SEM.

<u>Specific smoothing options</u>
As discussed above, the various smoothing options presented help reduce year to year volatility but do nothing to reduce long term investment risk. While it may be interesting for economists to debate the subtle differences between the smoothing options the bottom line is how much smoothing actually occurs and over what period. An averaging over a longer period along with a specific capacity payment for new investments would be best. The more important issue raised in the paper is the transition from today to a smoothed CPM. If a specific capacity payment for new capacity is not implemented, the RAs should ensure that any smoothing transition does not suppress the CPM in the next three to five years as it may hamper investor decision making on the next round of new capacity.

Finally, it is interesting to see the “Legacy” issue raised in section 6.3.1. This appears to be an example of the issue raised in paragraph three this response. The market participants requested a smoothed CPM during SEM implementation but RAs didn’t accept the idea. Now that the CPM has shown itself to be volatile the RAs are willing to consider smoothing and indeed want to claw back what they must see as excess capacity payments in 2008 and 2009. PPL believes it would have been much simpler and cost effective to have capacity contracts with generators than a complicated and continually evolving “market”.