BNE Calculation Methodology within the SEM

Synergen's response to SEM-09-023

1 Introduction

This paper is Synergen's formal response to the RA's paper "Single Electricity Market - Fixed Cost of a Best New Entrant Peaking Plant Calculation Methodology - Consultation Paper" SEM-09-023. Synergen has no objection to this response being published.

SEM-09-023 sets out six options for the calculation of the fixed costs for the Best New Entrant Peaking Plant (BNEFC) within the SEM. The key changes considered within the range options are:

- smoothing / fixing for elements of input assumptions;
- smoothing / fixing for the outputs values (i.e. BNEFC); and
- discrimination between new entrants vs existing players.

Section 2 sets out Synergen's views on the current review of the CPM calculation. Furthermore, Section 3 contains responses to the specific questions raised within SEM-09-023.

2 Discussion

This section discusses the key changes suggested by the RAs and various principles underpinning the CPM calculations related to the BNE calculation process.

Synergen notes the rise in BNEFC from 64.73 €/kW/yr in 2007 to 87.12 €/kW/yr in 2009. Rather than any demonstrable systematic failure within the existing methodology and its application, this indicates that there has been a significant increase in key input costs which in itself would not appear sufficient rationale for revision to the arrangements. Synergen considers that customers are best served via the provision of competitive wholesale pricing signals that will, in combination, deliver a suitable generation margin over the investment cycle – such year on year variations in price are not inconsistent with this. Synergen does not consider that the changes in BNEFC prices could be described as volatile.

The SEM is has only been in operation for 18 months, and investors will undoubtedly be considering the stability of the trading and regulatory arrangements as part of their investment appraisal process. This consultation SEM-09-023 demonstrates a degree of regulatory risk within the generation sector on the Island of Ireland, with arrangements recently adopted being potentially subject to material change. Such risks can only increase investor uncertainty, and this would have consequential impacts on the BNE cost inputs, such as the WACC. Synergen is concerned that this uncertainty for both existing and future participants will increase with the “second phase” consultation that is being planned by the RAs for Q3 this year.

Synergen considers that the key issues regarding the calculation of the BNEFC are that it is transparent and delivers a stable methodology for the calculation of the input costs. Synergen does not consider that the outputs have proved to be volatile to date solely reflecting changes in the cost drivers. Given the overall SEM design and associated regulatory requirements (notably SRMC bidding principles) it is imperative that existing players and new entrants recognise that over time the CPM delivers something as close to the “correct” answer as can be reasonably determined.

Given the long term nature of generation investment, Synergen does not consider that material changes to the methodology at this point is prudent. It considers that a smoothing of outputs may have some advantages, assuming that the sums recovered under the CPM through such an approach are the same as a more dynamic CPM calculation. It does not consider that input smoothing can provide such an assurance.

Synergen considers that future stability within CPM is required and the removal of the RAs’ discretion is vital to ensure the stability of the mechanism moving forward. The RAs should also make a long term commitment not to seek changes over the medium period. Synergen makes explicit suggestions to deliver stability within Section 3.

Synergen considers that the CPM should present a level playing field with all plant rewarded based on their contribution to system security; as such any difference in the rewards to new entrants compared with existing plant should be based on observed performance.

In summary, Synergen rejects any elements of discrimination or input smoothing and as such only considers that options 1 and 3 are valid. Consequently, all other options should be discounted at this stage. Synergen requires that the CPM provides a level playing field with differences in reward based on generator performance.

3 Specific Consultation Points

Within this section, Synergen sets out views against each of the consultation points as raised within SEM-09-023.

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 imposing considerable costs to customers.

Synergen doesn't consider that the administrative costs related to the determination of the BNE peaker costs within the CPM should be considered as a key determining factor given the material impact on generators; such costs are not material compared to the total value rewarded via the CPM given that a 1% error in the calculation represents 6.4 €m based on the values for the current year.

Further, Synergen does not consider that there is a strong case for change at this point i.e. there has been no demonstrable systematic failure within the existing methodology and its application that is the driver for change.

In terms of potential improvements to the calculation of the BNEFC price, Synergen considers that removing elements of RAs' discretion would significantly improve the CPM calculation process in that it would deliver calculations that are stable, transparent and robust. Such changes are more important for investors compared to volatility of outputs given that generators can internalise / hedge known reward volatility whereas regulatory risks drives higher WACCs. In terms of BNEFC inputs, these should be determined by independent experts without any RAs discretion. This could operate as follows.

- Three independent expert consultant reports are commissioned - each to advise on the appropriate input values and calculating BNRFC.
- All of these reports and associated data would be published with a statement that these represent each firms' best professional opinion (i.e. signed by director / partner of firm to confirm this).
- The arithmetic average of the output would then be used within the CPM. To provide stability and reduce costs each expert firm would receive a rolling five year appointment.
- A further enhancement would be for the calculation of BNEFC to be the responsible of the SEMO. The SEMO would procure the required expert advice as part of T&SC rules which would also improve investor confidence.

The RAs have expressed some desire to retain discretion over setting the BNEFC value – notwithstanding Synergen's fundamental concerns with this and the increasing risk it leads to – the RAs should publish all advice received by consultants verbatim.

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.

Synergen does not consider that the BNEFC calculation has proved to be volatile – an increase in its level as the input cost drivers have increased, cannot be defined as volatility. Volatility of the BNEFC is not itself problematic rather it is the uncertainty driven by regulatory risk that should be reduced thereby improving the year on year predictability by stakeholders. There is a risk that a desire to removal of volatility is translated into CPM suppression which must be avoided.

Certainty and transparency of approach is required, rather than a revised mechanism to smooth out perceived volatility. Consequently, removing RAs discretion as per the expert outsourcing option set out in response to Consultation Point 1 would enhance the predictability of BNEFC.

Synergen suggests that the RAs should also consider an alternative approach within the BNEFC determination whereby a floor is applied to BNEFC e.g. the annual values would only be increased year on year with the RAs required to give 10 years notice for any reduction – this would provide enhanced certainty for investors.

Consultation Point 3: The RAs welcome comments from participants on the materiality of any adverse effects of the current method of calculation.

Synergen considers that the current approach (i.e. Option 1) is acceptable subject to improvements set out in response to Consultation Point 1 above.

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

The input smoothing within Option 2 presents the scope for over or under recovery. For example, if inputs to BNEFC had been fixed in autumn 2007 for three years ahead then generators may have forgone recent higher rewards and similarly fixing costs in summer 2008 for three years ahead may have locked in higher costs hence disadvantaging customers.

Synergen is concerned that the over / under recovery issue within Option 2 gives rise to asymmetric risks i.e. strong external pressure on the RAs to claw back "windfall gains" from generators but less pressures in the circumstances where generators are seeking to any recover historic revenue shortfalls.

In summary, Synergen considers Option 2 (i.e. smoothing of input data) to be an unacceptable approach.

Consultation Point 5: The RAs have detailed four indexing options above: ● RPI, ● CPI, ● HICP and ● PCCI. The RAs welcome views on which of the above would be the most appropriate method of indexing. In addition, the RAs welcome suggestions from participants on other indexing options.

Synergen considers that the approach of input smoothing is inappropriate. Consequently, the selection of the appropriate index to be smoothed would not arise.

Consultation Point 6: The RAs welcome views on the following: 1) Is smoothing as described above a suitable tool to reduce the perceived stability of the BNEFC 2) If so, other what timeframe should the 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?

Synergen considers that smoothing described is a suitable tool to reduce the perceived stability of the BNEFC and 3 year period of smoothing would be required. A simple arithmetic average would appear reasonable, with any weighted average providing unnecessary complexity. Consequently, Option 3 would be 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.

There is clearly a requirement for this legacy issue to be addressed should any output smoothing be adopted. In principle Synergen would prefer that arrangements are forward looking, and the complexity of adjusting any historic payments is minimised.

Synergen suggests a technical industry working group is set up to review explicit details of such arrangements should a smoothing approach be adopted.

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

Option 4 builds on Option 2. Consequently, Synergen's comments regarding the principle of input smoothing under Option 2 also hold for Option 4. According Synergen considers that Option 4 is also inappropriate and should be rejected.

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

Synergen does not support the approach adopted in Option 5, and believes that it should be rejected at this stage. Option 5 applies the failings within Option 2 to all elements of the calculation. Synergen's comments on Option 2 also hold for this option.

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.

In principle, Synergen rejects the discriminatory nature of Option 6, and thus believes that it should be rejected as it is inconsistent with the basis of the SEM design. Synergen does not believe that there is a robust basis for creating asymmetric CPM risks between generators that are all contributing on a accepted (if differential) to the MW requirements of the system as a whole.

Synergen is unsure whether the approach suggested within Option 6 has been validated as legally robust under EU Law – and believes that the RAs should comment specifically on this question in the decision document.

4 Summary

Synergen considers that there is no evidence presented within SEM-09-023 to demonstrate that the BNEFC calculation is producing an unacceptable level of volatility. Clearly input cost drivers have led to increases in costs since the SEM start, and it is quite plausible that changes in these same cost drivers will lead to the BNEFC falling in future years. Given the nature of the CPM as a means of recovery of some generator fixed costs that cannot be recovered through bids into the energy market it is of central importance that the calculation of such costs is unbiased and can be widely accepted as reasonable. This would be best served through:

- stability of the system;
- ensuring that all relevant costs are included and feed into the CPM "pot" over a defined period;
- transparency of the calculations; and
- impartiality of the calculations.

This does not require further measures to reduce perceived volatility, but would be best served by allowing for existing and future entrants to make their own estimates of such costs knowing that the methodology is stable.

Regarding the Options, Synergen is strongly opposed to any form of input smoothing. Synergen considers that such an approach does not guarantee the recovery of actual (or out-turn) costs but solely of estimates of cost. Synergen thus opposes Options 2, 4 and 5.

Synergen considers that the discriminatory approach set out in Option 6 is unacceptable in principle, and in terms of equity. Synergen thus opposes Option 6.

Option 1 could be refined (as set out earlier in this paper) and represents a reasonable future approach as it guarantees the recovery of the best estimate of BNEFC as a driver of the CPM pot. Option 3 would also maintain this principle and is thus considered a viable approach.

Finally, Synergen is concerned that there is no evidence to suggest that the CPM is failing to work as anticipated, and is concerned at the uncertainty, and risk, inherent in re-visiting such mechanism so soon after the start of the SEM.