Viridian Power & Energy Limited

Energia House
62 New Forge Lane
Belfast
BT9 5NF

Tel: +44(0)28 9068 5941
Fax: +44(0)28 9068 5935

Kevin O'Neill
NIAUR
Queens House
14 Queen Street
Belfast
BT1 6ER

Priti Dave-Stack
Commission for Energy Regulation
The Exchange
Belgard Square North
Tallaght
Dublin 24

7th April 2009

Dear Kevin and Priti,

RE: CONSULTATION ON BNE CALCULATION METHODOLOGY

Viridian Power and Energy (VPE) welcome the opportunity to respond to the consultation on the capacity mechanism methodology. We consider the results of this consultation to be a very important component in delivering new flexible generation capacity and providing adequate security of supply for the electricity customers on the island of Ireland. We fully agree with the SEM Committee (SEMC) view that the Capacity Payment Mechanism (CPM) is an integral part of the SEM design, and note that there is significant international precedent to support the concept of a capacity mechanism in liberalised electricity market designs. We are concerned however that the consultation paper only considers one of the various aspects of volatility in the current CPM, and thus does not address the objective of the consultation paper.

We need to reiterate our ongoing concern that we have raised consistently through the SEM design process, that a CPM + SRMC regulated market may not be sufficient to remunerate generation capacity in the market. The failure to include real costs, such as gas transportation capacity, in SRMC increases this concern.

VPE has raised the issue of the risk inherent in the current CPM arrangements on numerous occasions with the RAs, including a letter from our Group Managing Director on the issue, which we have attached for your convenience. This letter notes, as an example, the risk to an investor in a peaking plant purchased at today's capital cost that may not be satisfactorily remunerated over a five or ten year timeframe, given that the capacity payments are set by an annual review. The letter acknowledges the CPM as the primary source of income to a peaking plant and thus the central role capacity stability plays in underpinning a peaking plant investment.

VPE note that the consultation discussion is limited to a review of the BNE OCGT calculation methodology, but this falls significantly short of the SEMC objective of reducing volatility in capacity payments[1].

Capacity payments are the primary income for a new entrant peaking plant, and are essential to support investment in these flexible generation facilities. The major volatility in capacity payments comes from three main areas:

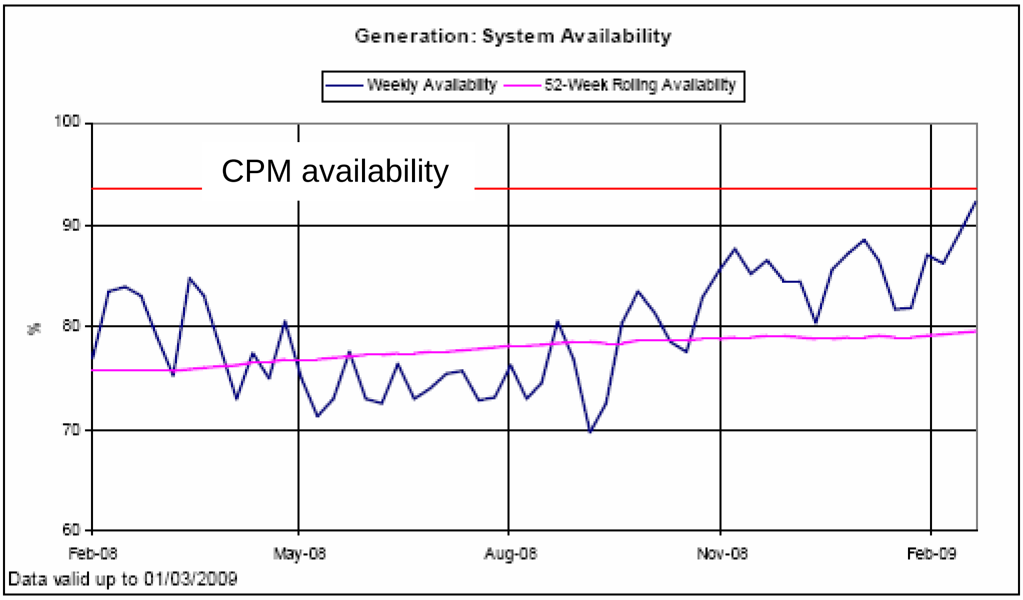
1. The BNE OCGT calculation methodology

   The volatility in this section is primarily from variations in international equipment prices augmented with variation in local costs and variations in WACC. The other significant area of volatility is a regulatory risk of what the RAs consider the scope of a "best" new entrant OCGT project. This has already been subject to differing interpretation by the RAs over the three years of history of this regulated price. Issues such as how ancillary services are calculated and the RAs treatment of Infra Marginal Rent (IMR) for a peaking project further increase the scope for volatility.

2. Variation in the capacity requirement used to calculate the size of the capacity pot

   VPE has consistently raised concerns about the lack of transparency on calculating the total capacity requirement that is used in setting the capacity pot. Our concern centres on the opacity of the calculation process together with the heroic assumption that the availability of RoI plant will rise to the NI availability as a result of the SEM. The graph below shows that the latest RoI rolling average availability continues to vary by less than a small number of percent, against the RA assumption of more than 15% improvement.

[1] As set out in first phase objectives section 4, page 8, of the consultation paper.



3. Volatility and complexity in the distribution of the capacity pot

The set of complex distribution calculations used to distribute generator payments increase the volatility of payments to generators, and we remain unconvinced that the original SEM design intent of improving generator availability has been demonstrated through experience. In this context we suggested in our response to consultation on the CPM parameters (SEM-08-172) that the fixed component of the capacity pot distribution should be increased and the variable components reduced. Given that these parameters are set annually by the RAs, no change to the underlying SEM design is necessary. This approach would have the added benefit of improving convergence of capacity values for generators with capacity payments by suppliers.

In considering the various options set out in the paper we consider a variant of option 6 is best placed to encourage new capacity. We set out in appendix I to this letter the key details of how this fixed price option for new entrants could be designed.

We note however that in comparing the other options set out in the consultation that option 5 based on a 5 year fixed regulated price and option 2 where elements of the BNE OCGT price are fixed would both be improvements on the current arrangements. Indexing would provide added certainty to these options provided the indexing has a floor of zero[2].

We understand that option 6 may take some more time to finalise and that in this context the RAs may wish to consider the other options on a transitional basis in advance of an enduring solution. Our preference is for a variation of options 6, 5 and 2, in that order.

[2] There is precedence for this approach with the current REFIT mechanism for renewable projects.

In appendix II to this letter we address the specific questions raised in the consultation document.

We would welcome an opportunity to discuss this further with you.

Yours sincerely

Garrett Blaney
Head of Regulation

Appendix I – Suggested Design of Option 6

Introduction

Elsewhere in this response we have stated a preference for a variation of options 6, 5 and 2, in that order. This appendix provides further details on the suggested design of option 6.

Option 6 – Fixed Price for New Entrants

We see a variant of option 6 as the preferred reform to the current BNEFC methodology. We understand that this option will take time to implement and would be subject to further industry consultation on the specific methodology to employ. We would hope to contribute to such a process. In the meantime, however, we suggest the following design features:

- Capacity income to a new generator would be struck for a period of 5-10 years based on the prevailing BNE OCGT price in a given year. We suggest that the new generator capacity income should not be subject to volatility as a result of changes in the capacity requirement year on year, or the variability of generator capacity distribution as a result of demand changes or relative LOLP.

- This could be implemented through a financial instrument, e.g. a contract for differences that would sit outside the SEM rules and thus not require specific changes to the SEM rules.

- We suggest that Eirgrid/SONI (either as TSO or MO) would be given a regulatory right to recover the costs (or return excess revenue) from the CFDs from all suppliers on a socialised basis. We have not reviewed whether this would legally require a PSO mechanism to be implemented.

- We suggest that such a CFD would have a number of tests to satisfy before being made available to any new generator. These tests could include a credible commitment to build, evidenced by a signed connection agreement, planning consent, an IPPC licence, proof of access to land (requiring a solicitor's affidavit), and some form of equipment commitment (possibly through a conditional EPC contract).

- CFDs would only be made available up to a quantity determined by the TSOs as necessary for security of supply.

- The RAs may want to consider limiting CFD availability to generators who are sufficiently flexible, e.g. mid-merit or peaking plants.

- In the event that there are more new entrants than quantity required, we suggest that CFDs could be allocated on a first-past-the-post basis.

Appendix II – Detailed Comments

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.

VPE Response: Please refer to our cover letter.

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.

VPE Response: Please refer to our cover letter.

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

VPE Response: Please refer to our cover letter.

Consultation Point 4: Taking the worked example and indexing options into account, 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.

VPE Response: Option 2 has merit over existing arrangements and is also preferable to options 3 and 4 because it provides extra revenue certainty to investors. As stated in our cover letter, option 6 is our preferred option but options 2 or 5 may have merit as transitional measures. Preferably option 2 would fix all E.P.C. costs, WACC, ancillary service revenues and inframarginal rent for a period of at least 5 years. VPE sees little merit in a reduction of this term below 5 years, based on our discussions with financial institutions.

Consultation Point 5: The RAs have detailed four indexing options above:

RPI
CPI
HICP
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.

VPE Response: VPE do not have a strong sense for which index is most appropriate but we do observe that PCCI is North American and would seem inappropriate. We would suggest that because CPI is already used in REFIT there may be some merit in using this. Whichever index is chosen it should come with a floor of zero, as applied to REFIT.

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

VPE Response: The difficulty with this approach is that it would under-reward in a rising capital costs scenario and conversely over-reward when capital costs are falling. On this basis, we suggest this approach is inappropriate.

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?

VPE Response: Any form of smoothing or weighted averaging is inappropriate and would be worse than existing arrangements.

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

VPE Response: Legacy problems associated with smoothing add the argument that smoothing is inappropriate. See our response to consultation point 6 above.

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

VPE Response: Option 4 would be worse than current arrangements because the BNE price may never be in the money with smoothing (see response to consultation points 6 and 7).

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

VPE Response: Option 5 has merit over existing arrangements and is also preferable to options 2, 3 and 4 because it gives greater stability to investors.

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.

VPE Response: A variant of option 6 is our preferred methodology providing it addresses the main aspects of CPM volatility as outlined in our cover letter. Please see appendix 1 for further details.