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10 June 2011

Clive/Jody,

Re: ESB PG Response to Fixed Cost of a Best New Entrant Peaking Plant & Capacity Requirement for the Calendar Year 2012

ESB PG welcomes the opportunity to respond to the consultation on "Fixed Cost of a Best New Entrant Peaking Plant & Capacity Requirement for the Calendar Year 2012". For 2012 it is proposed to reduce the Annual Capacity Payment Sum from €545m to €519.78m, a drop of 4.6% from last year.

As in previous years, it is ESB PG's opinion that the BNE methodology due to its volatility and unpredictability is an unsuitable means for generators to recover their fixed costs. Of particular concern to ESB PG is the subjectivity in determining certain criteria, which we believe to be the dominant cause for the BNE methodology's volatility. In previous years this has come about through an increase in the plant life and employment of WACC values that we consider not to be representative of market conditions. As a means of addressing these shortcomings we welcome the CPM Medium Term Review to more effectively remunerate generators for their fixed costs.

Below are specific concerns of ESB PG in relation to the proposed fixed costs for the 2012 Best New Entrant Peaking Plant:

WACC

To reiterate our viewpoint from previous years, we do not agree that the WACC calculation should assume the investor to be a subsidiary of an international utility as this does not facilitate IPP entry into SEM.

The environment for the raising of debt and equity capital for European based utilities continues to be challenging in 2011. Most European utilities are committed to divestments and ongoing rationalisation programmes with the aim of reducing significant capital expenditure programmes. Utilities are focusing on core markets

and operations while at the same time applying resources to growth opportunities such as emerging markets or renewable investment.

The required return for 'a subsidiary of an international utility' for investing in the SEM market is competing for capital with opportunities in higher growth markets. In light of the current economic downturn in the Republic of Ireland, which makes up 75% of the SEM market, an international utility looking at this investment opportunity would adjust its required rate of return. The location of the new plant in Northern Ireland does not change the characteristics of the investment and its exposure to the SEM market as a whole.

We believe that the WACC calculation range outlined in the consultation is conservatively stated for three reasons; the debt premium for an international utility is understated, the equity risk premium that would be applied to an investment in the SEM is too low for the risks surrounding Ireland in the current economic climate and the unlevered beta derived from the consultation paper is low compared to quoted generation focused companies.

The current market for raising debt is demanding higher debt premiums than the 1.50% - 2.00% range in the consultation paper. Distribution network operators (DNOs) in the GB market are currently facing debt premiums in the region of 1.75% - 2.25%. Many of these DNOs are subsidiaries of international utilities and are considered by the market to have lower risk profile than thermal generating assets.

We believe an equity risk premium range of 5.00% - 5.50% is more appropriate for the elevated risk of investing in the SEM market where the outlook for growth is low and regulatory risks are higher due to strained public finances. When applying this range we adopt the approach in the consultation paper that no adjustment for the risks of the SEM market should be applied to the risk free or debt premium and that this is instead captured in an appropriate equity risk premium.

The consultation paper includes an equity beta range of 1.2 – 1.3 and a gearing assumption of 60%. This approach equates to an unlevered beta assumption of circa 0.55 which we believe is too low for a generating station investment in the wider European electricity market today. A more appropriate unlevered beta for a generating asset is 0.70. We would be happy to share the list of comparator companies from which we derive this average beta. The comparators are generation specific utility companies primarily operating in the GB market.

In summary we believe that the WACC included in the consultation paper is too low, even when the general assumption that the BNE plant is to be based in Northern Ireland and financed by the subsidiary of an international utility is maintained. After adjusting for the risks of the SEM, a slightly higher but more realistic debt premium and the use of an appropriate unlevered beta a more appropriate range for the WACC is 7.2% - 8.8% giving a mid point of 8.0%. This level of return reflects the current cost of debt in the market, an appropriate equity risk premium for the SEM and also an appropriate beta for thermal generation investment.

Technology Choice

The RAs have consistently chosen the Alstom GT13E2 as the BNE peaking plant, given that no market participants have chosen this type of technology ESB PG considers that the RAs should consider other options further, in particular the 1 x Pratt & Whitney and 1 x LMS100 (both of which would require different site & connection requirements) .

With regard to the EPC cost for the chosen technology and fuel type, CEPA have estimated that EPC costs accumulate to €87m based on GTPro version 20, however ESB PG has independently verified these EPC costs with the current GTPro model (version 21) and finds that EPC costs are in the region of €95m. We have also estimated that adopting this updated figure would increase the overall annualised cost per kW from €79.20 to €84.23.

Grid Compliancy of BNE

ESB PG also has concerns regarding the Grid Code Compliance of the proposed new unit. While it has been stated in the CEPA report that "in general, EirGrid agreed with the proposed criteria" and that "SONI noted a need for all plant to comply with its Minimum Functional Specification", there is no evidence to support that the proposed BNE is in fact grid code compliant. Given that Grid Code requirements in SEM (ROI and NI) are stricter compared with most countries, ESB PG considers that very careful consideration should be paid to ensure grid code compliance.

In summary, the assumptions in the consultation paper seriously underestimate the returns required in today's market place. Capital continues to be scarce and is being directed to markets where returns are more attractive and risks are lower. We believe that the return requirement for the BNE should be stated at a realistic level to continue to encourage long term investment in the SEM marketplace

If you have any questions or would like to discuss any of the matters raised further please do not hesitate to contact me.

Yours sincerely,

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John Lawlor,
Manager, Strategic Regulation.