



Response to SEM Consultation Paper SEM-10-068

***CPM Medium Term Review
Work Package 7 – BNE Calculation Methodology Discussion
Paper***

on behalf of

AES Kilroot Power Ltd and AES Ballylumford Ltd

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Introduction

AES Kilroot Power Limited and AES Ballylumford Limited (formerly Premier Power Limited) (AES) welcome the opportunity to respond to the consultation paper on the BNE Calculation Methodology.

AES has always been concerned about the lack of stability and predictability of the existing BNE calculation methodology and therefore welcomes the Regulatory Authorities (RAs) desire to seek a methodology to reduce the volatility.

Summary

AES was disappointed that the RAs did not revisit Option 3 (calculate the BNEFC annually and then apply smoothing) as it considers a five-year rolling average of the BNEFC to be the most appropriate method of introducing both stability and predictability. AES accepts that there will be a slight lag in the investment signals but considers that the benefits of stability and predictability more than outweigh this.

AES has consistently argued the RAs have set the WACC too low and considers that the WACC calculation methodology should be revisited as it does not reflect the cost of capital for a likely new entrant. For consistency purposes all of the parameters should be reviewed on an annual basis although this could be reconsidered as part of any WACC review. AES has consistently argued the RAs have set the WACC too low and considers that the WACC calculation methodology should be revisited as it does not reflect the cost of capital for a likely new entrant.

Comments

BNE Calculation Methodology

Option 1 – Assessing the market equilibrium price of a peaking plant

Option 1 was originally discounted due to the difficulty determining the Value of Lost Load (VOLL) and Loss of Load Expectation (LOLE) and AES concurred with this. AES considers it prudent to have revisited this option given the subsequent determination of the input parameters.

AES agrees with the stipulated merits of Option 1 and these are endearing. It is true that the current values of the inputs produce values comparable with the BNE method however this is not unexpected since the value of VOLL was derived from the fixed and variable costs of the BNE peaking plant for 2007 and its forecast value for Q1 to Q3 2008. The primary disadvantage with Option 1 is that there is likely to be a potentially significant step change every five years when VOLL is re-examined. The same is true for the other input parameters. A further disadvantage is that it requires the use of an index to inflate VOLL within the five-year cycle which may or may not be reflective of the cost of constructing new plant. Option 1 is also extremely sensitive to a reduction in LOLE and while a reduction in LOLE should be accompanied by a corresponding increase in VOLL given the difficulty in calculating VOLL this may not actually be the case.

Option 2 – Calculate BNEFC on an annual basis but retain the cost of some components constant for a number of years

AES believes that while there is merit in fixing some of the components for a number of years the risk of a step change remains at the end of each review period. In addition there is the issue of

determining an appropriate index and this is discussed in more detail below. AES therefore considers a five-year rolling average of the BNEFC to be a more appropriate methodology of introducing both stability and predictability.

Indexing Options

For an index to be of value in the BNEFC calculation it must closely track the cost of constructing power plants. AES agrees that reliance on a commercially produced index could be open to manipulation. It also considers that the potential for regulatory adjustment to the index would undermine its value and only serve to introduce a new element of regulatory risk for investors.

The difficulty then in selecting one of the generic inflation indices is the relatively short history of the BNEFC over which to compare it. AES's preference is therefore to avoid the calculation methodologies which are heavily dependent on indexing and particularly over longer periods of time.

Option 5 - Calculate the BNEFC and retain for 3 or 5 years subject to indexing

AES is not supportive of Option 5 for a number of reasons. Firstly it is unclear how the base year would be determined i.e. is 2010 used as the base year/2011/some form of average over a number of years and how Northern Ireland participants would be impacted by movements in exchange rates if at all. Secondly there is likely to be a potentially significant step change at the end of each review period. Thirdly the difficulty in selecting an appropriate inflation index.

Option 6 - Fixed price for new entrants.

AES believes that if the RA's are successful in introducing stability and predictability into the BNE calculation methodology (such as the proposed five year BNEFC rolling average) a fixed price for new entrants is not required. In addition AES considers that the introduction of a fixed price for new entrants could discriminate against existing generators. It is also likely to be difficult to balance any fixed price for new entrants against the risk of over-investment and locking into what may become out of market prices.

Impact of Options on WACC Calculations

AES has consistently argued the RAs have set the WACC too low and considers that the WACC calculation methodology should be revisited as it does not reflect the cost of capital for a likely new entrant. AES believes that WACC should be recalculated annually in order to reflect actual market conditions although this could obviously be reviewed as part of any WACC methodology review. As the consultation paper highlights there may be a few parameters that are unlikely to change annually.