Bord na Móna

Consultation and Call for further Evidence on Indexation of Capacity Payments

SEM-23-014

Consultation Response

10 March 2023

1. Introduction

Bord na Móna (**BnM**) welcomes this opportunity to respond to Single Electricity Market Committees (**SEM-C**) consultation SEM-23-014 which calls for further evidence on the impact on the viability of projects resulting from inflation. Given the emerging capacity shortfall within the single electricity market (**SEM**) and the threat that high inflation is causing for the deliverability of new capacity this consultation is both timely and welcome.

In this response we provide evidence, clearly demonstrating the need for indexation of capacity payments. This follows our response to the original call for evidence regarding the impact of inflation on delivery of new capacity market projects[1] in which we provided detailed evidence of cost increases occurring over the specified periods.

BnM has responded to the consultation questions in detail but we would like to emphasise that we believe that indexation of capacity contracts should be introduced as an enduring feature of the capacity renumeration mechanism (**CRM**). When the CRM was initially designed the SEM had excess generation capacity, the managed exit of older generation and growth in electricity demand has changed that. To date the CRM has struggled to deliver new dispatchable thermal generation. This is a fact that needs to be addressed urgently if we hope to deliver the 2 GW of new gas generation that EirGrid indicate is required to provide security of electricity supply. It is important in our view to flag that the CRM design and initial decision around whether indexation should be applied to capacity payments was made amidst a period of sustained low inflation. The decision not to incorporate indexation into the CRM design was perhaps made as a matter of expediency to avoid additional complexity, with little apparent relevance at that time – all of which has now changed.

The EY report[2] on the functioning of the CRM concluded that one key issue is that insufficient capacity is participating in the auctions. Which reduces the potential for sufficient capacity to be contracted but also reduces the competitive tension of the auction. This fundamental issue of a shortage of capacity participating in the auction is due to the CRM not being an attractive route-to-market for energy developers in Ireland. The SEM is a small market, relative to other EU jurisdictions, with a relatively small number of developers who can deliver large scale energy projects. These developers make decisions under numerous constraints about where to allocate their resources. Other auctions such as RESS to date and predicted for ORESS1 and 2 are far more heavily prescribed.

BnM believes that the fundamental reason for a lack of participation in the CRM is the balance of risk and reward that participants are exposed to. Projects successful in the auction are exposed to a wide variety of risks that could delay or undermine the delivery of their project which are not within their power to control. These risks are in addition to the commercial risks inherent in developing new thermal generation capacity in an electricity system that is rapidly decarbonising. Measures to reduce this risk exposure, where sensible to do so, should be introduced to the CRM urgently. For clarity, the developer should of course be exposed to the risks within their ability to control.

To summarise our key points in relation to this consultation:

- <u>BnM strongly believes that indexation of capacity payments is required</u>

[1] SEM-22-071 5th October 2022

[2] EY Report Reference: Performance of the SEM Capacity Remuneration Mechanism, v2.0 28th June 2022

Indexation of capacity payments is required to enable projects by reducing investor risk to an acceptable level, without which projects will not proceed, with severe implications for Ireland's Security of Supply. We would expect that responses from participants, including our own response, clearly demonstrate the threat to the viability of projects from recent Capex inflation. With the recent return of high levels of inflation, how best to manage it is a topic of debate in many different countries. Indexation of support payments for energy investments appears to be the growing consensus in terms of managing inflation exposure. In an Irish context the O-RESS 1 T&Cs include indexation of contract prices and the RESS 3 T&CS, for which a decision is still pending, consulted on including a similar mechanism. France has experimented with the indexing of support payments with the Dunkirk offshore project and plans to change CFD market terms to index prices to inflation. Fully acknowledging that these policies for indexation apply to renewable investments, indexation of capacity contracts is already done within the GB and Polish capacity markets for non-renewable investments and is market standard broadly speaking in many countries.

- <u>Indexation of Capacity Payments for the T-3 2024/25 and T-4 2025/26 Capacity years</u>

  Developers have seen unprecedented levels of cost inflation, arising from the tail end of Covid-19 and the war in Ukraine, since the capacity auctions held in 2022. BnM firmly believe that participants who secured multi-year capacity contracts should receive an indexation adjustment to their capacity payments. The capital and other development cost increases seen far surpass general inflation seen in the economy as captured by the CPI index. Given the level of cost inflation seen we do not believe that an adjustment based on CPI inflation will be sufficient and instead a more specific index must be used. Given the different technologies participating in the capacity auctions no single index will accurately reflect the true increase in costs seen by the projects. But, utilising the Wholesale Price Index for building and construction materials produced by the CSO would be a significant improvement over CPI.

- <u>Indexation of Capacity Payments for future Capacity Auctions.</u>

  This consultation is focused on whether to apply indexation to the T-3 24/25 and T-4 25/26 auctions. We believe this is necessary to ensure these projects are restored to being financially viable. Beyond that BnM believes that indexation of capacity payments should be introduced for all future capacity auctions, including the upcoming T-4 2-26/2027 auction 2027 and T-4 2027/2028 auctions. Given that the inflationary environment remains extremely uncertain and the difficulty in fixing capital and other costs for the development of assets in this environment, we believe an indexation adjustment based on the Wholesale Price Index or similar should be used during the construction phase prior to the commencement of the capacity contract. In order for project developers to meet timelines of those future auctions, capital investments will need to be made in coming months, if not before then, and as such these projects are exposed to the same levels of inflation as those participants that were successful in the T-3 24/25 and T-4 25/26. We note that the SEM-C suggest that it 'may consider developing and adopting an enduring approach to indexation of capacity payments, potentially similar to the indexation arrangements within the GB Capacity Mechanism'. What we propose here is a move away from this approach but the Capex cost inflation currently in the market is unprecedented and we believe this approach is warranted.

- Indexation needs to be adjusted Annually over the Capacity Duration

  To reflect Operational cost volatility and project viability, we return to the GB approach believing that indexation needs to be applied across the lifetime of the Capacity contract to account for Operational Cost inflation volatility. We believe this should apply to both the T-3 24/25, T-4 25/26, and all future auctions where multi-year contracts are secured, including the upcoming T-4 2026/2027 and T-4 2027/2028 auctions. Once the construction phase of a project has completed and its capacity contract has commenced, indexation based on CPI as in the GB model would be suitable.

2. Questions

1. *Respondents are requested to provide further evidence in respect of the impact of unanticipated inflation on the financial viability of actual projects, by providing the project lifetime cashflow projections which underpinned their auction offers (demonstrating that expected returns exceeded costs of capital at that time), and updated project lifetime cashflow projections demonstrating that expected returns are now less than the cost of capital, taking into account awarded capacity prices. Evidence will be more compelling where respondents are able to produce documentary evidence of costs from suppliers.*

BnM has responded to this question in a confidential appendix.

2. *Any element of the proposed indexation mechanism for the 2024/25 T-3 and 2025/26 T-4 auctions, as described in Section 3, including the eligibility, form of indexation and risk-sharing proposals.*

Eligibility

We agree with the SEM-C proposal that indexation should not be applied to existing capacity. For new capacity securing multi-year contracts their payments are agreed for up to 14 years in the future, which makes estimating and accounting for future inflation much more difficult. Future inflation has a much smaller impact on participants securing a single year contract which, by their nature, are unlikely to be carrying capex inflation risk, in a T-4 or shorter auction. For projects not receiving a multi-year contract the impacts of increasing costs should, in theory, be captured by the recalculation of the BNE/CONE and in turn the existing capacity auction price cap. Rather than having to incorporate inflation within the Existing Capacity Price Cap we also note the existence of the USPC provisions within the capacity market code. Which participants with Existing capacity whose assets are not financially viable under the ECPC can avail of.

As a general point BnM believes that indexation of capacity contracts for New Capacity that has secured multi-year contracts should be introduced on an enduring basis. It is uncertain whether inflation will return to the relatively low and stable levels seen over recent years. At its current high and fluctuating levels, inflation introduces a large degree of risk to any new capacity being developed. We strongly believe that this risk, which is largely uncontrollable by project developers, should not be borne by them. We understand why for security of supply reasons the SEM-C is focused on the 2024/25 T-3 and 2025/26 T-4 auction winners. But given current market conditions, and the need for significant volumes of new capacity, it is our strong belief that indexation should be introduced as an enduring element of the CRM for all New Capacity that secures multi-year contracts in the T-4 2026/27 and future auctions.

Form of Indexation for the T-3 24_25 and T-4 25_26 Auctions

We believe that there is a need for indexation of both Capital and Operational Costs

<u>Capital Cost Indexation</u>

The SEM-C is proposing to use the HICP and CPI indices for Euro and Sterling currency zones. Neither of these indices comes close to reflecting the Capital Cost inflationary impacts being experienced by projects that secured multi-year contracts in the 2024/25 and 2025/26 auctions. We understand the SEM-C rationale for choosing these indices, but we do not believe this indexation approach will be adequate to ensure these projects viability. The levels of inflation related to the construction and connection of assets are multiples of CPI inflation over the past year. BnM believes an index more closely related to the real costs being seen by developers should be used. Given the different technologies participating in the capacity auctions a single index that captures this inflation is difficult to find but the Wholesale Price Index produced by the CSO[3] would more accurately reflect these cost increases.

<u>Operational Cost Indexation</u>

Notwithstanding that the SEM-C's immediate concern is with regards to inflation related to the construction phase of the 2024/25 T-3 and 2025/26 T-4 auctions, of great importance to these and subsequent auctions is the recovery of Operational Cost inflation. The last few years has shown us that world events can surpass reasonable expectations and projects/investors need to have adequate security to protect against uncontrollable factors which could impinge on the viability of the project.

We would support SEMC's proposals to use the HICP and CPI indices for Euro and Sterling currency zones in relation to Operational Cost indexation for subsequent years, i.e., with annual adjustment once the relevant capacity year has commenced and the project is operational. This approach also aligns with other capacity renumeration mechanisms which include indexation such as Britain's.

BnM's view is that if indexation were applied for the full duration of the capacity contracts, in addition to aiding the viability of projects, it would substantially reduce the financing costs of these projects, lowering the overall costs of capital, greatly aiding in the deliverability of new capacity by reducing the overall development costs. This would be of direct benefit to the consumer by improving Security of Energy Supply, as well as from lower pass through costs resulting from a more efficient market.

Risk Sharing

Given the reason why the SEM-C is considering the introduction of indexation for the T-3 2024/25 and T-4 2025/26 auctions BnM does not support the SEM-C proposed risk sharing measures currently suggested. Unless a very specialised inflation index is used to calculate the indexation

[3] We would also suggest Independent Power Renewables Index, as more relevant than HICP and CPI indices – in respect of Capital Cost indexation

adjustment actual cost inflation seen by projects will far surpass it. To support the delivery of these projects we believe that indexation should be applied without either risk sharing measure applied.

If indexation is introduced as an enduring aspect of the CRM, the question of additional risk sharing may need to be further considered. If the enduring approach mirrors the GB model, risk-sharing will already be a feature due to the impact that deflation may have on capacity payments.

3. *Is it correct that recent auction winners have not managed their inflation exposure via inflation swaps, and if not, why not?*

BnM has explored the potential of entering inflation swaps to manage inflation exposure but they are not appropriate for projects in the CRM for two main reasons:

1. Entering an inflation swap based on a revenue stream that is not guaranteed introduces significant risk. The inflation swap options we investigated involved annual payments to the counterparty which must be made to the agreed amount each year. Where the inflation swap is backed by a diversified bundle of assets the expected revenue stream is far more certain. Using an inflation swap for a singular asset entering the CRM, the participant would be exposed to significant risks if there was any interruption to the revenue stream such as an extended unplanned outage.
2. Entering a revenue swap where the revenue stream itself is fixed would incur a significant cost to the party trying to protect itself against inflation. Payments to the counterparty will be made based on a negotiated inflation expectation and an additional margin. In turn the party entering the agreement receives a hedge against unexpected inflation. In our experience however the costs incurred in doing so rendered projects non financially viable given the Auction Price Cap. Paradoxically the introduction of indexation for the lifetime of a capacity contract, guaranteeing them a revenue stream that increases in line with CPI, would make it far more viable for participants to hedge against unexpected inflation via a swap product.

More generally, BnM can find little evidence that the use of inflation swaps for development of electricity generation assets is a common practice, we suspect for the reasons above. It appears that inflation swaps are more commonly used to protect against inflation over much longer time spans and against highly diversified revenue streams and, utilised by entities such as pension funds. Where inflation swaps are considered in relation to energy investments it tends to be in relation to transmission and distribution related investments, whose lifetime can extend for 40 years and whose revenue streams are more certain and diversified.

4. *Do you have any other comments on the impact of inflation on the CRM and the design of the indexation provisions described in this paper?*

The period of historically low inflation seen during the 2010s may be over. Auction participants in the future will be required to be far more prudent about including an inflation expectation in their bid. Estimation of future inflation is however deeply uncertain and if over-estimated would lead to unnecessarily high bids (or otherwise viable projects not being able to participate in the auction due to needing to secure a Capacity Price higher than the Auction Price Cap) and if under-estimated may call into question deliverability of projects. In BnM’s view it would be better if this uncertainty and risk did not sit with developers but was accounted for in the conditions of the capacity contract.

Indexation in this manner could have benefits to customers increasing the deliverability of projects, reducing bid prices, and lowering the costs of capital for developers and benefitting consumers from greater market efficiency. As mentioned, in considering an enduring indexation solution, BnM would support the suggestion to follow the model used in the GB capacity market to capture Operational Inflation.

5. *Do you have any comment on whether it is appropriate to increase the cost of non-delivery via an increase in termination charges, if indexation is applied?*

Given the context within which these modifications to the CRM are being considered BnM does not believe it is appropriate to increase the cost of non-delivery via an increase in termination charges if indexation is applied. Given the insufficient capacity, as identified by EY[4], participating in the auction BnM believes the CRM needs to be made more attractive to investors in general. The indexation of capacity contracts is a key step in achieving this by de-risking projects and should not be accompanied by measures that disincentivise participation. We would also note here the decision to increase termination charges for the 2027/28 T-4 auction.

We would also question whether increased termination charges would significantly increase the prospects of new capacity being delivered. The SEM-C has better insight into why other projects which secured multi-year capacity contracts have not progressed to completion. However, from the EY report on the functioning of the CRM, external and largely non-financial factors to do with planning, for example, appear to have been the primary cause of capacity not being delivered. From the publicly available information it seems clear that increased termination charges would not have increased the probability of those projects proceeding to energisation.

[4] EY Report Reference: Performance of the SEM Capacity Remuneration Mechanism, v2.0 28th June 2022