Energy for generations

ESB GT response to the SEM Committee consultation and Call for further Evidence on Indexation of Capacity Payments

SEM-23-014

10/03/2023

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1. INTRODUCTION

ESB Generation and Trading (ESB GT) welcomes the opportunity to respond to this Call for further Evidence on Indexation of Capacity Payments SEM-23-014 and the form of indexation for contracts already awarded in the 2024/25 T-3 and 2025/26 T-4 auctions.

2. EXECUTIVE SUMMARY

ESB GT support the fundamentals underpinning capacity payment indexation and are in favour of the introducing an enduring and forward-looking mechanism in the ISEM beginning with contracts awarded in 2022. In our view, it is fair and reasonable to include this facility, in recognition of the potential impact of risks linked to inflation on capacity market projects. Furthermore, we believe the inclusion of an indexation will build investor confidence for future auctions and thereby help support delivery of capacity into the future.

However, we also emphasise the importance of ensuring a level playing field for all forthcoming participation and therefore do not support the proposed introduction of a short-term reactionary proposal which would see the indexation mechanism limited in application for specific projects that were successful in the 2022 auctions (CY2024/25 T-3 and CY2025/26 T-4). In our view such an intervention would serve to introduce confusion to the market and compromise the stable long-term signals needed to encourage investment.

3. RESPONSES TO CONSULTATION QUESTIONS

3.1 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. (Q4 in previous CfE).

Evidence will be more compelling where respondents are able to produce documentary evidence of costs from suppliers.

In the ESB GT response to the previous Call for Evidence regarding the impact of inflation on delivery of new Capacity Market projects (SEM-22-071) we explained the challenges faced by developers in the current economic climate of high inflation and how the large number of power generation projects and auction is stretching available OEM resources across all generation classes (renewable and thermal). Under these conditions OEMs are increasingly unwilling to fix prices for anything other than very short periods of time, and in some cases, EPC companies are only willing to offer a fixed price on certain elements of the contract with other elements offered as a direct pass-through cost, meaning the development is carrying the cost risk during construction. OEMs are also looking for price escalation mechanisms such as linking items such as cables, steel, lithium and transformers to recognised benchmark indices such as metal exchanges.

In our view the inflation analysis provided in the consultation provides an accurate representation of the current economic conditions. However, we argue that there is little value in introducing a mechanism for the Indexation to Calculation of Capacity Payments for New Capacity for a specific period. Whilst we recognise that the war in Ukraine is a key driver of the prevailing high levels of inflation and the impetus behind the proposal to introduce an indexation mechanism and consequently the focus on specific auctions. We also draw attention to the fact that the war in Ukraine is still ongoing and there is no certainty how long it will last and/or the impacts that it will have on the EU and elsewhere. It is also only one of several geopolitical events that could impact inflation over the course of the next ten-years. In recognition of the uncertain global economic climate ESB GT consider that it would be prudent to introduce an enduring mechanism would provide certainty for developers and encourage investment.

We therefore suggest that it would be more appropriate to adopt an enduring indexation mechanism, such as that applied GB Consolidated Capacity Market Rules - Ref. Clause 6.4 Indexation:

> *6.4.1 Capacity Payments in relation to Capacity Agreements issued following a T-4 auction are to be adjusted with effect from the commencement of each Delivery Year, by the 115 application of the CPI adjustment prescribed in paragraph 3(5) of Schedule 1 to the Regulations.*

For the reasons outlined above ESB GT support the introduction of an enduring a forward-looking indexation mechanism for capacity payments, beginning with contracts awarded in 2022. However, we do not support the proposed short-term reactionary proposal which would see the indexation mechanism limited in application for specific projects that were successful in the 2022 auctions (CY2024/25 T-3 and CY2025/26 T-4). We also recognise the importance of a forward-looking

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mechanism and agree that it should not extend any indexation provisions to contracts awarded prior to 2022.

3.2 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.

As previously stated, ESB GT support the introduction of an enduring and forward-looking indexation mechanism for capacity payments, beginning with contracts awarded in 2022. We emphasise the importance of ensuring a playing field for all forthcoming participation and therefore do not support the proposed introduction of a short-term reactionary proposal which would see the indexation mechanism limited in application to specific projects that were successful in the 2022 auctions (CY2024/25 T-3 and CY2025/26 T-4). Price uncertainty and inflation remain a feature of the market for developers seeking to participate in upcoming auctions. In our view such an intervention would serve to introduce confusion to the market and compromise the stable long-term signals needed to encourage investment.

In our view the proposal to introduce an indexation that would only be available to participants in specific auctions is discriminatory as it would mean select participants would have an unfair competitive advantage over others in the energy market for the entire duration of capacity market contract. This has the potential to undermine investor confidence in the capacity market and could ultimately result in further, prolonged issues with capacity adequacy within I-SEM.

Potential long-term measures

ESB GT draw attention to the potential long-term measures mentioned towards the end of the consultation paper. In our view the reference to the potential introduction of a long-term measure serves to introduce additional uncertainty in the market, which could result in developers submitting two tiered (speculative) bids in forthcoming auctions in an attempt to manage the risk introduced by this hesitation.

Proposed indexation design

ESB GT do however consider that the fundamentals of the proposed mechanism to be sound overall – the table on the following page includes ESB GT's considered views on each of the relevant design elements. We also suggest that consideration needs to be given to a range of scenarios, for instance when a project is delayed, will the indexation cover the full cumulative inflation up to the substantial completion? Or in the case where a project is early how would inflation be adjusted?

Specific elements of proposed indexation mechanism

Description of design element	ESB GT view
Eligibility	
This indexation mechanism would apply to projects that won in the 2024/25 T-3 and 2025/26 T-4 auctions, but not to projects that won in any prior, or future, auctions	Do not support the short-term reactionary proposal which would see the indexation mechanism limited in application for specific projects Support introduction of an indexation mechanism for capacity payments that would apply to both new and existing capacity projects going forward.
Indexation would apply only to the subset of New Capacity which is making a sufficiently large investment as to be able to obtain a multi-year contract	Agree with multi-year contract requirement, however, we remain concerned that the level of New Capacity Investment Rate Threshold (NCIRT, €300k/MWd/yr) is too high for existing projects seeking to upgrade. On this basis we do not support introduction of the NCIRT as a reasonable proxy for whether the project has potentially been subject to high and unexpected inflation in build costs.
Form of indexation:	
One-off indexation factor calculated based on cumulative unexpected inflation during the build period (from the Auction Date to the start of the first capacity delivery year). That indexation factor would be applied to capacity prices awarded at auction for that unit for all ten years of the contract.	Support the application of the one-off indexation factor for the build period. Support the application of a one-off inflation adjustment to apply just before the start of the first delivery year, and to re-fix the capacity price for that unit for all ten years at that price.
Indexation applied on a currency zone basis, with the HICP applied to capacity prices in the Euro currency zone and the UK CPI index applied to capacity prices in the Sterling currency zone	Support – Agree that the indexation should be applied on a currency zone basis.
Risk-sharing	
The risk-sharing: percentage of unexpected inflation being passed through to the capacity price, and hence to consumers versus "deadband" into the indexation provisions, between a lower bound and a higher bound.	Support – Recognise risk sharing as a pragmatic approach to balancing the potential impact of inflation between consumers and developers. Both approaches seem reasonable and will ensure consumer is protected.
Termination charges	
Proposal for generators to be more heavily penalised for non-delivery of that capacity.	Caution against increasing termination charges, recognising that very high termination charges may expediate exit for participants. A robust qualification method rather than increasing termination charges will minimise the number of projects seeking termination.

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

ESB GT consider that it is important to recognise the truly extraordinary circumstances in recent years that include a return to 'normal' after the unprecedented impact of the Covid-19 pandemic, which was then followed by the war in Ukraine leading to huge volatility in the gas markets and ultimately resulting in a pan European energy crisis. We therefore believe it would be unfair to expect developers to have envisaged such extreme circumstance and to have planned accordingly.

3.4 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?

ESB GT are supportive of a move from the current system whereby capacity contracts are awarded and fixed in nominal prices, to a system where investors enter a T-3 or T-4 auction knowing that prices will be indexed over the lifetime of the contract. We therefore suggest there may be value in conducting a review of the capacity payment indexation mechanism in GB capacity market and consideration of its suitability to the ISEM. We also agree with the risk sharing proposals as we recognise the fairness in balancing the inflation risk carried by the investor as well as the consumer.

We draw attention to SEM-16-022[1] where the SEM Committee recognised that the bulk of capacity would be procured a number of years ahead of when it will be contracted to be available. Acknowledging the lag between the time of a capacity auction and the time when capacity is delivered, and there may be potential benefits in indexing the price (option fee) that arises from the auction, as they will not represent the real price achieved at the time of delivery.

We note that at the time the SEM Committee decided against indexation on the basis that the majority of projects operating in the capacity market do not have (and are unlikely to have) inflation linked debt and could be expected to manage their inflation exposure via inflation swaps.

However, since then the acute impact of inflation in recent years has changed this situation and as mentioned previously, under prevailing conditions OEMs are increasingly unwilling to fix prices for anything other than very short periods of time, and in some cases, EPC companies are only willing to offer a fixed price on certain elements of the contract with other elements offered as a direct pass-through cost, which effectively means that the development carries the cost risk during construction. In addition, OEMs are now also looking for price escalation mechanisms such as linking items such as cables, steel, lithium, and transformers to recognised benchmark indices such as metal exchanges.

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[1] *SEM-16-022 I CRM Decision 2.pdf (sharepoint.com)

This change in circumstance has increased risk for developers and in the case where it is not managed by a indexation mechanism, could reasonably be expected to result in a risk premium being built into the auction bid price.

ESB GT therefore consider that the introduction of an indexation mechanism for capacity payments could be expected to deliver value for the end consumer, as the certainty it offers investors will encourage more competitive bid submissions into the auctions and therefore more cost-effective capacity for the system at large.

We also agree that moving to a system of indexed contracts could serve to lower the cost of capital to investors and increase the attractiveness of the SEM as a location for investment vis-à-vis other markets, again delivering real benefit to the end consumers.

We therefore consider that the introduction of such an indexation mechanism would align with the CMC objectives (A.1.2.1):

(b) to facilitate the efficient, economic and coordinated operation, administration and development of the Capacity Market and the provision of adequate future capacity in a financially secure manner;

(c) to facilitate the participation of undertakings including electricity undertakings engaged or seeking to be engaged in the provision of electricity capacity in the Capacity Market;

(d) to promote competition in the provision of electricity capacity to the SEM;

(g) through the development of the Capacity Market, to promote the short-term and long-term interests of consumers of electricity with respect to price, quality, reliability, and security of supply of electricity across the Island of Ireland.

3.5 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?

ESB GT draw attention to the many challenges facing developers engaged in the delivery of new capacity projects. Whilst we recognise that the RAs have accommodated delays to projects experiencing third party delays due to planning and JR, there is still no facility to accommodate delays due to grid connection. In our view the proposal to impose higher termination charges on projects experiencing delays due to grid connection would be grossly unfair, as the delays are totally outside of the control of the developer. We therefore do not believe that the proposal to increase penalties could be expected to ensure realistic auction bids and timely delivery of new build. On the contrary we argue that higher penalties have the potential to magnify the problem as participants may consider an early exit rather than risk higher termination charges later in the process, ultimately resulting in higher levels of project non-delivery and further issues with capacity adequacy within I-SEM. As a possible alternative, ESB GT suggest increasing performance securities a potentially effective means of ensuring timely delivery of new build capacity projects.

As previously advised in the ESB GT response to consultationSEM-22-092[2], we emphasise the importance of a robust screening process with clear qualification requirements in ensuring the highest levels of certainty in delivering capacity procurement, as well as the potential benefit in providing advance notice to the market of forecast capacity requirements for specific capacity years at least 2 years ahead of an auction. This approach is adopted for RESS auctions, whereby the volume of renewable energy, in GWh, is notified well ahead of the auction date and in our view would provide certainty to investors seeking to develop projects for participation in the capacity market.

[2] SEM-22-092 Capacity Market Code Modifications Working Group 28 Consultation Paper | SEM Committee