

Response of Bord Gáis Energy Supply

to

The SEM Committee

On the

**Fixed Cost of a Best New Entrant Peaking Plant for the Calendar Year 2009
Consultation Paper**

AIP/SEM/08/083

Bord Gáis Energy Supply (BGES) appreciates the opportunity to comment on the fixed costs of a Best New Entrant (“BNE”) peaking plant for 2009, published by the SEM Committee on 4th July 2008. The following is our response to that paper and we request that the Regulatory Authorities (RS’s) consider our views before progressing to a decision on this issue.

The Capacity Payment Mechanism is an important constituent of the current market design as generators are obliged to bid in only their Short Run Marginal Costs to the Single Electricity Market (SEM) pool. However the SEM capacity payments are not only designed as investment return for current generators and incentivise those generators to run; they are also in place to signal efficient Entry/Exit. Being such an important component and mechanism for efficient availability it is important that the process in place for determining the capacity pot is stable and transparent – affording generators, and more importantly the financial institutions which provide the required financial outlay, a reasonable level of certainty around future revenue streams. This also enables the generator to maintain reasonable financing costs.

Our initial thoughts on the consultation and the proposed 2009 capacity pot were that it is surprising that the total costs of delivering the BNE peaking plant have remained relatively unchanged since mid 2007 when the RAs initially undertook analysis of the costs. We understand that the Capex or development costs of building a peaking plant in Ireland have increased considerably even in the space of 2 years and therefore we would have expected an increase in both the Capex and overall costs of the BNE peaking plant. The views that have been expressed to us appear to be common among all generators currently considering investment in the SEM, including those in the Renewables sector.

To maintain economic viability, Suppliers must pass on capacity payment charges to customers as no efficiency savings can be made in relation to this cost. It is understandable therefore that customers are naturally inclined towards the implementation of smaller capacity pot(s) thereby reducing that element of cost in

their electricity bills. However this ignores the important link between the RA's annual determination of total capacity payments and requirement for new generator build to be completed in a timely and efficient manner. Under-representation of capacity costs has the potential to result in bad value for the consumer over the medium term as capacity payments continue to be made to the current generation portfolio without effective signals being made for new build. This runs a real risk to security of supply which may require urgent action later to address, which is usually associated with higher costs.

Technology Choice:

From a Supplier perspective, the most important aspect of technology choice is that consistency in the process for determining the capacity pot is preserved. We believe this is the best way of ensuring efficient Entry/Exit in the SEM and this is what provides value for money for customer's in the medium/long term. With that in mind, it was surprising that the 2008 technology choice, the Alstrom 13E2 unit, was discounted from the 2009 technology choice on the basis that investor(s) would logically seek to obtain a lower unit cost in return for any additional investment for extra capacity. In 2007, the RAs referred to the IPPC directive relating to Best Available Technology, which considers unit efficiency, and having done so identified the Alstrom 13E2 as being the most appropriate technology upon which to base the BNE peaking plant.

We do understand that the RAs must make the most appropriate decisions and that from time to time, decisions will of course require updating. However, as an Independent Supplier in the market we are very concerned that Independent Generation, which is beneficial to the entire market, will not be encouraged to enter the SEM due to uncertainty over how the substantial costs of a new build on a green field site are to be recovered. We do not believe that it is absolutely necessary from year to year to re-determine the technology choice; however it is necessary that from year to year the resulting costs from the RAs analysis are consistent with those around the most likely new build unit. We therefore assume that the RAs have spoken with those currently considering investment in the SEM and that this technology choice is consistent with those generators current choice options.

Fuel Choice:

The paper appears to interchange the difficulties with choosing a gas unit as being those associated with booking gas capacity and the liquidity of purchasing gas on a short term basis. It is our understanding that with the implementation of short term products from Bord Gáis Networks in October 2007 and the availability of secondary capacity products from Bord Gáis Energy Supply the difficulty with the former is no longer an issue. It is our understanding that there is sufficient access to commodity

gas to allow a peaking plant to operate effectively. The current portfolio of gas-fuelled generators appear to have little difficulty in relation to same. The choice of gas as the fuel would also enable higher utilisation of the gas network which would in turn lead to lower charges for all users of that network.

Economic & Financial Parameters:

Cost of Capital:

The significant reduction in the Weighted Average Cost of Capital calculation of approximately 0.5% is somewhat surprising given the current economic climate. Although this sections starts by stating that cost elements used are in real values based on price levels for a plant commencing commercial operations at the end of 2008, it is stated later that the nominal risk free rate, inflation forecast, debt spread and tax rate are fixed as of May 16th 2008. The use of a one fixed date for assessing the such WACC variables may need to be considered in light of the fact that the BNE calculation is not only to make an adequate return on investment for a plant commencing operations in late 2008 but also to encourage potential investors to enter the market.

1. Inflation

The consultation paper states that the ECB reports a 2.4% inflation forecast. It would be useful if this was sourced. As the RAs are aware there are various inflation figures quoted by the ECB. Our own analysis leads us to believe that the HICP (Ireland) for 2008 is likely to be in the region of 3.5%. The recent CER consultation paper on the allowed revenues for the Transmission Allowed Revenues (CER/08/094) quotes a 2008 estimate (of CPI) as 3.4% which is consistent with our own current forecast of 2008 CPI as being approximately 3.5%.

2. Equity Risk Premium

We note the RAs proposal to maintain the equity risk premium at 5.5%. The SEM Committee have however invited comment on the appropriateness of same following more recent precedents such as that set by the UK Competition Commission, which (in 2007) quoted a range of 2.5% - 4.5% in its decision regarding Heathrow and Gatwick airports. While we appreciate the RAs efforts to incorporate up-to-date information in its calculations of the capacity pot we are reluctant to accept that an ERP adopted in one industry and country is automatically applicable to a different industry in a different country.

3. Gearing

The paper states that the SEM Committee considers a 70% gearing is achievable for generating companies and have quoted three organisations as

having gearing ratio of between 62% - 81%. We do not believe that these adequately represent the appropriate gearing for a BNE peaking plant. We understand that on a more general level, organisations would employ a gearing rate of approximately 50%. In 2005, the CER decided on a 50/50 ratio for ESB Networks (see CER/05/138; PG. 42).

Investment Cost Estimate:

Site Procurement:

The consultation paper has reduced the RoI site costs from €2.5m in 2007 to €1.3m in 2008. This reduction equates to almost 50% and we do not believe that this is achievable. We would also query the size of the site (at 1.2 acres) that is quoted in the paper.

EPC Contract:

The consultation paper refers to a 10% reduction in these costs from 2007. This is inconsistent with our general understanding on the costs that potential new plant builders have advised us. However, we have to assume that the RAs have discussed this issue with those generators and that therefore these costs represent the most likely costs.

Recurring Cost Estimate:

We note that the RA's have increased the LTSA considerably however we presume that the €1,176m includes the category of costs previous covered under Owner's general and admin costs. When this adjustment is made, the actual costs have reduced well in excess of 10%. We would request that the RA's clarify these costs and on what basis the costs have reduced.

We also note the substantial reductions in Insurance and Rates incurred by the BNE of 45% and 30% respectively. In the interests of preserving the integrity of the process that has been adopted to calculate the annual capacity pot we request that the RA's provide their justification for the change in assessment to these costs.

Conclusion

The Capacity Payment Mechanism is a fundamental component of the SEM design. As such, it is imperative for all market participants and consumers that the process for calculating the capacity pot from year to year is stable and consistent and produces the correct number to encourage future Entry/Exit in the generation portfolio of the SEM. This will deliver the most efficient and cost effective results for all.