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Kevin O' Neill and Priti Dave-Stack,  
Northern Ireland Authority for Utility Regulation,  
Queen House, Queens Street,  
Belfast BT1 6ER

**Ref: AIP/SEM/09/035 Scope of CPM Medium Term Review**

Dear Kevin and Priti,

I attach ESB International (ESBI) response to the above consultation

Kind regards

[Ramón Cidon](#)

**Market Strategy Manager, Independent Generation, ESB International**



**ESBI RESPONSE TO  
Scope of CPM Medium Term Review  
SEM/09/035**

## **1. Introduction**

ESBI appreciates the opportunity to comment on this consultation paper. We have no objection to all or part of it being published by the Regulatory Authorities (RAs). This response is submitted on behalf of ESBI's SEM generation business and its NI are RoI independent supply businesses.

ESBI has carefully reviewed the proposals contained in the Consultation Paper.

We are concerned that the Regulatory Authorities' proposals, taken together, would change the nature and purpose of the capacity payment mechanism and increase uncertainty and risk for potential investors in the Irish electricity market. We believe that the long-term interests of the electricity supply industry in Ireland and of its customers would be best served by having a stable market which will ensure security of supply at a fair and sustainable cost.

Capacity payments should reward available generating capacity. Any attempt to encourage particular technologies or technical characteristics through the capacity payment mechanism would interfere in the competitive market, placing the Regulatory Authorities in the role of central planners.

Generator technical performance, above and beyond that required under the grid codes, which system operators may wish to have at their disposal should be procured and rewarded appropriately through the ancillary services mechanism.

The basis for capacity payments should reflect actual (rather than idealised) performance, costs and financial factors. In particular, the capacity requirement should take account of actual plant availability. The best new entrant annual cost which is the basis of the annual capacity pot should reflect actual site and construction costs including realistic connection costs. Return on investment should reflect the actual current financial conditions faced by investors.

Our comments on the specific Consultation Points raised in the paper are set out below.

## **2. ESBI Comments on Consultation Points**

*Consultation Point 1: The RAs welcome comments and backup material from participants in relation to any historical analysis they have carried out in relation to the CPM*

Our analyses have shown that changes in capacity payment have been difficult to predict, making it difficult to offer customers long-term supply contracts. However these changes have reflected market conditions. We believe that that the capacity payments should continue to reflect market conditions and that it should be left to suppliers to devise market solutions to deal with capacity payment changes.

*Consultation Point 2: The RAs welcome comments from participants in relation to the impact of the CPM on consumers and the methodology of payment by suppliers*

ESB Independent Energy (ESBI), like other suppliers, passes through capacity payments through its retail tariffs. Variability of price in the capacity charge is important to ensure that the demand side of the market responds efficiently to supply costs. The capacity charge mechanism imposes a level of risk on the demand side of the market. However, suppliers who are concerned about the risk that this methodology imposes on them have the potential to charge customers for capacity, directly as the charges are incurred. In order to give the supply side of the market some predictability in the levels of price to which they can respond it is recommended that the current capacity charging mechanism is left unchanged.

*Consultation Point 3: The RAs welcome comments from participants in relation to incentives that could be introduced within the CPM or covered under the Ancillary Services mechanism*

The purpose of capacity payments is to reward the necessary generation capability that ensures security of supply. It was not intended to provide incentives for investment in particular types of generation. Introduction of such incentives would put the Regulatory Authorities into the role of central planners and undermine the competitive market.

If the system operators require certain support services, these should be provided through the ancillary services arrangements and not through the capacity payments mechanism.

This position is reinforced by the following extract from paper SEM-08-177:

‘The Harmonised All-Island Ancillary Services Policy decision paper (SEM/08/013) states the following:

- *“Reserve payments serve the purpose of ensuring that sufficient plants are available in the right locations, capable of providing the response required by the TSO. The issues relating to the design of the CPM (including how it interacts with the provision of AS) were consulted on previously by the RAs during the development of the CPM. The CPM does not, and was not designed to, ensure that generators offer sufficient reserve within certain geographical boundaries or to particular technical specifications.”*

Therefore, currently the responsibility of incentivising the *type* of availability is within the remit of ancillary service payments.’

ESBI concurs with the Regulatory Authorities opinion stated in SEM-08-013 and reiterated in SEM-08-177.

*Consultation Point 4: The RAs welcome comments from participants in relation to the timing and distribution of Capacity Payments as described in Sections 7.4 and 7.5<sup>1</sup>.*

The distribution of Capacity Payments was decided by the Regulatory Authorities after a considerable amount of deliberation and consultation.

As intended by the Regulatory Authorities, the current method of distributing Capacity Payments provides a firm basis for market participants to plan their operations and maintenance and to offer sales contracts to customers, while minimising opportunities for gaming and market manipulation.

ESBI favours maintenance of the current arrangements for Capacity Payment distribution.

*Consultation Point 5: The RAs welcome comments from participants in relation to the Capacity Requirement Calculation and what parameters should be considered in the review.*

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<sup>1</sup> There is a mistake in the referencing – the referenced sections are 6.4 and 6.5

ESBI favours continuation of the current method of calculation of the Capacity Requirement using CREEP or an equivalent probability-based capacity adequacy planning programme. Alternatives, such as 'rules of thumb' for capacity margin, that were used prior to electronic computing, while providing transparency, would not have a scientific basis.

However, the inputs to the adequacy calculations should reflect reality. The forced outage rate of 4.23%, used to date, is lower than the actual forced outage rate in the SEM and results in an unrealistically low Capacity Requirement. ESBI suggests that the average all-island system forced outage rate be used for the Capacity Requirement calculation.

*Consultation Point 6: The RAs welcome comments from participants in relation to the calculation of WACC and the approaches that could be used in calculating the various WACC parameters*

ESBI agrees with the capital asset pricing model approach of the Regulatory Authorities to the derivation of the Weighted Average Cost of Capital on the basis of its transparency compared with possible alternatives. However, the assumptions on which the derivation is based should reflect financial costs and conditions faced by generators in the Irish market.

In particular, the RAs should recognise:

- the debt/equity ratios that are achievable for generation project financing in Ireland
- the debt service coverage now demanded by lenders
- the country risks attaching to Ireland and the UK
- the appropriateness of using regulatory determinations relating to infrastructure investments as references for the risk premia that should attach to debt and equity investment in generation in Ireland, which are subject to technical, market and country risks
- the increased cost of arranging finance

- the medium term inflation outlook

The WACC of 7.07% incorporated in the 2009 Capacity Payment decision is too low under current and likely future conditions. Future determination of WACC by the Regulatory Authorities should take account of the financial conditions facing generation investors in Ireland.

*Consultation Point 7: The RAs welcome comments from participants in relation to impact of infra-marginal rent on the BNE*

Infra-marginal rent introduces unpredictable uncertainty into the calculation of capacity payment. It also provides a contradictory market signal in that the tighter supply is, and the more new capacity is needed, the higher will be infra-marginal rent and the lower will be capacity payments.

For these reasons, ESBI favours dropping infra-marginal rent from the capacity payment mechanism.

*Consultation Point 8: The RAs welcome comments from participants in relation to impact of exchange rate fluctuations may have on the CPM*

Exchange rate fluctuations are a business risk for which hedging arrangements are available. Any 'improvements' introduced by the Regulatory Authorities to deal with this risk are likely to lead to market distortions and to provide potential opportunities for anti-competitive behaviour.

ESBI suggests that the existing arrangements should stand, leaving individual generators and suppliers to hedge currency risk as they see fit.

*Consultation Point 9: The RAs welcome comments from participants in relation to treatment of wind in the SEM*

ESBI favours maintenance of the existing capacity payment arrangements in order to provide stable income to generators and predictable tariffs to customers.

The market should reward all generators (including wind generators) equitably for the capacity and energy that they provide. Only if there are

distortions which unjustifiably favour a particular generation sector should the Regulatory Authorities change the market mechanisms. Such changes should be introduced with sufficient notice to allow participants to provide for the resulting market impacts.

*Consultation Point 10: The RAs welcome comments from participants in relation to the interconnector treatment within the CPM*

ESBI favours maintenance of the current capacity charge arrangements for interconnector trading. These arrangements are both fair and transparent.

*Consultation Point 11: The RAs welcome comments from participants in relation to the relationship between Ancillary Services and the CPM*

As stated in relation to Consultation Point 3, ESBI's view is that capacity payments should reward available capacity and that any incentives to reward particular types of capacity or particular generator performance should be provided separately through the ancillary services arrangements.

ESBI thus agrees with the RAs' own statement of principle on these matters quoted in our comments on Consultation Point 3.

*Consultation Point 12: The RAs welcome comments from participants in relation to any other aspects of the CPM that should be included in the scope of the Medium Term Review*

ESBI does not favour changes in the CPM. The market has been in existence for less than two years, it is working reasonably well and it should be left to develop in a predictable manner over the medium term. Frequent changes in the market arrangements could increase perceptions of regulatory risk on the part of potential investors in SEM generation in the future.

ESBI is assured by the RAs' statement that they do not intend to use the CPM to expand generation diversity but does not understand the subsequent statement that they will be 'cognisant of this concern' (relating to diversity) and will consider any impact on diversity in their analytic work. As we have already stated, the CPM should not provide guidance with respect to type, performance, location or characteristics of generators.





### **3. Summary**

To provide market stability and predictability, ESBI favours maintenance of the current Capacity Payment Mechanism.

In the context of an unchanged CPM, ESBI urge the Regulatory Authorities to use realistic values of:

- forced outage rate to calculate the Capacity Requirement and
- weighted average cost of capital to calculate the Best New Entrant (BNE) annual fixed cost.

ESBI favours dropping infra-marginal rent in the calculation of the BNE fixed cost.

The Capacity Payment Mechanism should reward available capacity. It should not be used to provide incentives for particular types of generation. If the system operators require certain generator characteristics (above and beyond those required by the grid codes) these should be procured through the ancillary services arrangements.