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RE: Scope of CPM Medium Term Review

Bord Gáis Energy (BG Energy) welcomes the opportunity to respond to the regulatory authorities (RAs) consultation on the scope of the Capacity Payment Mechanism (CPM) Medium Term Review.

While we support the review and its objective to introduce further stability in the CPM, fundamentally BG Energy's position can be summarised as follows:

As a recent investor within the SEM, the changes to the CPM mechanism should not jeopardise investors already in the market. Investments made to date in the SEM have been made based on the current CPM mechanism being maintained (unlike some of the older power generation investments which may have recovered their initial outlay and most likely earned a ROE).

BG Energy strongly agrees with the SEM Committees view that the CPM is retained, particularly in light of the investments that have been made in response to its introduction.

The calculation and distribution of the CPM should be transparent and stable for all participants such that the revenues and costs can be reasonably forecasted. Furthermore, the mechanisms should not be the subject of arbitrary adjustments as this sends uncertain signals to new and potential investors, increasing the risks of investing in Ireland and the SEM. With this in mind, it is also important that in reviewing and developing the current regime, potential changes do not negatively impact on the investment decisions and choices taken by recent investors to the market.

The remainder of this response addresses the specific questions raised by the RAs in their consultation paper.

1. Impact on the Retail Market

The volatility in the calculation of the capacity pot year-on-year is an issue for the retail market as the payments required to fund this pot change accordingly. Suppliers and customers value predictability of costs and the current mechanism whereby the total pot changes on an annual basis creates uncertainty and therefore increases risks for participants in the retail market. As suggested in our recent response to the BNE calculation for 2009/10, BG Energy would suggest a fixed medium term calculation of certain elements of the pot, potentially on a 5/6 year basis, to reduce this uncertainty and provide stability to the market.

To contribute to energy efficiency, supplier payments could be reshaped to directly address demand-side management by distinguishing between mid-merit and peak capacity values throughout a trading day. BG Energy has not assessed the administrative complexity that may be involved, but capacity payments could be shaped such that suppliers/customers consuming at peak trading periods pay more than those consuming during other trading periods. This would require further analysis and consultation by the relevant parties before a decision regarding its appropriateness could be reasonably made.

2. Incentives for Generators

In establishing and implementing the CPM, the RAs stated goals in the applied methodology are to incentivise; a) efficient entry/exit; and b) capacity availability of generation as a means to ensure security of supply to the system. BG Energy does not believe that the current ‘one size fits all’ methodology, whereby all generators receive equal payments relative to their capacity availability, encourages the right type of generation or gives the appropriate signals for inefficient generators to exit the market. In reality the current methodology rewards those generators already on the system to continue operation, while the uncertainty of revenue payments Given the government’s demanding policy to achieve 40% renewable generation by 2020, it is imperative that the supporting conventional generation is both flexible and efficient to accommodate the fluctuating and unpredictable nature of renewable generation. The payments outside of the energy market should incentivise and remunerate investments in such assets.

BGE is cognisant of the fact that the current implementation of the CPM awards plant availability but does not take into account plant flexibility. To appropriately and proportionately reward both **available** and **flexible** plants, BG Energy believes it may be more effective if they are remunerated separately through **capacity payments** and **ancillary service payments** respectively. In essence, capacity payments would incentivise and reward capacity availability and adequacy on the system, particularly during those periods when most required. However, the characteristics of this capacity, i.e. its flexibility, would be rewarded through ancillary service payments, which were originally designed to compensate for contributions towards system security and integrity. Differentiating between types of capacity will improve the exit signals provided to less efficient/older plant, which currently does not exist in the market.

This proposal would require changes to the structure of the ancillary services mechanism, which is currently agreed independently between the system operator and the relevant generator. This should become a more structured and transparent calculation and reward investments which better meet the requirements of the islands future generation mix.

BG Energy recognises that in the long term it may not be palatable to reward all plants on the system equally as many will have recovered their initial capital outlay and made a return on their investments. However as stated above any changes should be cognisant of the fact that investments made in the last number of years have been based on the CPM mechanism as it is currently designed . Should the CPM change to the detriment of these recent investments, confidence in the markets ability to support future investments will be diminished significantly.

3. Distribution of Capacity Payments

Unlike the energy component of the SEM, the capacity payment mechanism does not include a payment structure to recoup revenues should the generator in reality not be able to produce electricity despite declaring availability. One method of addressing this would be to increase the ex-post proportion of the capacity pot, thereby rewarding generators which are actually available. This could be done in conjunction with an element of testing to ensure overall compliance with the spirit of the payments stream.

4. Capacity Requirement Calculation

One of the important elements of the capacity requirement calculation is the determination of the capacity margin which in turn informs the forced outage and loss of load probabilities. BG Energy would like to see more transparency in the assumptions and methodology used in calculating this margin such that it reduces the information asymmetries in the calculation and distribution of the monthly capacity pots.

Given the treatment of interconnectors in the capacity pot, the uncertainty of their actual availability and therefore its contribution towards security of supply, BG Energy questions the inclusion of interconnectors in the capacity requirement calculation.

5. WACC

The WACC methodology is widely used by investors to estimate the required return and cost of capital for capital projects and therefore using it in within the CPM is an accurate reflection of reality for investors. However, calculating the WACC for a project on an annual basis is not reflective of market realities whereby the cost of debt and equity as well as the risk free rate of return can change considerably within a 25 year investment period. BG Energy suggests that the weighted average cost should be calculated over the lifetime of the investment and note solely for one year of that investment. Again, this would provide further stability in the calculation and reduce the uncertainty and risk associated with the annual calculation of the capacity pot.

With respect to the actual calculation, the methodology and the assumptions underpinning the methodology should be more transparent and reflect actual market realities at the time. Again, these assumptions should not be subjective or open to arbitrary changes year on year, but should remain constant for a medium-term period as suggested for the calculation of the BNE Fixed Cost.

6. Impact of Exchange Rate

Exchange rate risk is an everyday risk managed and hedged by both generators and suppliers operating in a cross-jurisdictional market. Any payments made to and from the capacity pot should reflect the ongoing fluctuations in exchange rates and should not be based on a snap-shot at a point in time. This could be facilitated by resetting the Capacity Exchange Rate in advance on a monthly, as opposed to an annual basis. This reset should be performed as close as possible to each Capacity Period (month).

7. Treatment of Wind

We understand that the issue of wind is under review by the RAs and BG Energy looks forward to engaging further on this issue during future consultations. As a basic principle for this review, the value of all generators in contributing towards capacity availability and security of supply must be fairly and proportionately remunerated in the market.

8. Relationship of CPM with Ancillary Services

As stated previously, BG Energy beleives that ancillary service payments should be restructured such that the payments properly reflect the ability of the available capacity to provide flexibility on the system and contribute to system security and integrity. The current process whereby ancillary service contracts are struck bi-laterally with the system operator is not sufficiently transparent or robust for generators to risk investing in more flexible and more expensive assets to meet the systems requirements. BG Energy therefore suggests that that the ancillary service payment mechanism should be modified and enhanced to better meet the requirements of the system and investors.

The current calculation of the BNE Fixed Costs include ancillary service payments as an additional revenue stream for generators, however given the subjectivity of the current contract process, these payments are not guaranteed to all generators. Therefore, BG Energy does not believe that it is appropriate, under the current structure, to include ancillary service payments as part of the BNE calculation.

9. Summary of Key Points

The key aspects of this review in the view of BG Energy is that the non-market payments to generators are reviewed and structured such that;

- recent investments are not jeopardised by any changes made through the CPM review

- rewards for flexibility, such as fast starts, ramp rates etc, should be decoupled from the capacity payment pot and paid out separately as part of ancillary services.
- the overall transparency in the calculation of the capacity pot and payments into and from the pot is improved. This will act to reduce the risks and therefore costs for parties investing in the Irish market. BG Energy has suggested previously in its response to the BNE methodology consultation for 2009/10 that the capacity pot should be calculated over a longer-term period, potentially over a 5 or 6 year period.

It is imperative that this review considers the impact of any changes to the regime on recent investments. Changes to the current regime should not be made to the detriment of investors already in the market thereby eroding investor confidence in the Irish market and future investments.

I hope this response helps inform your interim review of the CPM and BG Energy looks forward to engaging with the RAs further throughout the consultation process.

Yours sincerely

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{by e-mail}