Scope of CPM Medium Term Review

Synergen's response to SEM-09-035

This paper Synergen's views on the medium term review of the CPM in response to the RA's paper "Single Electricity Market - Scope of CPM Medium Term Review - Consultation Paper" SEM-09-035. Synergen has no objection to this response being published.

In principle, Synergen considers that customers are best served through the provision of competitive wholesale pricing signals that will, in combination, deliver a suitable generation margin over the investment cycle. The variations in CPM parameters (and thus the size of the CPM pot) over the initial period of the SEM are not inconsistent with this objective. Synergen notes that the intent of the CPM is to smooth out the payment profile that would have otherwise arisen under an implicit capacity mechanism.

SEM-09-035 sets out how the RAs have considered elements of CPM design since May 2005. Although the SEM has only been in operation for 19 months (a short period within the long term generation investment cycle) there is a stated desire by the RAs to review the CPM. At this point, Synergen considers that: (1) there is no evidence to suggest that the CPM is not operating in the manner anticipated in the RAs design of it i.e. the outcomes are not unexpected; (2) there is no evidence to suggest that the design is inconsistent with the RAs objectives; (3) minor changes to the CPM methodology at this point are neither prudent or required; and (4) any significant changes would not provide the regulatory certainty required to encourage new capacity. Therefore, there appears to be limited justification for the "medium term" review of the CPM as envisaged within SEM-09-35. Synergen considers that stability within the SEM is vital to the ability of the CPM to meet the RAs stated objectives, and therefore suggests that the CPM review is not appropriate at this time and a substantive should be scheduled to start in January 2013 once there has been five full years of CPM operation.

In summary, Synergen considers that there is no evidence presented within SEM-09-035 to suggest that the envisaged CPM review is necessary. Specifically, there is no evidence presented to suggest that the CPM is failing to work as would reasonably be anticipated given the RA's design of the CPM. Synergen is concerned at the uncertainty / risk inherent in re-visiting the CPM mechanism so soon after the start of the SEM.

Notwithstanding Synergen's view that the need for a review of CPM is not supported by any evidence by the RAs, Appendix A contains Synergen's initial views on the specific consultation points raised within SEM-09-035 for consideration by the RAs if the decide to take forward the review. For the avoidance of doubt, Synergen believes that the CPM arrangements as put in place have not had sufficient time to be shown to have any material failings against the desired regulatory outcomes, and that any material changes are likely to give rise to a level of market uncertainty that outweighs any perceived benefits of change.

Appendix A Specific Consultation Points

Notwithstanding Synergen's view that the CPM review should be rescheduled to start in January 2013, this Appendix sets out views against each of the consultation points as raised within SEM-09-035.

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.***

Synergen does not have any historical analysis of the CPM that it is able to share with the RAs.

Synergen requests that any submissions by other stakeholders are published to allow for independent assessment / verification by other participants to avoid the unfortunate situation whereby the RAs place undue reliance on data that is subsequently found to be flawed. Further, the RAs should, with minimum delay, set out the scope and outputs of any analysis that it has undertaken up to this point.

Synergen has previously expressed concerns that the CPM regime represents a regulatory estimate of capacity value and the inherent risks that this entails given that this is a surrogate for market based price revelation. Given the recent issues relating to the SEM directed contracts modelling by the RAs' independent consultants, the RAs should set out in detail an independent verification of the modelling approach used to set:

(1) the CPM methodology; and

(2) the parameters used within the first 19 months of CPM operation.

It is critical to ensure that where reliance is placed on a modelling approach to set participant revenues, the approach and execution are sound. The RAs should therefore explicitly set out the analysis undertaken to determine whether any errors may have arisen in relation to the CPM, along with detailing the approach that has been taken in assessing this historic analysis.

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

In considering the impact of CPM on customers, the RAs should assess the merit in shorter term demand side pricing signals for the CPM (consistent with generator payments) as the current flattening of supply side CPM payments doesn't encourage demand management. There should be a clear explanation of the relative ability of demand to respond to price signals compared to a generating unit – noting that each contributes equally to the capacity margin. This should include an assessment of the CPM being "live" for both demand and generation sides of the market rather than the existing year ahead allocation for suppliers.

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

Synergen considers that any CPM regime that seeks to reward flexibility is likely to be highly problematic to assess, and subject to elements of gaming given the technical nature of these facilities. Consequently, rewards for physical flexibility should sit solely within the Ancillary Services mechanisms.

Synergen considered that the primary incentive within the CPM should be longer term availability - and the extent to which each plant contributes to the overall capacity adequacy as assessed by the TSOs, and therefore the rewards to intermittent generation, should be scaled down based on a broad availability factor. Synergen also notes that flexible generation is not necessarily more reliable than baseload generation – indeed at times when the system is relatively tight there is equally strong desire retain operational plant on the bars as to have back up generation available. At times when the margin is tight (and thus CPM payments are likely to be higher) all generation has equal value to the system and CPM rewards should reflect this.

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.***

In considering the distribution of CPM rewards to generators, the RAs should cognisant of the extent to which generators are able to respond to any signal.

Synergen considers that a generator already unavailable (either due to a scheduled outage or an unexpected technical failure) isn't generally able to respond to return the plant to service quicker – in fact there are already significant incentives to return to service in these circumstances around forgone SMP revenues / exposure to CfD payments. The most likely response that an IPP can make to an CPM incentive is to defer a scheduled outage. The RAs should therefore consider the impact of delaying an outage for a generator already on the bars and assess the extent to which the CPM provides sufficient rewards. It is also important to recognise that in some circumstances generators may be required to undertake important maintenance when scheduled e.g. to avoid their insurance cover being revoked / to comply with health and safety requirements.

Within the current regime, the fixed pot nature of the CPM is such that an IPP may not be able to secure the expected ex-post incentive, hence the rationale for the balance towards significant ex-ante elements within the CPM which Synergen supports. For example, a generator may decide to delay an outage by one week within a month based on the forecast for ex-post lambdas. However, the ex-post lambdas could give an entirely different allocation of capacity payments based on events across the whole capacity month. In such circumstances, the decision to postpone was inappropriate as the IPP doesn't receive the capacity payment signalled as an incentive.

Consultation Point 5. ***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.***

In principle all determinations within the CPM calculation should be performed by the SEMO / TSOs and subject to the market audit regime – this would enhance the stability of the CPM regime and reduce regulatory risk. Further transparency within this calculation would be welcomed. These calculations should be consistent with the assessment / public reporting of generation adequacy within the SEM (i.e. http://www.cer.ie/en/electricity-security-of-supply-generation-adequacy.aspx).

Synergen considers that outage rates should reflect actual plant performance rather than any arbitrary choice such that the CPM is reflective of the current generation fleet.

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.***

The RAs should ensure that the WACC calculation for the CPM continues to be made consistent with international best practice i.e. via utilisation of the capital asset pricing model (CAPM). There are international precedents for the continued use of the CAPM e.g. Australian Energy Regulator (www.aer.gov.au).

Consultation Point 7. ***The RAs welcome comments from participants in relation to impact of Infra Marginal Rent on the BNE Peaker.***

The assessment of infra marginal rent is important in the derivation of the appropriate level of CPM rewards. However, the RAs should also seek to determine the extent to which CPM plus SMP is compensatory for an efficient generator. Clearly the approach is dependent on the modelling accuracy and the assumptions on the BNE (and Synergen has previously commented on how it believes this approach should be undertaken). Synergen thus understands that the workings of the BNE and infra-marginal rent calculations are consistent with the RAs methodology. Synergen considers that if the RAs believe that their approach is conceptually flawed, or not executed in line with their expectations, then the reasoning should be clearly set out.

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 inherent in the CPM design given the combination of an annual ex-ante fixed pot approach to the CPM, and the dual currency basis of the SEM. However, each SEM participant is able to take a view on the market expectations in relation to CPM and undertake currency hedging as it considers appropriate. Therefore, there does not appear to be merit in considering this matter further. This exchange rate fluctuation is entirely consistent with the SEM design. To the extent that the RAs believe that this effect is not acceptable, this could be approached through CPM market segmentation into separate RoI and NI pots.

Consultation Point 9. The RAs welcome comments from participants in relation to the Treatment of Wind within the CPM.

Synergen concurs with the view set out in AIP-SEM-08-127 (*SEM Committee - Wind Generation in the SEM: Policy for Large-Scale, Intermittent, Non-Diverse Generation - Initial Response to Comments and Next Steps*) that the current CPM provides an overpayment to intermittent generation, notably wind. Further, SEM-09-002 (*Impact of High Levels of Wind Penetration in 2020 on the Single Electricity Market - A Modelling Study by the Regulatory Authorities*) shows that a tripling of wind capacity makes little contribution to capacity requirements. The CPM regime should be changed so that the rewards to intermittent generation should reflect the overall contribution made by such plant to system adequacy such that the CPM payments reflect capacity contributions (notably at times of peak demand).

Consultation Point 10. The RAs welcome comments from participants in relation to the Interconnector treatment within the CPM.

In principle Synergen does not consider that interconnectors provide capacity adequacy given the scope of the GB market to scale down exports at times of system stress any therefore their rewards should be scaled down accordingly i.e. the CPM regime should be changed so that the rewards to interconnectors should reflect the overall contribution made to system adequacy such that the CPM payments reflect capacity contributions (notably at times of peak demand).

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

The assessment of the relationship between ancillary services and the CPM should also ensure neutrality for generators. Furthermore, to the extent to which flexibility is rewarded by the Ancillary Services mechanism, then these Ancillary

Services payments should be netted out from CPM rewards for the generators concerned to avoid any double counting.

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***

Central to the CPM design decisions made by the RAs to support the economic case for the Bidding Code of Practise is that the CPM is fully remunerative of the economic rents not returned through energy payments for an efficient generator (as notionally manifested by the BNE plant). Consequently, all stakeholders are reliant on the adequacy of the CPM. For customers, this provides the theoretical basis of adequate and appropriate generation to meet reported security standards. For generators CPM revenues are critical as energy market bids and thus revenues are currently capped by regulatory intervention. Accordingly, the question of whether the existing CPM rewards plus SMP revenues provide sufficient rewards for efficient plant should be assessed within any review. This would include both a plant that provided required peaking capacity, but ran infrequently, and potentially at the margin (based on cost reflective SRMC bids) and high capital cost plant in the baseload and mid-merit sectors which receive revenues at SMP but also require CPM payments - given the SRMC bidding rules that have been adopted by the RAs.

The issues related to the physical transfer capability between NI and the RoI should also be considered given that the CPM assumes that capacity is available across the whole of the SEM and does not reflect extent to which the North / South transmission constraints impact on the SEM.