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16 June 2009

Dear Kevin and Priti,

CPM SEM SCOPE OF MEDIUM TERM REVIEW

Thank you for the opportunity to comment on the above consultation.

As currently designed the Capacity Payment Mechanism (CPM) is integral to the Single Electricity Market (SEM) and is a necessary corollary to energy payments in a market constrained by short run marginal cost (SRMC) bidding principles¹.

According to the proposed high level SEM design published 31 March 2005 (AIP/SEM/06/05) the Regulatory Authorities (RAs) have noted that the CPM should provide the following advantages over an energy only market²:

- (1) More stable market prices with less price spikes required each year to ensure revenue adequacy
- (2) Added revenue certainty and predictability for generators and hence greater security of supply for consumers
- (3) Reduced risk of regulatory or political intervention and hence reduced risk premiums for investors and consumers

¹ We have consistently raised a concern through the SEM design process that a CPM + SRMC regulated market may not be sufficient to remunerate generation capacity in the market. The failure to include real costs, such as gas transportation capacity, in SRMC increases this concern.

² See page 24 of above referenced paper available online @ <http://www.allislandproject.org/en/high-level-design-consultation.aspx?article=f87b8dba-3fd8-48cb-9562-6a9e278a1830>

- (4) Greater transparency of energy pool prices, which by corollary is conditional upon transparency of CPM calculations and payments themselves
- (5) More helpful in dealing with market power and promoting competition

The Global credit crunch has placed an unprecedented premium on any potential risk or revenue uncertainty. In this environment extra emphasis may be warranted on reducing the cost of capital for the long run benefit of consumers – principles 2, 3, and 4 are especially important in this context.

System marginal prices (SMP) in the SEM have fallen dramatically since the beginning of 2009 in line with significantly reduced commodity prices and demand. At the same time credit conditions have tightened beyond all expectations. The CPM in this context should serve to stabilise generator revenues and provide certainty and predictability for future investment and security of supply. Any change to the CPM must be tempered with the need to maintain consistent, stable and predictable investment signals and revenue streams. The credibility of the CPM would be seriously undermined at this stage by radical change or by political intervention to reduce capacity payments. Instead the focus should be on improving the CPM in line with the principles set out above. This means that reform should stabilise prices for generators and consumers, improve revenue certainty and predictability for generators, minimise political and regulatory intervention (and the potential thereof), improve transparency, and be competitively neutral, treating all generators and technology types equally.

In the interests of fairness, as per CPM objectives, Viridian Power and Energy (VP&E) suggest that CPM reform should not consider discrimination being built into the CPM. Among other things this means that all generators get paid on availability and rightly wind generators are not available when there is no wind resource.

Adding greater complexity to the current design would be unhelpful and inconsistent with CMP objectives. On this note Viridian Power and Energy (VP&E) do not consider the CPM an appropriate mechanism to incentivise generator flexibility. We do however recognise this is an important issue to address with increasing penetrations of wind going forward and suggest that it can be more easily achieved with greater transparency and focus through the ancillary services mechanism³.

Improving transparency should be made a key priority of CPM reform. Calculation of the capacity requirement would particularly benefit from this as the process is opaque at the moment. Recently the RAs held a workshop to review the best new entrant (BNE) input parameters. This level of enhanced transparency and interaction with market participants is a welcome development and it would be worthwhile extending this exercise to calculating the

³ We have previously written to the regulatory authorities separately on this and would be happy to discuss our proposals further if that would be useful.

capacity requirement. The system operators should be required to calculate an all-island capacity requirement using a standard methodology in a transparent manner, with full consultation on the inputs to this calculation. There should not be scope for interpretation in the figures used, by either the system operator or regulatory authorities. Any opportunity for interpretation will reduce the confidence investors place on the capacity value when making new generation investments.

Certain additions to the CPM are necessary and should be welcomed, particularly the introduction of demand side participation. According to the SEM design paper published 31 March 2005 “[t]he Regulatory Authorities view demand side participation as an important contribution to both competition in the all island energy market and as a potential contributor to security of supply”. The CPM could be designed to promote demand side participation but this is surprisingly not included within the scope of the review. We note that Eirgrid continues to use legacy mechanisms for demand side participation, in particular, for example, powersave and winter peak demand reduction scheme (WPDRS). These mechanisms were expected to fall away with the introduction of the SEM, but they are still being used extensively. We suggest that the review considers replacing these mechanisms with market led arrangements based on the SEM design.

Given that CPM volatility is a well understood impediment to financing peaking plant it is also surprising that this has not been automatically included within the scope of the medium term review. This should be included within the scope and addressed appropriately otherwise new flexible generation capacity may not be delivered to provide adequate security of supply for the electricity customers on the island of Ireland. We are aware of a separate consultation about volatility of the BNE calculation methodology however that paper only considers one of many aspects of volatility in the current CPM. Consideration of CPM volatility should include the BNE calculation methodology, variation in the capacity requirement used to calculate the size of the capacity pot, and volatility and complexity in the distribution of the capacity pot.

In appendix I to this letter we address the specific questions raised in the consultation document.

Please do not hesitate to contact us if you would like to discuss further or to arrange a meeting if that would be helpful.

Yours sincerely

A handwritten signature in blue ink that reads "K Hannafin".

Kevin Hannafin
Senior Regulation Analyst

Appendix I

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.

VP&E Response

We have no analysis to provide at this stage but we can suggest the following areas that would benefit from analysis:

- (1) Identifying the statistical relationship between availability and generation margins would be useful in understanding why availability might have improved. This is based on the premise that generators with low utilisation tend to have high availability.
- (2) Quantifying the contribution demand side response has made to security of supply to date
- (3) Identifying the evolution of capacity payments as a proportion of total SEM payments to generators since the market began
- (4) Calculating capacity payments made when availability was absent for system constraint reasons

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

VP&E Response

We are aware that some consumers have raised concern about the volatility of capacity charges. Given this it would be useful to explore whether capacity charges can be set out for consumers in advance, as applies to imperfections charges. This would provide greater certainty to consumers and facilitate more accurate charging by suppliers.

We would also welcome a review of how demand side response initiatives might help consumers meet environmental targets as well as provide capacity and increased flexibility to the system.

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.

VP&E Response

As noted in our cover letter VPE are not in favour of discrimination being built into the CPM. This is in keeping with the CPM objectives of fairness and simplicity. Incorporating flexibility criteria into the CPM would be discriminatory, introduce significant complexities to what is already a complex mechanism and would inevitably reduce transparency. We agree however that generation should be rewarded for providing flexibility to the system and believe that the ancillary services mechanism is the best way of achieving 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.

VP&E Response

We remain unconvinced that ex post capacity payments based on relative LOLP increases availability and suggest that CPM objectives might be better facilitated with the fixed capacity payments stream parameters increased. This would provide greater certainty to investors and capital providers hence reducing the cost of capital to the long run benefit of consumers, without wholly removing short-term signals in the CPM. Such an approach would also align the half hourly capacity signal to generators with the capacity payments by suppliers.

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.

VP&E Response

As noted in our cover letter, VP&E's key concern in relation to the capacity requirement calculation is the current absence of transparency. We can comment further once we have a better understanding of the model and assumptions used in calculating the capacity requirement but for now we note the following:

- 1) The system operators should be required to calculate an all-island capacity requirement using a standard methodology in a transparent manner. There should not be scope for interpretation in the figures used, by either the system operator or regulatory authorities. Any opportunity for interpretation will reduce the confidence investors place on the capacity value when making new generation investments
- 2) All plant availability should be based on historical data and not projected from expected improvements. If improvements in performance do materialise then they will automatically be factored in future historical data.

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.

VP&E Response

We have no particular issue with the Capital Asset Pricing (CAPM) methodology per se and consider it a reasonable approach. However it is essential that the assumptions and parameters that feed into the model are realistic and achievable. They should be based on actual real financing arrangements and not derived from a theoretical basis that cannot be replicated in the all-island market.

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

VP&E Response

VP&E are strongly against the deduction of Infra Marginal Rent from the BNE price because this substantially increases the forecasting error and is perverse in nature because it reduces capacity payments when needed most.

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

VP&E Response

Exchange rate risk has to be managed by market participants. We cannot suggest any improvements at this point in time.

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

VP&E Response

We note that the RAs have a separate workstream on wind and we look forward to contributing to that.

At this point we note the government (and EU) targets for energy from renewable sources and that any reduction in capacity payments to wind will only increase payments through support mechanisms, and thus gives no clear benefit for consumers. We have not seen any conclusive analysis to date to show that the capacity payment to windfarms is unduly generous when all aspects of the effect of wind on the market are considered.

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

VP&E Response

We struggle to see justification for changing the treatment of the Interconnector (IC) within the CPM. For example giving the IC a capacity value when it is not flowing would be difficult to justify. However we would look forward to further analysis from the RAs if they think a change can be justified.

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

VP&E Response

We are not convinced that ancillary services revenue should be deducted from the BNE price given the volatility this can add to the CPM and we would therefore welcome justification for this approach.

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

- As noted in our cover letter demand side participation should be added to the scope of the medium term review because of the security of supply, financial and environmental benefits it could bring.
- From a security of supply perspective the BNE OCGT should be a dual fuel unit. Measures to incorporate this into the CPM should be included within the scope of the medium term review.
- The treatment of non-firm generators within the CPM is worthy of analysis. Such analysis might consider whether payment for capacity is equitable in all cases, particularly if network constraints were such that the generator cannot contribute to security of supply.