BORD NA MÓNA POWERGEN

Submission by Bord na Móna PowerGen

on

Fixed Cost of a Best New Entrant Peaking Plant
&
Capacity Requirement for the
Calendar Year 2012

June 2011

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Introduction

Bord na Móna welcomes the opportunity to make a submission to the consultation on the "*Fixed Cost of a Best New Entrant Peaking Plant & Capacity Requirement for the Calendar Year 2012*", the mechanism by which the Annual Capacity Payment Sum (ACPS) for 2012 is ultimately determined.

In previous years comments by market participants and, in particular, generators, have focused on the methodology used to calculate the cost of the BNE and the value of ACPS. There have been a number of hardy perennial issues, several of which are again highlighted in this response, see below. However, unlike previous years the consultation for the Medium Term Review of the Capacity Payment Mechanism is now 'live'. While this medium term review is timely and welcome, the temptation to postpone implementation of 'adjustments' submitted by participants in this consultation process in order to realign, in particular, the actual costs associated with the physical delivery of a BNE peaker must be avoided.

In this response, attention is first focused on the underlying assumptions supporting the estimation of the WACC value used in establishing the fixed costs of the BNE peaker. Furthermore, technical considerations concerning the choice of plant and the apparent failure to take into consideration costs which would be experienced in a real life development project are also discussed. In addition, while the criteria of using 20 years for the economic payback period is now well established, essentially by custom and practice, a point which was raised in Bord na Móna's 2010 response and which appears not to have been adequately considered, is restated here. Likewise, and notwithstanding some concessions made last year during the period between the Consultation Paper and the Final Decision, the assumptions currently buttressing the value of Ancillary Service payments to a BNE peaker can not be substantiated in practice. Finally, the Deemed Capacity Requirement continues to remain exceedingly tight with respect to the projected peak demand.

Financing and the Weighted Average Cost of Capital (WACC)

In general, the ongoing fiscal crisis has resulted in a scarcity of debt financing in the money markets as regulatory authorities have increased the levels of reserves lending institutions must keep on hand. The simple net effect of this more prudent regulatory environment is that the cost of debt and equity must increase (and increase significantly) from last year's value.

In addition, the use of the Capital Asset Pricing Model (CAPM) for determining the cost of equity allows the volatility in the underlying indices used in the computation to 'wash' through each year the calculation is run. It would be preferable to instead employ a long term moving average of the component indices rather than the current practice of utilising spot prices. The absence of such a 'smoothing' mechanism creates annual variations which range from *circa* 5 – 14% and results directly in financial uncertainty (essentially facilitated by the regulator) for market participants. While it is acknowledged that CEPA may cross check spot rates against recent trends in order to give their best estimate of the appropriate range for the WACC; the current (spot based) methodology nonetheless feeds regulatory uncertainty directly into the ACPS.

As previously stated, the industry in Ireland is operating in the most difficult trading conditions in recent history. It was presumed that a rise in the ERP with respect to last year's would have been appropriate. Furthermore, highlighting a comment posited by the NEAI concerning a notional investor in the SEM while notwithstanding the fact that the jurisdiction for this year's BNE peaker is NI, such a unit's predominant market would be the RoI. It therefore, raises the very obvious point that a rational investor when evaluating the risk profile of his/her proposed venture would focus attention on the prevailing conditions in the RoI and that the WACC should naturally take account of this fundamental.

The CEPA/PB consultation paper recommends that the "*appropriate cost of equity to allow a BNE peaking plant investment in the RoI for 2011 lies within the range 9.40% - 13.50% and for the UK in the range 6.90% - 8.50%*". However, the figure used by the RAs in the consultation paper is the simple average of the upper and lower bounds for each jurisdiction – other than convenience, there appears to be no rationale for taking the average, particularly as the WACC itself is a composite figure. Surely the prudent and rational investor would seek to use a value closer to the upper limit when making his/her investment decision.

While Bord na Móna is not commenting on the extension of the physical lifetime of the peaker plant from 15 -20 years *per se*, there has been no explicit decoupling of the fact that while the payback period has been extended, there has not been a commensurate modification in the rate of return on equity which a rational investor would expect for a investment period which has been extended by 33%. As stated previously, the failure to take account of this fact results in an inherent underestimation of the WACC.

Technology Selection – Capital Costs

In last years consultation Bord na Móna commented that the exclusion of capital costs associated with grid code compliance for an 'off the shelf' peaker was a material shortcoming. In the Decision Paper which followed, it appears that this point was not substantially considered. Again the point is now re-iterated that it is not sufficient to assume that the BNE plant will be grid code compliant 'out of the box' without properly addressing the potential costs associated with achieving compliance.

Ancillary Services

The ancillary services rates for 2011/2012 have not yet been developed, and the estimations used in the consultation paper are based on the indicative harmonised rates which are currently under consultation.

It has been previously indicated that Eirgrid is under no obligation to contract with all/any generators to provide AS at any level above the minimum requirements set out in the Grid code.

Fundamentally, Bord na Móna is aligned with the comments of the NEAI in opposing the concept of deducting AS and IMR rents from the annual cost of a peaker. The current practice introduces unpredictability which a rational investor would be obliged to exclude or heavily discount, and as such Bord na Móna believes that the RAs should, for the purpose of providing regulatory certainty, exclude these deductions.

Deemed Capacity Requirement

Bord na Moná notes the comments contained in last year's Decision paper in relation to '*the removal of capacity credits for wind*' and the treatment of '*reserve margin*' on the system. However, again this year the deemed capacity requirement reserve margin, (ratio of the deemed capacity requirement to peak demand) remains extremely tight at *circa* 7%. Citing, the BNE Decision paper (SEM-10-053) "*the cold weather in January 2010 was more like a 1 in 40 year weather event*". However, it would labour the point to refer back to the harsh conditions and the all time record demand which occurred in late December 2010. Surely now it '*would be prudent and responsible to calculate peak demand recognising that economic conditions are not necessarily the main driver*"[1]. Bord na Móna would again urge the Regulators to review and revise upwards the capacity requirement for 2012.

[1] SEM-10-053 at pp 31

I trust that the about comments will be helpful in the consultation process. If you have any queries or comments please do not hesitate to contact me.

For and on behalf of

Bord na Móna PowerGen

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Projects Manager

Bord na Móna PowerGen

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