IWEA Response to the Discussion Paper CPM Medium Term Review: Work Package 7 – BNE Calculation Methodology

12 November 2010

IWEA welcomes the opportunity to comment upon the discussion paper on the CPM Medium Term Review – Ref SEM/10/068. In this response we set out our views on the work package presented, but would note that as a further paper is due on other work packages, it is difficult to take a definitive view on any issue without sight of all the proposals together.

Background

We commend the RAs on the work done analysing different capacity payment mechanisms in different countries. This piece of work is particularly useful and demonstrates the SEM is built around a methodology and principles that have been proven elsewhere. The knowledge gained on the products / mechanisms identified, could also be used in any work carried out on ancillary services, in terms of structure of commercial products, etc.

We would also reiterate our comments from the previous consultation that the Medium Term Review process should be carried out in a timely manner, particularly in light of the number of grid connection offers currently being issued to developers under the Gate 3 process. The process should also take a holistic view of all work packages in order to ensure a consistent approach is taken to any decision making. In particular we understand separate work is being carried out on ancillary services – it is imperative this work is done in parallel with this work-stream as both items are closely related. It is clear that following the review of both issues, the SEM should be structured to incentivise plant that complement renewables and allow the system operators to run the system optimally, i.e. flexible, efficient, provide inertia, etc. In this response we highlight below our particular concern with the specific proposal within Option 6 which suggests treating renewable's differently on the basis they receive external support. IWEA considers this a very dangerous precedent which should be ruled out immediately.

Below we give our comments on the specific options presented for consideration.

BNE Calculation Methodology 2006

The paper refers to the RAs wish to revisit Methodology Option 1, which uses VOLL, FOP and LOLP to calculate the annual Capacity Pot. The paper states that historically this process would have produced comparable results to the current methodology, therefore suggesting the methodology is in the correct range and warrants further consideration. However this is solely the case because VOLL is currently based on the BNE calculation and therefore the resultant pot will inevitably be very close to that calculated under the BNE methodology. The stability and simplicity that it is suggested Methodology 1 would deliver is purely a function of how VOLL has been calculated over the last few years. Without seeing proposals on how it might be calculated into the future it is not possible to support this methodology.

IWEA believes that continuing to base the capacity pot upon a best new entrant is a much more stable and transparent methodology over basing the pot on VOLL and LOLP. The advantage of the current methodology is all the individual line items can be tested against market conditions. While VOLL and LOLP are credible economic parameters, they are much less understood and more difficult for investors to predict.

Review of Option 2 – Some components of capacity pot remain constant

IWEA sees merits in further investigation of Option 2 whereby some elements of the annual capacity pot would be fixed for a period of 3-5 years. It would bring a greater level of stability and certainty to the annual capacity pot calculation while allowing for the adjustment for other more appropriate line items as needed. It would be important that the items fixed are those which would not be expected to move to any significant degree over the time horizon. Indexation of the fixed items would also be appropriate. For those items that remain unfixed and change annually, refereancable sources for each item should be consulted and agreed upon.

Review of Option 3 & 4 – Smoothing of capacity pot

Under the earlier SEM consultation an Option 3 and 4 were proposed, whereby the annual capacity pot would be smoothed by using a rolling average of the previous number of years. We note that this option is not considered further in this paper but believe it warrants further analysis and consideration under this consultation process.

Option 5: Keep pot stable for a number of years

IWEA agrees that this option which would fix the capacity pot for a number of years will most likely a stepped change in capacity payments at the end of each period it is set for. It would also introduce the risk of providing a cyclic investment signal, where there would either be a flood of investments over the set period or a scarcity, depending on how the market costs move against the capacity pot.

Option 6: Fix Price for New Entrants

We would like to highlight our considerable concern to the specific proposal under option 6, which sees wind farms excluded from a market mechanism purely on the basis it receives external support, rather than on any technical or commercial rationale. We believe this proposal to be a worrying precedent and would strongly oppose such a concept. As pointed out in the recent proposed position paper on the 'Principles of Dispatch and Design of the Market Schedule' (SEM-10-060), whilst the SEM Committee is not tasked explicitly with delivery of renewable targets, it should ensure as a minimum that the SEM is not configured in a manner that actively frustrates the delivery of these targets.

In terms of what this proposal seeks to achieve, it does appear that the current mechanism acts as a signal deterring plant to retire, as much as it does to incentivise new plant. Whilst this is not necessarily a bad feature it does not seem appropriate at the present time as there appears to be an over capacity on the system, with many plants not required to provide energy to the system. Furthermore the CPM should act to ensure that the conventional plant that enters the market has the right characteristics in terms of flexibility, cost to produce, etc.

IWEA has previously stated its belief that the ancillary services market is the best place to ensure new entrants have the 'right' characteristics. However the proposals introduced here certainly warrant further consideration.

Fixing Elements of WACC Calculation

IWEA also recognise that there may be merit in setting those elements of the WACC calculation that do not change year-on-year in order to give investors greater certainty on the extent of the annual movement of the capacity pot. In addition, IWEA would suggest that the SEM Committee define fixed public sources for the inputs to the WACC calculation, so that market participants can follow the movements of these inputs and will prepared for any changes to the WACC.

Alternative Financial Methods

In terms of the proposal to potentially move to a Discounted Cash Flow mechanism or Adjusted Present value mechanism, a greater level of analysis would be required before industry participants can give an informed view.