To: Mr Clive Bowers
Commission for Energy Regulation
The Exchange
Belgard Square North
Tallaght, Dublin 24
12 November 2010

Submission of Consultation Paper (SEM/10/068)

Dear Clive,

The Peaker Plant Investors Group (PPIG) would like to take the opportunity to respond to the SEM Discussion Paper 'CPM Medium Term Review Work Package 7 – BNE Calculation Methodology' (SEM-10-068). Our response raises issues of key importance for generation investment in the Single Electricity Market in summary form, rather than a detailed submission on these. One of the fundamental facets of the CPM is to offer certainty to investors. Our overall view is that to support this certainty there should be no sudden shocks to the CPM with the outcomes of the CPM review giving investors greater revenue visibility and increased project bankability.

The context of our comments is the facilitation of renewables over the next ten years and the need to have a generation plant portfolio to provide a safe and secure system consistent with a relatively small synchronous electricity system.

1. Energy Market v. Quantity-Based v. Price-Based Capacity Mechanism

Arising from the extensive analysis and consultation that took place on this topic prior to SEM Go Live a price-based capacity mechanism emerged as the preferred option over a quantity-based capacity mechanism or energy only market. To move away entirely from this, where the SEM only recently celebrated its third birthday**,** would add significantly to both regulatory and financial risk for incumbents and new entrants.

Since then the SEM Committee has consistently stated that it considers the CPM as a key feature of the SEM design. In view of this it seems prudent to accept that the CPM as a price-based capacity mechanism should remain in place for the foreseeable future and the CPM Review should address issues such as CPM price stability, market entry and exit signals, and incentivising the right portfolio mix for facilitation of renewables, while recognising investor risk and bankability of new projects if they are to materialise.

2. CPM Price Stability

One of the main drawbacks of the CPM that has emerged over the past three years is the current methodology of calculating the BNE Fixed Cost on a year-on-year basis, which creates significant uncertainty in the level of future payments. For new entrants, it means investing with the risk that the level of capacity payments considered when making the investment could change significantly during the lifetime of the plant if the RAs change the overall size of the capacity pot or any of the factors used in calculating the pot. It would certainly be beneficial if the RAs could agree not to change certain parameters (gearing, beta, investment horizon) in the WACC calculation for a period of 3 years and ideally 5 years.

We support the detailed consideration of both the current BNE methodology and the MCR approach (MCR= (1-FOP)*LOLP*VOLL). However, while the use of VoLL times Loss of Load Probability is very simple to calculate, the value of lost load is not at all clear. It appears to have been selected as €10,000/MWh at the start of the market and has been indexed upwards since. This number is much too open to regulatory discretion, and therefore its use does not increase investor confidence is a stable and predictable value of capacity going forward.

A further proposal is that the basis for calculation of the CPM could lean more towards the formulae used in its calculation currently included in international IPP power purchase agreements. There could be some factor to incentivise Flexible and Dependable capacity included which will support flexible gas turbine and pumped storage designs, assuming these are key to enabling the TSOs achieve up to 75% of wind generation in a safe and secure manner by 2020.

3. Peaking Plant and Absence of Gas Transmission Charges

It is worth noting the characteristics of peakers, i.e. they only run a few hundred hours per year but are intensive capital equipment at almost €100m per 100 MW BNE. Investors seek a minimum of 9% IRR in light of the current economic downturn. Taking WACC as 9% and total investment capital cost as €98m per 100 MW of BNE this amounts to €158/kW/yr over a 10-year period, to which the annual fixed costs must be added.

The fact that gas transmission charges are not included in the calculation is forcing investors to install simple diesel fired peakers, but these are not the most appropriate type of machine for a future grid with high penetrations of wind. This may be addressed by the new ancillary services payments, but it is hard to form a view for this CPM Discussion Paper without also seeing the new ancillary services payments. The BNE Fixed Price needs to employ a pass through recovery mechanism to mitigate against the high gas-connection charges and the uncertainty of recovering these.

4. Review of Options 2, 5 and 6 in the BNE Calculation Methodology

The Discussion Paper states the RAs propose to review three options namely:

- Option 2 (calculate BNE Fixed Cost on an annual basis but some components cost remain constant for a number of years)
- Option 5 (calculate BNE Fixed Cost and keep it in place for a multiple year period)
- Option 6 (fixed price arrangement for new entrants)

We strongly favour Option 6 for the following reasons:

1. Only this option gives the future revenue certainty that allows investors to obtain financing at the costs envisaged in the WACC calculations

2. The fixed price provides an increased level of stability to new entrants, strengthens investor confidence and hence facilitates market entry

3. It enhances project bankability and facilitates investment with financial institutions in a very difficult economic climate

4. It does not suffer the serious disadvantages the other proposed options have, i.e. they may be too short term and risky for financial institutions as they do not provide enough visibility to recover the capital investment

5. This option, namely guaranteeing a BNE price only to non-renewable generators for a period of several years, is already operating successfully in Spain

5. Market Entry and Exit Signals

Under the criterion "Efficient price signals for Long Term Investments" the RAs state that revenues earned by generators should efficiently signal appropriate market entry and exit. It is not clear from facilitation of renewables' studies to date what changes are required in the generation plant portfolio in order to ensure that Government 2020 renewable targets are reached. However, it is clear from statements by the SEM Committee, the RAs, EirGrid and the Facilitation of Renewables Report that more flexible plant will be required in the future to support largescale wind generation – some of this flexibility will come from modifications to existing plant but most will come from new plant and new investors. This CPM Review provides an appropriate opportunity to implement the right market entry signals together with the necessary revenue visibility and project bankability to deliver the required plant portfolio.

Regarding efficient market exit signals for old, inefficient and unreliable plant it is not clear that these signals exist under the current CPM rules; we suggest that under current CPM rules where a capacity surplus exists, there is no incentive for old, inefficient, under-performing plant to exit the market. The continued presence of these plants dilutes the economic signal to the type and quality of new plant required for security of supply in the future.

6. Rebalancing the CPM and Ancillary Service Pots

The 2011 approximate figures for the CPM and Ancillary Service (AS) pots are €560m and €60m, which are broadly guaranteed to the generation sector. If this total sum of €610m is increased in isolation from other factors then such increase must be borne by electricity users – this would not be acceptable in the current economic climate. We suggest therefore that the combined revenues of CPM and AS be considered jointly, rather than the current arrangement whereby this Discussion Paper focuses exclusively on the CPM, and the review of AS is understood to have got underway in October of 2010. In short, these should be reviewed jointly.

In view of the increasing importance of AS over the next ten years there may be a case for reducing the CPM payments and increasing the AS payment pot correspondingly, without changing the value of the combined pots. We do not have the detailed data or modelled results to demonstrate the benefits of this, but we do urge the RAs to undertake a joint CPM-AS review. Such an approach may take a little longer but it seems rational to apply 'joined up thinking'; as the REFIT mechanism ensures that REFIT-supported renewables are not dependent on CPM or AS revenues, any delay arising will not impact on the construction of new windfarms or the delivery of the Government 2020 renewable targets.

7. In Conclusion

- It is clear we are entering a turbulent economic period, with quantitative easing and other unorthodox monetary tools, all of which could contribute to inflation in some jurisdictions and not others. Should indexation be necessary in any of the options selected, then the most appropriate indexation to use must be the one that most closely matches the costs of building new power plant.

- We strongly urge that non-renewable connection applicants should not have to decide about taking up their connection offers until after the completion of such a CPM-AS review, and that a more reasonable period (e.g. 90 business days) be allowed between a final decision on the CPM-AS review and the signing of connection offers.

- We recognise that the Ancillary Services required in the future need to be further studied, understood, defined and valued – and that this will take a period of time. However, there is a window of opportunity to get this right thereby removing the need for a further review in two or three years; the current economic downturn provides such an opportunity without causing any significant delay in shaping the generation portfolio and bringing the new flexible generation plant on stream to facilitate largescale renewable generation.

8. Recommendations

We make the following recommendations to the RAs in response to this Paper:

1. That the CPM and Ancillary Services reviews be carried out jointly, rather than in isolation as seems to be currently planned; there is a window of opportunity to get these right, thereby removing the need for further significant reviews in two or three years time

2. That Option 6 be adopted as:

    a. Only this option gives the future revenue certainty that allows investors to obtain financing at the costs envisaged in the WACC calculations

    b. The fixed price provides an increased level of stability to new entrants, strengthens investor confidence and results in facilitation of renewables

    c. It enhances project bankability and facilitates investment with financial institutions in a very difficult economic climate

    d. It is already operating successfully in Spain

3. That this option be structured in the form of a 10-year Renewables Facilitation Contract (RFC), which could be a combination of CPM + Ancillary Services.

4. That non-renewable connection applicants should not have to decide on taking up their connection offers until after the completion of such a CPM-AS review, and that a more reasonable period (e.g. 90 business days) be allowed between a final decision on the CPM-AS review and the signing of connection offers. The reason is to allow promoters have clear visibility of the economic viability of projects before connection agreements are signed and taken up

5. That the CPM and AS revenue pots are rebalanced in a ratio of (for example) 75:25 instead of the current of approximately 90:10; this is to reflect the increasing importance of AS as enunciated by the SEM Committee, The RAs and TSOs

6. That the BNE Fixed Price employs a pass through recovery mechanism to mitigate against the high gas connection charges and the uncertainty of recovering these

As an important group in the future generation sector we look forward to further contact and interaction with the Regulatory Authorities and their modelling consultants Poyry on these crucial matters.

Sincerely Yours

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