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Dear Clive, Jody

RE: CPM Medium Term Review Work Package 7 – BNE Calculation Methodology

Recognising that this consultation is part of a Review of the Capacity Payment Mechanism (CPM), it should nevertheless be put in context with the other ongoing developments in the Single Electricity Market (SEM). It would be useful and indeed pragmatic at this stage if a high-level vision or plan for the SEM in light of regional integration, interconnection and increased intermittent generation was to be consulted on and provided to the market. A high-level understanding and insight into the desired future direction of the SEM would provide a better perspective to the overall review such that a CPM can be designed to meet the **future** requirements of the SEM.

As a general comment on the consultation, Bord Gáis Energy (BG Energy) does not feel that there is enough detail and analysis in the Regulatory Authority's (RAs) paper at this time to give a firm and established position on the different proposals presented. It is our understanding however that further analysis and detail will be forthcoming in the RAs next consultation which is scheduled to be published in the near future. On that basis, BG Energy has only some high-level comments and observations on the consultation and it's proposals in general at this stage.

1. CPM Design in Other Regions and International Experiences in Delivering Adequate Capacity

The international comparison provided in the consultation provides a useful insight in understanding other methods of pricing capacity and how the SEM model compares internationally. Noting the comments that capacity mechanisms, while effective in delivering capacity, tend to be at a higher price than energy only markets, BG Energy would suggest that this is dependent on how security of supply is valued in respective markets. A small, minimally interconnected market on the peripheries must manage capacity margins strategically on an ongoing basis. Providing capacity in these markets, particularly at periods of tight margins, has a high relative value and therefore the relative price to another market is not directly comparable.

2. Options for the BNE Calculation Methodology

The principle objectives of the CPM are to provide signals to new investors when capacity is needed and also to incentivise capacity availability amongst generators particularly during periods of tight margins. In terms of calculating the capacity price, it is therefore important that the calculation is transparent, predictable, stable and equitable such that generators can anticipate and react accordingly to the signals it is trying to provide.

In revisiting the proposal to use a combination of Value of Lost Load (VOLL), Loss of Load Probability (LOLP) and Forced Outage Probability (FOP) as inputs to calculate the price of capacity, the RAs suggest that a retrospective calculation of the formula has produced stable yet comparable results relative to the current best new entrant (BNE) calculation. Stability in this formula has been achieved not by design but because the RAs have chosen not to change any of the inputs (which are all administered by the RAs) in the intervening years. The comparable results relative to the BNE calculation are to be expected considering that the calculation of VOLL is currently based on the same BNE calculation used in the CPM.

BG Energy does not believe that a mechanism based on VOLL, LOLP and FOP would deliver the transparency and stability needed by investors. Although stable at this juncture the inputs are likely to come under greater scrutiny if they are to underpin a mechanism as strategically important to the design and operation of the SEM. Although not without its flaws, the current methodology of calculating the BNE is more transparent and is a more robust methodology for participants and therefore, in BG Energy's view, has greater merit than the MCR proposal using VOLL, LOLP and FOP.

The RAs proposal to fix certain elements of the BNE calculation for a number of years has merits in providing stability and longer-term signals to investors. Further detail and analysis on what and how long certain parameters would be fixed is needed to better understand the implications of this proposal but at a high-level it would seem to provide the transparency and stability desired by investors as well as the incentives and market reflectivity desired by the RAs. This is however dependent on what parameters are fixed and for how long.

The further option to fix the BNE calculation over a number of years is in BG Energy's view a step too far and could indeed create even greater instability between fixed 'block-years' than the current methodology. A more appropriate methodology may be to calculate a rolling average cost of the BNE over a designated period of time. This would ensure that the costs are market reflective on an ongoing basis while yet also providing a greater level of stability to the market in a consistent manner. This option had been proposed previously by the RAs and BG Energy urges the RAs to include it in their analysis as part of the next consultation.

The final option, to provide a fixed price for new entrants, again potentially has merits and BG Energy looks forward to the RAs detailed assessment of the proposal in the next consultation. With respect to the reference of excluding renewable generators from the pot on the basis that they receive support payments through REFIT, BG Energy would make the following brief points. Firstly, not all renewable generators are in receipt of REFIT payments and to exclude all renewable generators from the capacity pot would discriminate against merchant generation projects. Furthermore, given the components of a REFIT payment, the exclusion of renewable generators from the capacity mechanism could potentially, in low price scenarios, increase the cost of renewable supports levied on customers through the PSO.

3. Impact of Options on WACC Calculations

In this section the RAs suggest that the "CPM is not designed in principle to mitigate financial turmoil and it is certainly the case that the volatility of the WACC parameters is outside the control of the RAs". While BG Energy certainly agrees with the second part of this assertion the CPM has been a key feature of the SEM as a means to provide stability and certainty to the market such that prices and thus revenues remain stable. As such, it underpins the business plan, financial projections and financial risk associated with investing in the market.

In short, the CPM does have a role in mitigating financial risk and reducing the costs of investing in the SEM and therefore this must be taken into account in the RAs analysis and considerations in future. In general, greater consistency between annual calculations of the WACC and the WACC calculations for different regulated formula[1], be that through fixing certain inputs or the indexes and benchmarks used in the calculation would reduce volatility and would be a welcome step. BG Energy would welcome greater detail and analysis on the RAs proposals and the impact it would have on the outturn BNE cost in the RAs subsequent consultation.

In summary, BG Energy welcomes the RAs initiatives to introduce a level of stability in the CPM through the BNE calculation. Such stability will more closely meet the objectives of the CPM in terms of signalling investment and incentivising availability. However, BG Energy requests more detail on the individual proposals as well as further analysis on the impact each of the proposals will have on the BNE calculation, the signalling of market entry and exit, and the incentivisation of not just capacity availability but the availability of appropriate capacity to meet the system needs.

Finally, a clear view of the future strategic direction of the SEM is needed if a CPM is to be designed to correctly incentivise and reward the right type and

[1] Specifically this refers to the discrepancy between the assumptions made by the CER in its calculation of the BNE WACC for 2010/11 and its calculation of the rate of return to be earned by ESB Networks over the coming five years. The BNE WACC was reduced on the basis that the financial environment is more stable this year than last, yet the rate of return for ESB Networks was increased on the basis that it "reflects the increased costs that are faced by the DSO to finance its business".

timing of capacity investments which compliment and facilitate market developments. Without such a ‘roadmap’ for the SEM, ad-hoc changes in the CPM will create uncertainty and contradict the objectives and incentives it is seeking to provide.

Please do not hesitate in contacting me if you have any queries on any of the above comments.

Yours sincerely,

Jill Murray
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Bord Gáis Energy