

13th January 2012

Re: CPM Medium Term Review Draft Decision Paper

Endesa Ireland welcomes the opportunity to respond to the *CPM Medium Term Review, Draft Decision Paper*.

In general, Endesa Ireland is in favour of the RAs' proposal to retain the CPM in its current format and not to make any substantive changes. Endesa Ireland welcomes the RAs' recognition of the landscape change that has occurred since embarking on the CPM Medium Term review, and feels that retention of the CPM in its current format serves to best achieve the objectives of the mechanism, as set out in SEM-53-05, which are still valid and important for the SEM.

In this regard, Endesa Ireland notes the SEM Committee's comments in SEM-09-105 that it is 'mindful not to propose options that are disproportionately expensive or different to the current design relative to the benefits the changes would create'. In the Executive Summary to this draft decision the SEM Committee states that it agrees with respondents' position not to support any substantive changes to the SEM, but will make 'minor changes to certain aspects of the CPM calculation'.

Endesa Ireland considers that the change to the calculation of Infra-marginal Rent (IMR) proposed in the draft decision is in direct opposition to this criterion and constitutes a substantive change to the CPM. It is Endesa Ireland's view that the draft decision does not illustrate the benefits of the proposed amendments nor justify the change proposed. Endesa Ireland considers that the RAs should set out the reasons behind implementing such a change and the benefits it would create and allow market participants to comment on these reasons, prior to deciding on such a change.

Endesa Ireland makes the following points on specific aspects of the paper:

Infra-marginal Rent Deduction

As outlined above, Endesa Ireland considers that the change to the calculation of IMR proposed constitutes a fundamental change to the design of the Capacity Payment Mechanism.

In support of this position, Endesa Ireland refers to the decision in SEM-07-187 which states that IMR should be calculated by way of Plexos run on the basis of the 'current competitive system state' and not from an artificial scenario. This has been the underlying principle behind the selected design for calculation of IMR. The change proposed by Option 2 is fully in opposition to this principle, as the proposal is based on an artificial scenario.

Contrary to SEM Committee's statement in the draft decision paper, Endesa Ireland is not concerned that the IMR deduction calculation is a source of instability or unpredictability, it has not proven to be such so far in the SEM. Endesa Ireland considers that regulatory uncertainty has proven to be the main source of volatility in the Capacity Payment Mechanism as a whole.



Endesa Ireland does not support the proposal for calculation of the Infra-marginal Rent Deduction as set out in Option 2. Endesa Ireland is in favour of maintaining the Option 3/Status Quo approach.

Endesa Ireland considers that Option 2 is flawed for a number of reasons:

- Endesa Ireland believes that if the RAs wish to make the assumption of equilibrium, they must provide participants with input data for the system at equilibrium so that they may do their own modelling to provide informed comment on the specifics of the proposal.
- Endesa Ireland agrees that 'not all peakers will be equal or will have bought the fuel at the same price; therefore there will be some differences in their bids and some of them will be slightly infra-marginal' but given the current capacity margin, it is unlikely that more than one peaker would be included in the market schedule. As such, the peaking unit would be the marginal plant and therefore does not earn any infra marginal rent.
- As set out by Endesa Ireland in its response to SEM-10-046, in reality, the SMP has only hit PCAP once, in January 2010, and that event was repriced. Therefore, in practice, no generator has ever earned IMR from a PCAP event, leading to the conclusion that the proposal does not reflect reality.
- The SEM Committee's argument that Option 2 will reduce volatility only holds if the value of PCap is not amended, which is by no means certain. Endesa Ireland therefore questions the validity of this assumption.

Endesa Ireland is in favour of maintaining the Status Quo option, which involves using Plexos runs to evaluate IMR. Given that we are entering an extended period of surplus capacity, we consider that IMR will continue to remain at zero in the coming years.

Endesa Ireland also considers that Option 2 would result in an increase to the barriers to accessing project finance for new investments. While Endesa Ireland is able to self-finance new projects, this is not the case for most investors. The Regulatory Authorities should be aware that proposals such as a change to the IMR calculation make it more difficult and expensive for investors to obtain finance. Endesa Ireland would note that such moves may result in many companies being unable to access finance for new generation assets in Ireland, which would be detrimental to competition and security of supply.

Forced Outage Probability

Endesa Ireland is in favour of the proposed change of the Forced Outage Probability to 5.91%, and considers that this is a more realistic figure than for previous years.

Constant over 3 years

Endesa Ireland supports the proposal that the BNE would remain constant for three years, adjusted for inflation. This feature would provide existing generators and new investors with



stability and certainty, both objectives of the CPM. This support is conditional upon there being no material changes to current CPM arrangements.

Gas Capacity Costs

Endesa Ireland considers that the absence of a means to recover gas capacity costs continues to be a serious gap in market design, which has yet to be addressed, despite the RAs' insistence that prices should reflect costs. We would not object to this being treated as a fixed cost or a short run marginal cost (SRMC). We would consider it legitimate for gas capacity costs to be treated as SRMCs especially given that it is required under EU law for short term capacity products to be available. It is also noteworthy that in a study published by the RAs into the impact of wind on the SEM in 2020¹ they included short term gas capacity costs in the bids of the OCGT. The lack of implementation of this requirement in NI is no reason to disallow this cost in the SEM.

WACC

Endesa Ireland considers that the WACC calculation must be reformed within the Medium Term Review. Given the current economic climate and our experience with the markets, we consider that the proposed WACC is significantly lower than the WACC a rational investor would need to take into account. Endesa Ireland requests that the RAs identify a source for the inputs to the WACC calculation that will be utilised in future BNE calculations. In addition, we consider that an investor in the all-island market would take into account the all-island economic situation (rather than Northern Ireland or Ireland separately and certainly not the UK) when calculating a WACC. A blended WACC would be more appropriate for the BNE; this reality should be incorporated within the Medium Term Review.

¹ http://www.allislandproject.org/en/market_decision_documents.aspx?article=f8de4cfd-9a6b-4c04-8018-b89e74d0f6ba