



## **IWEA response to the Draft Decision Paper for the CPM Medium Term Review**

**13 January 2012**

The Irish Wind Energy Association (IWEA) welcomes the opportunity to respond to the Regulatory Authorities draft decision paper on the CPM medium term review. IWEA has concerns that the overall impact of the proposals will reduce the total capacity payment, and that the reduction is disproportionate for the wind industry. IWEA is in favour of stability in the CPM for the next 3 years, but it needs to be on a realistic and sustainable basis.

### **Increase forced outage probability (FOP)**

IWEA notes that on page 12 of the draft decision paper, there is a graph of the historic Forced Outage Probability since 2004. The average over the last 5 years is 7-8%. While the increase from the previously proposed FOP of 4.23% is welcomed, IWEA is concerned that the value proposed in this paper (5.91%) is still significantly below the average for the past 5 years. IWEA requests clarification on how this target is arrived at and proposes that **the 3 year average (c7-8%) would be more appropriate**. The effect of setting an artificially low FOP is to reduce the capacity requirement below what is required in the SEM. IWEA requests more information and transparency around the methodology so it can be better understood how it will change in the future for investor certainty reasons.

### **Proposal to deduct IMR based on a formula in place of the current Plexos modelled approach.**

The proposal is a significant change in the methodology even though the SEM Committee stipulated in their Proposed Decision that they are not minded to change the methodology at this stage given the changes that are expected in the market as part of regional integration.

It seems counter-intuitive that the capacity pot has decreased substantially over the past number of years when in reality investors are actually experiencing increases in their investment costs. This anomaly and increased regulatory risk has a direct impact on the financial risk and costs of investments in the SEM.

The aim of the CPM is to avoid price volatility in the market by providing a level of certainty to market participants. In designing the methodology the RA's had due regard to stability, providing appropriate entry and exit signals, cost reflectivity and reducing risk premiums for investors. The latest proposals put forward are somewhat contradictory in terms of trying to reflect realistic system and market conditions with respect to FOP and WACC but then use a theoretical and practically unacceptable perspective for the calculation of IMR. Given that the CPM is a tool to provide signals to investors, it would seem more

appropriate for the methodology to be consistent and reflective of the status of the system and market in which investors are investing.

The current approach calculates the IMR for deduction based on a Plexos dispatch model showing what hours a BNE peaker is forecast to run in the incoming tariff year. The effect for the last 2 years has been zero IMR, on the basis that there has been virtually no requirement for peakers to run, and when they do run they set the price, and therefore do not receive any inframarginal rent. The effect of the SEM committee's proposed approach (Option 2) would be to further reduce the capacity pot by approximately 9% and therefore to undermine all generators', including windfarms' revenues through a significant reduction in capacity payment revenues. Option 2 uses a theoretical formula, based on PCAP that does not correspond to reality. This proposal is contrary to the prior decision of the SEM as published in SEM 07-187, which stated that IMR should be calculated on the basis of the 'current competitive system state' and not from an artificial scenario. To-date PCAP has never occurred in SEM. It is unlikely that a BNE peaker would be financeable on the basis of a theoretical revenue calculation that has never occurred in practice in the 4 years of SEM operation.

IWEA believes that the status quo should be retained in the calculation of the IMR reduction. If it is to be a signal to investors, IMR should be deducted but only when it is reasonably expected to earn IMR. The current Plexos modelling is the best estimate of plant running for the next year and should continue to be used to forecast whether the BNE will earn IMR. The most recent modelling does not envisage that the BNE will earn IMR (on the basis that it will be at best the marginal plant and therefore setting the SMP) and therefore reducing the capacity pot by a theoretical IMR would undervalue capacity in the market.

#### **Flattening Power Factor increase from 0.35 to 0.5**

While the current paper notes that the Flattening Power Factor (FPF) is to remain at the value of 0.35 with a view to increasing it to 0.5 in 2013, IWEA is opposed to an increase in the power factor. We note that proposals on this are to be put forward towards the end of the year. An increase in FPF increases the volatility of Ex Post capacity payments. It also increases the exposure of not being available and has the effect of putting more capacity payments into periods when the wind does not blow. Such an increase would affect the revenue risk of all generators but particularly wind farm generators. IWEA is opposed to increasing the FPF, as this is particularly discriminatory against wind capacity. IWEA also notes that increasing risks for investors at this stage is particularly unsatisfactory considering the uncertainty that is currently faced by investors as a result of regional integration.

#### **WACC**

IWEA notes that the calculation of WACC has not changed in the CPM proposal. IWEA notes that although an NI peaker has been used for the purposes of calculating the BNE for the past number of years, it is impractical to use UK rates for a SEM (all Ireland) market. Consideration must be given to the fact that the BNE would be earning its revenues on an all-island basis and is therefore exposed to the economic risks in both NI and RoI. It would therefore in IWEA's view be more appropriate to use a

combined average of a pre tax NI WACC and a pre tax ROI WACC to more accurately reflect the market in which investors and financiers will make decisions.

### **Conclusion**

It is vital that one change is not made in a particular area such as capacity payments without consideration of the cumulative impact on particular generator types. Moreover, all proposed changes introduce volatility in the business case which causes debt and equity providers to require higher margins. In contrast, there is a fundamental simplicity and fairness in treating all generators in the same manner under the CPM, as currently designed. IWEA would strongly encourage stability in the CPM for the next 3 years, but it needs to be on a realistic and sustainable basis.