Response to SEM Consultation Paper SEM-12-029

Fixed Cost of a Best New Entrant Peaking Plant
&
Capacity Requirement for the Calendar Year 2013

on behalf of

AES Kilroot Power Ltd and AES Ballylumford Ltd

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Queries to

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Introduction

AES Kilroot Power Limited and AES Ballylumford Limited (collectively 'AES') welcome the opportunity to comment on the Fixed Cost of a Best New Entrant Peaking Plant & Capacity Requirement for the Calendar Year 2013 Consultation Paper ('the Consultation Paper').

Comments

AES is concerned that the value of the Annual Capacity Payment Sum (ACPS) for 2013 has been retained at the 2012 level. This translates into a drop of 17.5% since 2009 (€641m v €529m). AES considers it unlikely that an investment in the Best New Entrant Peaking Plant (BNE) would be made on the basis of the proposals in the Consultation Paper.

The erosion in the value of the ACPS has been accompanied by an ongoing dilution in capacity payments to generators due to the steady increase in wind connecting to the system and the accompanying downward pressure on the System Marginal Price - all of which continue to increase the risk of operating in the Single Electricity Market (SEM). These risks are in addition to the significant risk and uncertainty facing the SEM because of regional integration, all of which combine to a point where the SEM revenue streams for the BNE would not compensate an investor for the risks associated with investing in the market.

Regarding the 2013 BNE calculation AES is particularly concerned that the SEMC has not adopted a blended all-island WACC given that an investor will be exposed to the cash flow risks on an all-island basis and AES would strongly urge the SEMC to do so.

AES also disagrees with the SEMC's decision to amend the IMR methodology from a realistic assessment of the IMR that a BNE plant would earn to a theoretical calculation.

Weighted Average Cost of Capital

<u>Blended v UK WACC</u>

The Weighted Average Cost of Capital **(**WACC) is a key component of the BNE price and as such is a key area of concern for investors. AES welcomes the fact that the SEMC instructed CEPA to consider a blended all-island WACC as part of its assessment of costs for the BNE for 2013, but is extremely disappointed that the SEMC decided not to include or refer to this in the Consultation paper and instead continued to use the UK WACC for the BNE.

As highlighted in previous years, AES is concerned that the continued use of the UK WACC range for the BNE does not reflect the reality of an investor contemplating an investment in the SEM. While NI is jurisdictionally part of the UK, AES does not consider that the UK WACC reflects the risk of investing in a single market that operates across two separate legal and economic jurisdictions and the unique risks that this brings. The reality is that a prudent investor considering an investment in NI will value cash flows and associated risks that will be obtained from and exist within the SEM.

AES recognises that when the methodology for calculating the WACC was originally established the economic climate was significantly more stable and therefore the difference between a UK and blended WACC would not have been so pronounced. However, the economic climate and investment risk has changed significantly since 2008 and therefore the difference between a UK and blended WACC has become more significant. A prudent investor is likely to use a blended all-island WACC rather than a UK WACC when assessing the economics of new generation in the SEM.

In its report CEPA clearly points out that

> 'As capacity payments (the BNE's principle revenue stream) are funded on an all-island basis and covered by all-island credit cover arrangements, this implies that investment risk – driven by payment default in the SEM – of the BNE located in NI (RoI) is as much dependent on payment and credit risk of market participants domiciled in the RoI(NI) as NI (RoI).[1]'

CEPA then goes on to state that

> 'As discussed above, the circumstances of investing in a market that operates across two jurisdictions has relevance as it is the cash-flow risk of the investment which investors will in reality consider.[2]'

AES fully supports these statements.

CEPA's only argument against the use of a blended WACC is that it would be a major change to the way the ACPS has historically been set. However, since a major change has occurred in the investment climate a review of the WACC methodology is appropriate and necessary. AES believes that continuing to use a methodology that does not reflect the current investment climate and cash flow risks in the SEM is completely inappropriate. AES therefore strongly requests that the SEMC recalculate the BNE WACC using a blended WACC for NI and ROI based on the mid-point of the NI and ROI.

<u>Value of Debt Premium</u>

The SEMC has chosen the lowest point of 1.75% of the debt premium range (1.75% - 2.75%) for the UK value on the basis that the Utility Regulator in NI assumed a value of 1.2% in its draft determination of the NIE Transmission and Distribution Price Control for 2012-2017. While in the Consultation Paper the SEMC states that it recognises that the NIE T&D business would be able to access a lower debt premium than the BNE since it is a regulated utility, AES does not consider that the lowest end of the debt premium adequately reflects the premium that an investor in the SEM would incur. Furthermore the price control is effectively backward looking whereas the BNE is a forward looking estimate of the cost of capital that an investor would face when seeking new debt and equity at the current time. AES believes that a debt premium of 1.75% is therefore unrealistic and that at a minimum the midpoint of 2.25% should be used.

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[1] CEPA Costs of a Best New Entrant Peaking Plant for the Calendar Year 2013 P68
[2] CEPA Costs of a Best New Entrant Peaking Plant for the Calendar Year 2013 P69

Infra Marginal Rent

As noted in its response to the CPM Medium Term Review Consultation AES does not support the SEMC's decision to amend the IMR methodology from a realistic assessment of the IMR that a BNE plant would earn to a theoretical calculation. AES believes that this does not reflect a realistic annual scenario upon which the BNE would earn IMR throughout its lifecycle (i.e., a credible model which an investor would value a BNE investment) and is flawed based on the SEMC's own definition.

AES has the following comments on the IMR calculation as set out in the Consultation Paper and on the basis of the clarification note published following the CPM Workshop.

1. The BNE bid price should be based on the average of the peaking plants in NI only rather than on an all-island basis since the BNE will be based in NI.
2. The start-up cost of the BNE should be added to the weighted average bid price.
3. The BNE bid price should be increased to reflect the Carbon Price Support tax which will be applied to the cost of purchasing fossil fuels used for electricity generation from 1 April 2013. Since the SEMC intends to fix the IMR for 3 years an average of the CPS for the next 3 years should be used[3].
4. The Transmission Loss Adjustment Factor for the Belfast West site should apply to the BNE.

Initial Fuel Working Capital

The initial fuel working capital costs should be increased to reflect the Carbon Price Support tax which will be applied to the cost of purchasing fossil fuels used for electricity generation from 1 April 2013. Since the SEMC intends to fix the IMR for 3 years an average of the CPS for the next 3 years should be used.

Electrical Connection Costs & Gas and Make-up Water Costs

The Electrical Connection Cost has only been increased by 2% from the 2012 cost to take account of the increase in metal prices. It has not also been increased to reflect the movement in the exchange rate. Similarly the Gas and Make-up Water Cost remains static at the 2012 level whereas this should be increased to reflect the movement in the exchange rate.

Exchange Rate Risk

Since the SEMC intends to fix the exchange rates embedded in the ACPS calculation generators could be exposed to significant exchange rate risk if the Annual Capacity Exchange Rate continues to be set on an annual basis. AES would therefore recommend fixing the Annual Capacity Exchange Rate for a corresponding 3 year period.

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[3] HM Treasury has set the CPS rates for 2013/14 and 2014/15 respectively at £4.94 per tonne and £9.55 per tonne and has indicated that the rate for 2015/16 will be £12.06 per tonne.