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Fixed Cost of a Best New Entrant ("BNE FC") Peaking Plant & Capacity Requirement for the Calendar Year 2012, Consultation Paper AIP/SEM/12/029 ("the Consultation")

Dear Kenny,

Bord Gáis Energy ("BG Energy") welcomes the opportunity to respond to the above noted Consultation. BG Energy understands that the goal of the new CPM methodology is to alleviate volatility in the Annual Capacity Payment Sum ("ACPS"), and believes it imperative that in light of the decision to fix the BNE FC for three years, the inputs to its calculation this year must be robust to provide certainty to generators as to the stability of capacity revenues.

At the forefront it is necessary to recognise that the BNE's central role in calculating the ACPS is intrinsically linked to the role and objectives of the CPM itself. Chief among the objectives are ensuring short-term capacity availability *as well as* providing efficient signals for long term investment including *efficient* investment. Fairness is another key objective[1] and when participants operate in a single market such as the Single Electricity Market ("SEM"), it is crucial that the equal risks faced by SEM participants in the North and Republic of Ireland ("ROI") are fairly reflected and adequately compensated through the market's remuneration streams.

BG Energy's primary concerns with the Consultation relate to the inputs to the BNE FC and their conflict with these CPM objectives. Specifically certain WACC parameters are considered unreflective of the SEM environment encountered today and IMR levels are very much overstated. BG Energy urges the RAs to seriously consider its views on these issues in particular before finalising its decision.

1. The Appropriate WACC

In light of the cross-jurisdictional nature of the SEM, its common market and regulatory regime and the approach a rational investor in SEM takes to assessing the cost of capital, BG Energy supports CEPA's suggested approach to achieving a blended WACC and suggests the RAs should consider such an approach. It is equally important that accurate inputs to the WACC parameters are used for both the North and Republic of Ireland ("ROI") WACC calculations. The current WACC calculation approach does not reflect reality. There are also a number of inconsistencies in terms of WACC inputs which BG Energy also highlights below.

[1] The final refined criteria of the CPM - AIP/SEM/95/06

i. A Blended WACC Rate

BG Energy supports CEPA's methodology of calculating a blended WACC, and strongly encourages the RAs to present CEPA's approach to the SEM Committee. A blended WACC is a more accurate reflection of the SEM investment environment and the approach a rational investor would take to investing in SEM.

Regardless of the location of the investment it is the investment's returns, primarily the expected energy and capacity revenues, which financiers are most concerned about when assessing a project's bankability. All SEM generators are exposed to equal risks of payment default of expected market revenues. In light of the decision to fix the BNE FC for three years, BG Energy urges the RAs to give full consideration to a blended WACC approach to reflect realistic investors' considerations.

ii. The Cost of Debt ("CoD")

<u>Risk free rate</u>

BG Energy welcomes the increase in the UK risk-free rate from 1.75% last year to this year's proposed 2%, which is more in line with the Bank of England's inflation target of 2% on the CPI measure.

<u>Overall Cost of Debt</u>

Taking into account the breadth of CEPA's analysis and commentary, BG Energy believes that the RAs have taken an arbitrary approach to keeping the CoD inputs to a minimum without convincing justification.

UK
BG Energy disputes the accuracy of decreasing the UK Debt Premium ("DP") from 2% to 1.75% since last year. The RAs chose a 1.75% UK DP by reference to the NIE Draft Determination of DP of 1.2%. Despite recognising the different nature of a regulated business to a competitive business and despite the fact that "the BNE would be unable to obtain such a low debt premium, it has influenced the decision on the debt premium…"[2] The 1.75% is also the lowest point on CEPA's suggested range of DP which is contrary to the standard practice of choosing at least the midpoint of the inputs to the BNE.[3]

The UK DP figure also discounts CEPA's analysis that evidences a requirement for an additional 50bps at the top end of the range for the UK BNE's DP, compared to spreads implied by generic UK corporate bond indices.[4] The RAs do not acknowledge the difference between investing in the NI as compared to the UK. On this basis BG Energy urges the RAs to adjust the UK DP to accurately reflect market realities, at the midpoint of CEPA's proposed range – 2.25%.[5] The UK CoD should be 4.25%.

ROI
BG Energy does not believe that a decrease in the ROI CoD since last year's calculation is realistic of today's investment environment. CEPA's ROI CoD range is lower than last year[6] but BG Energy

[2] P. 32-33 of the Consultation
[3] The midpoint of the proposed DP range for ROI was used for example, most WACC input figures use the midpoint
[4] CEPA p. 47
[5] CEPA p.61
[6] The range last year was 5.5%-9%, SEM-11-025, p.24

believes that more weight should be given by CEPA to the correlation between the State's CoD and utilities' CoD in RoI, as well as the continuing impact of the Euro-zone crisis on ROI. The 1.5% decrease is unrealistic as Irish yields continue to include significant default premiums beyond the risk free rate.[7] Moreover, CEPA attribute the lower of the ROI CoD range of 3.5-8.5% mainly to 'periphery' Euro-zone corporate utility debt currently trading with higher debt premia than CoD for generic Euro-zone corporate bond indices.[8] However, as CEPA and the CER do recognise, utilities' cost of debt is correlated to the State's cost of debt.[9] Recent announcements that Irish bond yields increased by 40-50 basis points in mid-May, which analysts expect to continue to widen, [10] that Italian borrowing costs have spiked and of Spain's 10-year bond yield euro lifetime high of 7 per cent[11] implies that the cost of debt for ROI is worse than last year given its Euro-zone links. BG Energy believes that the ROI CoD range should thus be higher - the rate should be closer to 2012's ROI CoD range midpoint of 7.5%.

iii. Cost of Equity ("CoE")

The returns from regulated markets are not the same as and do not reflect the returns that can be expected from a competitive market such as the SEM.

The RAs have used the NIE T&D determination as a basis for the UK Equity Risk Premium ("ERP") of 4.8%.[12] The difference between regulated and non-regulated companies and the risk they face must be acknowledged and investing in a competitive wholesale market requires adjustment for systematic risk, which should be reflected in a higher ERP. Regulatory developments, particularly regional market integration, affect the UK and ROI having become more prominent in the last year and are likely to cause regulatory uncertainty for at least the next three years.

On this basis BG Energy believes that the ERP on utilities' investments in competitive markets should reflect more risk than last year. The ERP should, for both ROI and the UK, be closer to the higher end of CEPA's range, of 5%.

2. The IMR Deduction Formula

As BG Energy has previously noted[13] it believes the deduction of IMR from the BNE FC via the chosen formula is based on a flawed methodology and applies inappropriate theoretical assertions to the operation of the market. While the BNE FC is a theoretical exercise based on a "rational" investor's decisions, a rational investor would not assume IMR earnings of 8 hours at PCAP into a project's projected market revenues. Market evidence of peaker IMR since SEM's inception illustrates that such IMR levels are unrealistic.

However, as the RAs have closed off this aspect of the CPM, BG Energy's comments focus on the new formula. While recognising that the double-payment of generators in SEM must be avoided, so too must the risk of under-payment. Company analysis illustrates the BNE's potential IMR earnings are

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[7] Oxera report, "What is the cost of capital in Bord Gáis Networks?", 21st May 2012, p.3
[8] CEPA p.33
[9] CEPA p.33 (CEPA's view); p.60 (CER's view)
[10] http://www.irishtimes.com/newspaper/breaking/2012/0518/breaking27.html, 18th May 2012
[11] http://www.irishtimes.com/business/markets/, 14th June 2012
[12] The Consultation, p.32
[13] 13 January 2012, BG Energy's response to SEM-11-088

extremely overestimated by over 20 times. BG Energy cannot overstate the importance of using an appropriate formula for calculating the IMR to ensure continued capacity adequacy and investment.

In compliance with CPM objectives, the bid price used must be fair, simple, transparent and consistent. In this regard, BG Energy considers that on the chosen day the average price of the peakers' bids should also include relevant start-up costs, TLAFs and factor in published carbon floor prices for the next three years. The calculation should also be sense-checked against movements in future fuel prices to protect against anomalies on the day of calculation. BG Energy also requests that further liaison with industry occur on this important issue before the bid price calculation is finalised.

3. The BNE Technology and Fuel Choice

In line with CPM objectives, the BNE peaker technology has a central role in sending correct signals for capacity investment. BG Energy opines that power system requirements and environmental obligations are factors a rational investor would take into account and should be central considerations in the choice of the BNE technology.

i. Ramping and Environmental Issues

The key role of the BNE peaker is to signal capacity adequacy and long-term investment. Rational investors in the SEM are being heavily influenced by policy drivers such as renewables, low carbon and energy efficiency requirements. BG Energy submits that in light of these drivers, the Alstom GT13E2 is an inappropriate technology choice for the BNE.

BG Energy is of the view and suggests that the recent DS3 Project consultations support its view that investment in fast-ramping[14] conventional capacity is needed in the longer term to facilitate the penetration of renewables in SEM. The Alstom GT13E2's 20-minute response time is thus insufficient.

Furthermore, renewables and energy efficiency requirements demand low carbon generation and plants with low start-up and carbon emitting costs such as an aero-derivative turbine. CEPA[15] notes that the P&W SwiftPac 60 and the GE LMS100PA are being actively considered by SEM investors evidencing that capital costs and efficiency are considered equally by SEM investors. Further, the Generation Capacity Statement 2012-2020 ("GCS") also notes that at least three of the confirmed contracted OCGT generation capacity to 2021, are aero-derivative technology.[16] The fuel choice of the Alstom GT13E2 is also inadequate in this regard.

Unless significant consideration is given to such policy drivers in choosing the BNE technology and fuel choice, the result will be inefficient plant coming on the system at variance with energy policy. The fixing of an Alstom GT13E2 for three years sends wrong investment signals to the market in light of power system, low carbon and efficiency needs. BG Energy submits that the aero-derivative is the more appropriate and rational technology choice to meet CPM objectives.

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[14] To support power balance fluctuations in time frames from seconds to minutes
[15] CEPA p. 13
[16] GCS, p.31

4. Summary and Conclusions

In conclusion, the new methodology aims to reduce volatility in the ACPS. However, equally important is the credibility of the mechanism which is undermined by applying unrealistic and theoretical assumptions which is discouraging for investors in the SEM. While the BNE FC is a theoretical exercise, it is predicated on a rational investor's approach to investment and appropriate consideration must be given to such an approach.

In this regard, BG Energy submits that:

a. A "blended" all-island approach to the WACC calculation in the format suggested by CEPA should be adopted;
b. More market-reflective assumptions, realistic in the current investment environment, should be applied to the CoD and CoE inputs– BG Energy urges the RAs to seriously consider CEPA's view of the higher CoD for NI as compared to the UK as well as giving more weight to the correlation between State and utilities' CoD – ROI CoD should not be reduced. CoE figures also require adjustment upwards given the explicit, and CEPA/RA recognised, difference between investing in a regulated as compared to a competitive market;
c. For the IMR bid, the average price of the peakers' bids should be used and include relevant start-up costs, TLAFs and published three year carbon floor prices. The calculation should be sense-checked against movements in future fuel prices to protect against anomalies. Further liaison with industry should occur before this important issue is finalised;
d. Start-up and carbon costs as well as power system (e.g. ramping) and efficiency requirements, should be heavily weighted factors in ascertaining the appropriate technology for the BNE and to protect against investment that runs contrary to energy policy. The GCS and CEPA verify that the aero-derivative is currently the rational investor's choice of technology in the SEM which BG Energy believes is a more appropriate technology choice for the BNE.

The BNE FC methodology is as much a theoretical exercise as being based on a rational investor's viewpoint. The BNE FC's role must comply with the CPM short and long term objectives of providing investment signals. BG Energy submits that theoretical considerations currently outweigh rational considerations. If the above suggestions are not seriously taken into account by the RAs, this will further undermine the credibility of the CPM as an investment signal, resulting in unsuitable new plant being commissioned and threatening the maintenance of and new investment in capacity.

I hope you find the comments and suggestions useful and if you require further detail or wish to discuss any of the above, please do not hesitate to contact me.

Yours sincerely,

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Bord Gáis Energy

{By email}