

IWEA response to the Consultation on the BNE Peaker for 2013, SEM-12-029
19th June, 2012

The Irish Wind Energy Association (IWEA) welcomes this opportunity to respond to the SEM Committee consultation paper on the fixed cost of a Best New Entrant (BNE) peaking plant and capacity requirement for calendar year 2013. This is a very significant consultation in the context of the compensatory function of capacity payments in the SEM (which is governed by SRMC bidding rules) and the role of the capacity mechanism for attracting new investment. This year it is especially important because it follows the CPM medium term review and forms the basis for the BNE price that will apply for at least the next 3 years.

IWEA's response to the CPM medium term review in January 2012 favoured stability of the CPM for the next 3 years providing that it was done on a realistic and sustainable basis. IWEA had particular concerns on the latter note about the:

- Proposed forced outage probability of 5.91% being artificially low
- Proposed IMR deduction (based on a formula instead of Plexos modeling) being theoretically and practically unacceptable
- RA's minded to position of increasing the flattening power factor from 0.35 to 0.5 being particularly discriminatory against wind capacity
- Need for consideration to be given in the WACC calculation 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.

IWEA's strong views have not changed in relation to the above, but particularly relevant in the context of the current consultation is the need to correctly calculate the WACC reflecting the all island nature of the SEM and the reality of current financing conditions applicable to a forward-looking green-field investment in generation. IWEA comments further below on this and other aspects of the current consultation.

Calculation of WACC

IWEA notes that the calculation of WACC has not changed in the consultation paper from previous years – it effectively disregards the all island nature of the SEM by calculating an RoI-specific WACC applicable to a peaking plant physically located in RoI and an NI-specific WACC (based on generic UK fundamentals) applicable to a peaking plant physically located in NI. This is clearly incorrect (as increasingly evident) and needs to be addressed as was highlighted by IWEA and others in response to the CPM medium term review. IWEA previously suggested that it would be 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. Indeed this is the approach suggested by CEPA in Annex 3 of their report

accompanying this year's BNE consultation. The need for a single electricity market WACC is clearly recognised by CEPA as illustrated by the following extracts from Annex 3 of their report:

"...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".

"...were a RoI or NI market participant to fail to make payments due in the SEM (including capacity payments) and the participant's credit cover was not sufficient to cover the shortfall, then the unsecured loss would be socialised amongst all generation units in the SEM; those domiciled in NI and the RoI".

"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)".

Given the inseparable cross-jurisdictional (all-island) cash flows associated with a peaking investment in the SEM, CEPA recommends that a single (blended) WACC approach for calculating the BNE WACC "should be considered further by the RAs", and note their understanding that a "blended all-island WACC will be presented to the SEM Committee as an option for the final consultation paper".

Despite the above the consultation paper is strangely silent on the need for a single electricity market WACC and how this should be implemented. IWEA nevertheless notes the clarification note issued 8th June 2012 (following the workshop of 6th June) that the RAs "welcome responses on any and all aspects of the consultation, including issues described within the Appendices..." IWEA therefore expects that the SEM Committee will duly consider and implement a single electricity market WACC for the 2013 BNE calculation. IWEA can see no compelling reason why this would not be done, for reasons outlined below.

- (1) A single electricity market WACC is wholly consistent with SEM design and the fundamental premise of the BNE methodology that the rate of return earned by a new entrant must be sufficient to cover the risk of entering the SEM. It is necessary for the effective functioning of the CPM, and to preserve required confidence in the integrity of the regulatory process to attract capacity at a reasonable cost of capital when needed.
- (2) Implementing a single electricity market WACC in the BNE calculation can be easily and suitably achieved by means of the blended WACC approach, as suggested by CEPA. Whether or not this is a (major or minor) methodological change to the way the capacity payment mechanism has historically been set is entirely irrelevant. It is the correct thing to do in light of the evidence and the all island nature of the SEM.

It is unclear why a particular question has been raised by CEPA on selecting a point estimate in the context of a blended WACC. It is suggested by CEPA that the RA precedent of adopting the mid-point of the WACC range in previous BNE decisions may no longer be appropriate in this context and that the RAs should instead consider adopting the lower end of the RoI WACC range. Allegedly this is because the BNE credit risk and borrowing costs, while likely to be correlated to the cost of finance faced by the [Irish] state, will primarily be related to the risks associated with participation in the SEM. IWEA is not convinced by this rationalization. The risks associated with participation in the SEM cannot be

disconnected from the risks of the Irish state (or Northern Ireland for that matter). To choose the lower end of a range whose risk benchmarks German sovereign bonds incredulously implies that the risk associated with participation in the SEM is closer to the cost of finance faced by Germany than that of the Irish state.

IMR calculation

In the information note published by the RAs on 8th June 2012 it is confirmed that the average bid price of peaking units operating in the SEM has been used to proxy the bid price of the BNE, as per the formula below, applied 31st March 2012.

$$\text{Weighted Average Bid Price} = \frac{\text{No Load} + P1Q1 + P2(Q2-Q1) + \dots}{\text{Max capacity}}$$

IWEA questions the suitability and rationale surrounding the choice of using the weighted average bid price as suggested, and would welcome more details on this from the RAs. It is important to note that the above bid price methodology does not include relevant start-up costs or losses. These are significant omissions in the calculation of IMR. It is quite conceivable that over a year a peaking plant could start up 16 times cumulating the 8 hours assumed running time in the market over which the plant is assumed to earn infra-marginal rents. Generator offers must be adjusted for losses. The above calculation does not include these costs and this needs to be corrected in calculating the IMR. It should also be noted that the Carbon Price Floor (applicable to generators in Northern Ireland from April 2013) is not factored into the above calculation, this is further discussed below.

Carbon price floor

A carbon price floor will be introduced UK-wide on 1 April 2013. Supplies of fossil fuels used in most forms of electricity generation will become liable either to the climate change levy (CCL) or fuel duty from that date. Such supplies will be charged at the relevant carbon price support rate. Carbon price support rates from 1 April 2013 are now published, along with indicative rates from April 2014 and April 2015, by HMRC and are available online @ <http://www.hmrc.gov.uk/>.

The carbon price floor will apply to fuel costs (distillate and gas) of peaking generators located in Northern Ireland. This has not been accounted for in the BNE 2013 consultation and this needs to be corrected in the fuel cost assumptions, noting that a three year average carbon price floor should be calculated based on published rates for 2013, 2014 and 2015.

Capacity requirement

In response to last year's BNE consultation IWEA explained why it would be appropriate to adopt a "high water mark" approach to the demand used to calculate the capacity pot, unless there was a sound rationale for expecting demand to show a permanent reduction.

Along related lines, the peak demand calculation includes an average cold spell (ACS) adjustment. It is unclear how this methodology works but the following extract from page 36 of last year's decision paper

gives the impression that historical extreme weather events are discountable outliers: “This analysis enables the ACS adjusted winter peaks to be compared on the same level as extreme weather conditions are therefore taken out of the equation”. Given that peak demand records are predominantly determined by cold weather rather than economic conditions this approach would overestimate generation adequacy.

Conclusion

IWEA strongly encourages stability in the CPM for the next 3 years, but it needs to be on a realistic and sustainable basis. It is essential that the assumptions used in the calculations for the BNE Peaker are valid and plausible. The purpose of the Capacity Payment Mechanism is to remunerate the long-term financing requirement of investment in generation capacity and to incentivise availability of plant that has been built. This long-term aspect must be kept in mind when determining the assumptions, in particular in relation to the cost of capital, IMR calculation, carbon price floor and the capacity requirement as outlined above. It is also essential that the manner in which the figures used are arrived at is plausible, consistent and transparent.