

Kevin Baron
Utility Regulator
Queens House
14 Queens Street
Belfast
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June 22nd 2015

Dear Kevin,

Re: Fixed Cost of a Best New Entrant Peaking Plant, Capacity Requirement & Annual Capacity Payment Sum for the Trading Year 2016 (SEM-15-032)

Bord Gáis Energy (BGE) is hugely concerned about the proposals in the latest consultation on the Capacity Requirement and Annual Capacity Payment Sum (ACPS) for 2016.

From a policy perspective, the proposed ACPS fails to meet the intended regulatory objective of providing a “greater degree of revenue certainty to generators and a more stable year to year pattern of capacity payments” (SEM-11-088). From a practical perspective, an independent analysis of the CEPA BNE calculation for 2016 highlights grave errors in the relevant estimates and benchmarks used by CEPA and therefore in the proposed ACPS for 2016. These errors under-estimate the risks for generators operating in the all-island market and as a result, under-estimate the cost of operating and investing in the all-island market.

BGE therefore urges the SEM Committee (SEMC) to; revise its proposed decision on the BNE costs for 2016 and considering the points outlined below, in conjunction with the appended report from Frontier Economics (FE), and to more accurately reflect the risks and revenue streams of a generator in the all-island market such that revenue stability and security of supply for electricity is achieved.

1. Practical Errors in the BNE Calculation: Analysis of the WACC

BGE as part of the Electricity Association of Ireland (EAI) commissioned FE to examine and provide insight into the CEPA analysis underpinning the latest ACPS calculation. Their analysis is outlined in detail in the attached report, and should be read for detailed reference, but in summary it highlighted the following errors:

- 1) The estimate of the Total Market Return is over-reliant on the recent CMA report for NIE and does not reflect the appropriate benchmarks for a generator in the all-island market;
- 2) The risk free rate used by CEPA is too low; it is below the short term average of circa. 4% and is even below that of a 10 year UK government bond at 2%;
- 3) The inflation rate applied to the risk free rate is incorrect and should reference the Consumer Price Index as opposed to the Retail Price Index;
- 4) The BBB investment grade assumed for the BNE is not appropriate, and
- 5) The gearing level assumed for the BNE is too high and not appropriate for investors in the all-island market.

Based on FE’s assessment, the WACC should be at least 150 to 200 basis points higher than CEPA’s estimation.

Appropriate Debt Benchmark

BGE believes that the range of credit ratings used by CEPA to estimate the cost of debt does not capture all potential peaking plant investors such as standalone generators. While a BBB rating may be an appropriate benchmark for network firms or regulated companies, it does not reflect the levels of risk that a standalone generator would face. Empirical evidence of those parties investing in generation markets across Europe suggests that a rating along the B category are equally as likely and should therefore be reflected within the range of costs. FE conducted analysis on a range of debt yields in the ‘B’ category of credit ratings to reflect riskier businesses and found that the debt yield estimated by

CEPA was at the lower end of the range. They found the upper end of the range to be 200 basis points above CEPA's estimate.

The debt yield benchmark should also consider any forecasted changes in the time period that it applies to. Given that the BNE cost will be fixed and indexed for 3 years (or until I-SEM is implemented in 2017), it would be more appropriate to forecast the debt yield looking out over time. CEPA's analysis on the debt yield benchmark examined the forecasted changes of 2016, which BGE believes to be an inaccurate representation of the likely market conditions facing an investor in an asset with an expected lifetime of between 15 – 20 years. FE's analysis suggests that the debt yield should be up to 40 basis points higher in Northern Ireland and 50 basis points higher in ROI.

Appropriate Inflation Rate

The risk-free rate in the WACC calculation requires an inflation index in order to convert nominal rates to real rates. In previous BNE calculations, the Consumer Price Index (CPI) was used to determine the real risk-free rate. CEPA's analysis applied the RPI index which has resulted in a lower risk-free rate and lower WACC. In the interest of consistency BGE believes that the CPI index is more appropriate.

Country Risk Premium

There has been a noticeable change in the debt yields used to calculate the BNE costs between 2013 and 2016. FE have highlighted that they do not believe that an appropriate "country risk premium" is reflected in the CEPA analysis. According to the recent PNG bonds, there is a higher debt premium in Northern Ireland compared to GB, which is to be expected given the impending market reform under I-SEM, not to mind the different economic circumstances. FE have also highlighted that the additional debt premium also exists in ROI and should be captured in the Cost of Debt analysis. On that basis, BGE would expect the WACC for a BNE in the all-island market to be higher than the 6% recently proposed by the CMA in its energy market investigation.

Choice of Technology

The choice of BNE peaker technology has a central role in sending correct signals for capacity investment in the all-island market. BGE is of the view 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.

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. BGE submits that in light of these drivers, the Alstom GT13E2 is an inappropriate technology choice for the BNE.

BGE is of the view, and believes that the DS3 Project supports its view, that investment in fast-ramping, conventional capacity is needed in the longer term to facilitate the penetration of renewables in SEM and I-SEM. Furthermore, renewable and energy efficiency requirements demand low carbon generation and plants with low start-up and carbon emitting costs. The Alstom GT13E2" is therefore an inappropriate benchmark for investment in the all-island market.

In summary, bearing in mind the empirical evidence provided by FE and given the level of uncertainty in the all-island market arising from the I-SEM and DS3 projects, BGE does not believe that the analysis conducted by CEPA appropriately reflects the risks, costs and choices of investment for parties in the all-island market. BGE therefore asks the SEMC to review and revise this analysis to more appropriately reflect the investment environment of investors in the all-island market.

2. Under-Estimation of the Capacity Requirement

The all-island Capacity Requirement is calculated annually by the TSOs with reference to the all-island security standard. According to the EirGrid's most recent Generation Adequacy and Security Standard calculations (2015 – 2024), the Capacity Requirement for the island for 2016 should be at least

8,000MW. This is substantially higher than the figure proposed by the SEMC in this consultation and it is unclear how a capacity of 7,070MW could be expected to meet a security standard with a value equivalent to 8 hours loss of load (LOLE). BGE requests that the SEMC revise their calculations on the Capacity Requirement to reflect the detailed analysis and calculations provided by the TSOs in the Generation Capacity Statement. Furthermore, in the interest of transparency, we request that the SEMC publish any analysis conducted on the 2016 Capacity Requirement ahead of their final decision.

3. Policy Context and Implications for Investors

In designing the capacity payment mechanism the stated objectives of the SEMC have been to provide: (i) capacity adequacy; (ii) price stability; (iii) simplicity; (iv) efficient price signals for long-term investments; (v) fairness, and (vi) susceptibility to gaming. As BGE has outlined in its responses to the I-SEM consultations and in its interactions in response to the European Commission's consultation on capacity mechanisms, the SEM as a market design has to-date successfully achieved a balance in providing investment signals while also ensuring that prices paid by customers are cost reflective. That is, the price of power has equated to the Long Run Marginal Cost of producing power. This has helped to stimulate investment in both the wholesale and retail markets, resulting in greater competition across both markets.

In its medium term review of the capacity payment mechanism, the SEMC stated that its objective was to "provide greater degree of revenue certainty to generators and a more stable year to year pattern of capacity payments".

BGE believes that the latest consultation reviewing the BNE and the ACPS for 2016 undermines these objectives. In choosing short-term and arbitrary reference points and combining this with; increasing levels of intermittent generation; restricted revenue recovery in the energy market, and impending market change, the SEMC is at best in danger of undermining the investment signals trying to be created through the DS3 programme and at worst, driving capacity exits from the market.

In the interests of providing confidence to the market and meeting the stated regulatory objectives and duties, BGE urges the SEMC to review the analysis conducted by CEPA and amend the errors as suggested above and outlined in detail in the attached report.

In conclusion and in short, BGE believes that the WACC and Capacity Requirement used to calculate the BNE and ACPS for 2016 is too low. Based on an independent review of the WACC analysis and a review of EirGrid's latest Generation Adequacy Statement we believe these inputs into the annual ACPS should be 6.4% and 8,000MW respectively. I would welcome an opportunity to discuss the points above with you in more detail. In the meantime please do not hesitate to contact me if you have any questions.

Sincere regards,

Brian Larkin
Regulatory Affairs – Commercial
Bord Gáis Energy

{By email}