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

Dear Kevin,

The members of the Association welcome the opportunity to respond to this Consultation but are deeply unhappy with the manner in which this proposal, having such a significant impact on a key component determining generator incomes, was advanced. EAI is not at all convinced of the arguments put forward by the RAs, in particular in relation to the derivation of the WACC, as it runs contrary to our current experience. We ask that the SEM Committee gives serious consideration to the analyses developed by our consultants before concluding this matter. Otherwise a real risk of disorderly plant closures arises that will damage the reputation of both industry and the Regulatory authorities.

High Level Comments

Following a 'ground-up calculation', the RAs propose to reduce the annual capacity payment sum by 20% in 2016 (on 2015 level) and index this sum for 2017.

In light of concerns that CEPA's analysis affords particular weight to the views of the SEMC and owing to the materiality of the resulting proposals, EAI has commissioned Frontier Economics and Poyry to conduct a comprehensive review of the methodology used to calculate the annual capacity payment sum. The respective reviews are attached to this response. Our analysis concludes that the proposed Weighted Average Cost of Capital (WACC) significantly underestimates the level of regulatory risk in the all-island electricity market and that the methodology used to derive Inframarginal Rent (IMR) is deeply flawed. A more explicit review of the methodology used to calculate the capacity sum is warranted before any final decision is made on the sum to apply in 2016/17.

The proposed decision has increased the perception of regulatory risk with potential knock on effects on price stability and system security and runs contrary to the RAs stated objective to minimise risk in the transition period before the introduction of new market arrangements.

The RAs' stated objective that the CPM would provide financial certainty to generators and a stable pattern of capacity payments has also been undermined by this decision. The 2012 decision to index the sum for three years from 2013-15 has delivered on the objective of the CPM. The RAs committed to reviewing this decision after three years In Spring 2015 and noted that both DS3 and European integration may impact the three year timeline. The proposed decision is inconsistent with the spirit of the medium term review and does not reflect the implications of ongoing delays to both the respective DS3 and ISEM projects.

The proposed reduction in the capacity sum exacerbates the difference between BCoP-restricted SRMC earnings from the Energy market and that necessary to ensure revenue adequacy for capacity providers with potential knock on effects on wholesale price stability. The uncertainty created as to the behaviour of the RAs will have long-term implications for system security.

In proposing this decision, the CER does not appear to have given due cognisance to its statutory duty to have regard to the need to ensure that licence holders (such as generators) are capable of financing their undertakings[1].

WACC, Capacity Requirement and Infra-Marginal Rent Derivations

The approach adopted in this instance risks undermining investor confidence in the all-island regulatory regime at a time of already great uncertainty given the I-SEM redesign. Our members see serious shortcomings and inconsistencies in the ground up review conducted by the RAs and CEPA, specifically in relation to the determination of WACC, capacity requirement and IMR.

- ***Weighted Average Cost of Captial (WACC) is underestimated by 150 basis points(See Frontier Report)***

Following a review of the WACC calculation assumptions and parameters with reference to appropriate comparisons for non-regulated generation investments such as the recent CMA working paper, Frontier have concluded that the RAs' proposals underestimate the WACC by 150 basis points. Frontier propose that pre-tax WACCs of 6.45% and 5.69% would more accurately reflect the investment risk in NI and ROI respectively.

The assumption that any new investment in 2016 will be linked to a VIU ignores the reality that the risk profile of any project is evaluated on a stand-alone basis and discriminates against independent investors. EAI members also question why CEPA have been instructed by the SEMC to apply a gearing ratio of 60% when the reality would dictate that a lower gearing ratio should apply.

[1] Electricity Regulation Act 1999, Section 9 (4) (c) (page 11)

Based on the most recently published information Frontier propose that CEPA's calculation of the WACC should be revised to allow for the following;

- Higher Total Equity Market Returns of 7.1% in NI and 6.8% in ROI based on the most recent evidence of long-run realised equity market returns(Feb 2015 report by DMS)
- Higher cost of debt based on the latest EU/UK benchmarks for new debt
    - A risk range is applied with BBB firms at the bottom and below investment grade firms at the top
    - A risk premium is applied to ROI/NI over GB
    - The CPI inflation rate is applied to convert nominal to real rates
    - A gearing ratio of 30% is applied based on an analysis of other VIUS and the latest information available from the CMA GB market investigations (20-40%)

- ***The Capacity Requirement determined is unrealistic and falls short of the volume required to meet a security standard with a value equivalent to eight hours loss of load***

The requirement determined (7070MW) represents a plant margin of 399MW relative to the median TER Peak for 2016 and 538MW against the median Transmission Peak. Eirgrid's most recent Generation Adequacy Report(GAR) estimates that in excess of 8000MW is required to meet the security standard which represents a plant margin of some 22% (which is at the low end of the historical range)[2]. The consequence of the volume determined is an unrealistic margin roughly equivalent to the capacity of one large generation unit.

The action taken last year by SONI to competitively tender for a further 250MW of local reserve to protect security of supply in Northern Ireland is proof that the TSO would not in reality tolerate such a tight margin. The implication of the SONI intervention is that the lowest acceptable margin for Northern Ireland in 2016 is 578MW when considered alongside the 328MW margin anticipated in the GAR. Please note that this margin ignores any contribution from 857MW of renewable generation and uses the higher peak demand figure.

In summary, facts on the ground clearly demonstrate that the Total Capacity Requirement of 7070MW for the all-island market, that equates to an all-island capacity margin of 399MW to 538MW, is too low and is not sufficient to meet the required security standard for customers or to enable the TSOs to operate the system securely.

- ***Inconsistencies in the IMR Derivation lead to under-payment (See Poyry Report for further)***

Poyry have concluded that the formulation of the Infra-Marginal Rent (IMR) discount is potentially inconsistent in a number of areas, each of which would lead to systematic under-payment to generators against the stated intention of the CPM. We propose that the report accompanying this response should inform a comprehensive review of the methodology.

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[2] http://www.eirgrid.com/media/Eirgrid_Generation_Capacity_Statement_2015.-2024.pdf

In summary, the Poyry report notes the following;

- fixing IMR is inconsistent with the distribution of money in the ACPS across all generators during periods of over-supply
- the IMR value calculated is out of line with recent SEM experience
- the LOLE used in the IMR calculation itself appears to be an unrealistic expectation of an equilibrium market position based on recent System Operator Actions.

Conclusion

This proposed decision has increased regulatory risk and jeopardised the revenue adequacy of generators with potential adverse consequences for market stability and system security. We ask the SEM Committee gives serious consideration to this response and the analyses developed by our consultants before concluding this matter.

We are available to meet and discuss this response at the earliest opportunity and look forward to hearing from you.

Yours sincerely,

Stephen Douglas
Senior Advisor
Electricity Association of Ireland (EAI)