



# **SEM-23-014 Consultation and Call for Further Evidence on Indexation of Capacity Payments**

**SSE Response**

## Introduction

SSE welcomes the opportunity to respond to SEM-23-014 Consultation and Call for further Evidence on Indexation of Capacity payments.

For the avoidance of doubt, this is a non-confidential response.

## Who we are

SSE is the largest renewable energy developer, operator, and owner in Ireland's all-island Integrated Single Electricity Market. Since entering the Irish energy market in 2008, SSE Group has invested significantly to grow its business in Ireland, with a total economic contribution of €3.8bn to the State's economy over the past five years. We have also awarded over €9 million to communities in the past 10 years as part of our community benefit programme.

SSE is building more offshore wind energy than any other company in the world right now. We are currently constructing the world's largest offshore wind energy project, the 3.6 GW Dogger Bank Wind Farm in the North Sea, a joint venture with Equinor and Eni. This is in addition to Scotland's largest and the world's deepest fixed bottom offshore site, the 1.1 GW Seagreen Offshore Wind Farm in the Firth of Forth, a joint venture with TotalEnergies, which reached first power in recent weeks. In the most recent Scotwind process, SSE Renewables was awarded the rights, along with partners Marubeni Corporation (Marubeni) and Copenhagen Infrastructure Partners (CIP), to develop what will become one of the world's largest floating offshore wind farms off the east coast of Scotland.

We plan to bring our world-leading expertise in offshore wind energy to Ireland with plans to deliver over 3 GW of offshore wind energy in Irish waters, starting with our Arklow Bank Wind Park Phase 2 project off the coast of Co. Wicklow.

Through our SSE Thermal business, we continue to provide important flexible power generation. SSE's power station Great Island is Ireland's newest combined cycle gas turbine (CCGT) power station and one of the cleanest and most efficient on the system, generating enough electricity to power half a million homes. The acute need for flexible generation in Ireland has been demonstrated over the last twelve months, with EirGrid's most recent generation capacity statement showing that a shortfall in generation capacity was a significant risk for a number of winters to come, resulting in emergency measures being implemented by the CRU and Government.

While existing power stations continue to play a critical role on the system, SSE view the future of dispatchable thermal generation as being abated thermal, with Carbon Capture and Storage, hydrogen or other low-carbon fuels being the primary options. SSE have over 5 GW of zero and low carbon thermal under active co-development in the UK.

We will continue to evaluate opportunities to bring our expertise and investment in decarbonised flexible generation to Ireland, but it is vital that the state, Regulator and TSO provides an appropriate investment landscape to unlock such developments.



## SSE Response

This Consultation and Call for Further Evidence contains the following 3 issues for consultation :

- Call for Further Evidence
- Potential Indexation Mechanism for 2024/25 T-3 and 2025/26 T-4 Auctions.
- Longer Term Enduring Approach

### **Call For Further Evidence:**

The Call for further evidence with respect to the impact of inflation on the financial viability of projects and how unanticipated inflation is putting projects in jeopardy focuses particularly on the 2024/25 T-3 and 2025/26 T-4 capacity auctions. These auctions have been selected relative to the invasion in Ukraine and the economic shock that has resulted.

SSE has not qualified for new generation for the specified auctions. Therefore there is little value in us providing the evidence requested as it is targeted at the impacts of inflation related to these specific auctions.

### **Potential Indexation Mechanism for 2024/25 T-3 and 2025/26 T-4 Auctions.**

We note that SEMC is consulting on the indexation for these auctions in order to be in a position to swiftly move to implementation if the need for indexation is established. This makes sense to ensure project delivery for security of supply reasons.

We also note that SEMC would be minded not to extend any indexation provisions that might be introduced to contracts awarded in auctions prior to these. There is a concern that this is a retrospective change of the price after the auctions are concluded. However as the focus is on special circumstances where an exceptional unforeseen level of inflation occurred, we support the principle of including an indexation mechanism for these specific auctions as they were impacted. A failure to account for indexation in this scenario would reduce the incentive for Capacity providers to build. At the same time a balance is needed between a reasonable cost increase vs the risk of no delivery of new capacity.

Regarding the elements of the design of the indexation mechanism:

#### ***Eligibility:***

The Consultation proposes that costs should be indexed only in line with CPI increases, and only where these increases exceed 2% for these 2 auctions.

SSE agrees that costs should be indexed for these particular auctions where the costs exceed 2%. However regarding the use of the generic inflation index CPI, it is worth noting that CPI on its own excludes some of the higher impacts of inflation in construction. The price of building and construction materials surged in the last 2 years as economies reopened and with the impact of the war. The construction of power stations e.g. CCGTs typically includes large quantities of metal and steel. Globally the price of steel soared in 2021 and in 2022. There are other more tailored indices e.g. sector and single-commodity metals indices which are designed to track the performance of the broad market as well as the performance of the individual metal commodity markets.

The other alternative is take the same approach as the GB market which is to use a levelised cost of capital approach (see under Longer Term Enduring Approach) to assess the cost of delivery of different technologies. This is then adjusted using a CPI factor.

SSE agrees that indexation would apply only to the subset of new capacity which is making a sufficiently large investment as to be able to obtain a multi-year contract.

***Form of Indexation:***

The consultation proposes that Indexation would only be applied during the build period, based on a one-off indexation factor that would be calculated based on cumulative unexpected inflation during the build period, i.e. from the Auction date to the start of the first capacity delivery year. SSE agrees with this proposal for a new build. However as a general principle it should also be borne in mind that existing units are also impacted by exceptional unforeseen levels of inflation. While existing units may not have construction costs, they will have other impacted costs e.g. outage costs.

SSE agrees that the indexation factor would be applied to capacity prices awarded at auction for a new unit for all 10 years of that contract.

***Risk sharing Measures:***

There are a number of factors which the Paper includes to consider whether risk-sharing measures would be appropriate for the potential indexation mechanism.

Given the likely level of residual risk that may be borne by an investor and that indexation provisions could be negative, these could be construed as a degree of risk sharing already inherent in a CPI indexation calculation. Any further risk-sharing could be argued to pose a risk to the delivery of much needed new capacity to meet security of supply.

***Termination charges:***

The Consultation proposes that there may be an argument for termination charges if indexation is applied. It would be useful to have sight of how these termination charges would be calculated and what level they would be set.

Termination charges could result in further increased costs for the Generator, charges/ penalties are already in place and this is more a 'stick' than a 'carrot' approach to non-delivery so these charges are not an ideal solution.

**Longer Term Enduring Approach**

SSE supports an enduring mechanism whereby prices will be indexed over the lifetime of the contract which is needed to apply to all future auctions. The effects of ongoing future inflation should be factored into future capacity payments, given that economies have moved from an extended period of stable low inflation to one where rates are higher and far more uncertain. This will ensure that there is a level playing field for forthcoming participation and to enable projects by providing investor confidence for future auctions. It will help to support the delivery of future generation.

On the subject of ongoing future inflation, we would point to the recent Frontier Economics analysis provided by EAI. This paper outlines the average inflation as predicted by various agencies across 2022-2024. Taking the forecasts from the Irish Central Bank for example, the average does not come near to the CEPA/Ramboll of a flat 2% projection. It would be hugely optimistic to consider that would be realistically at the level of 2% for foreseeable years.



We believe the best way this can be achieved is to consider the GB model. The GB Capacity market makes an adjustment for inflation for recent auctions. This Capacity market is run by the National Grid Electricity System Operator. This market ensures security of supply by providing a payment for reliable sources of capacity, alongside their electricity revenues. Payments are based on the Capacity cleared price achieved in the auction that the Capacity agreement was awarded from. The CCP is adjusted for CPI for the UK T-3 and T-4 auctions. The price is calculated 3 months before the commencement of the delivery year. The CPI-adjusted CCP is calculated in £/MW and is the price the Capacity Market Unit will receive for their capacity payments for the Delivery year. The amount of each payment is based on the CCP - adjusted for inflation, the sum of the Auction acquired Capacity obligation and physically traded capacity obligations, and an applied monthly weighting factor. An example of this calculation is described in Appendix 4 of the EMRS Guidance document<sup>1</sup>.

The GB market uses a levelized cost of capital<sup>2</sup> approach to assess the cost of delivery of different technologies. This is then adjusted using a CPI factor.

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<sup>1</sup> [G17 - Capacity Provider Payments \(emrsettlement.co.uk\)](https://www.emrsettlement.co.uk/g17-capacity-provider-payments)

<sup>2</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/911817/electricity-generation-cost-report-2020.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/911817/electricity-generation-cost-report-2020.pdf)