



Tom Reeves
Commission for Energy Regulation
Plaza House
Belgard Road
Tallaght
Dublin 24

Iain Osborne
Northern Ireland Authority for Utility Regulation
Queen's House, 14 Queen Street
Belfast
BT1 6ER

28 February 2008

RE: Capacity Payment Mechanism

Dear Mr. Reeves and Mr. Osbourne,

On 24 July 2007, IBEC's Energy Providers Working Group (EPWG) wrote to you regarding the importance of regulatory certainty in fostering investor confidence for the construction of much needed electricity generation capacity. Particular attention was given to uncertainty surrounding the capacity payment mechanism and the impact that this is having on investor confidence. Your subsequent reply (10 August 2007) "shared IBEC's concern about the potential for year-on-year fluctuation in the size of the annual capacity payments pot", and welcomed our views on "what a more robust and stable methodology for the calculation of the annual capacity payment might look like".

In the intervening period the EPWG have collectively worked to determine such a view and have also individually commissioned independent research. Having concluded our initial deliberations we set forth our findings for your consideration.

The design of the SEM must among other things provide signals for investment that will provide timely, adequate and appropriate investment in generating plant. The Capacity Payment Mechanism (CPM) is a fundamental component of the pricing structure providing investors with a degree of financial certainty which will allow new projects to be delivered. In a market where the rules require generators to bid in their Short Run Marginal Cost, a capacity mechanism represents the minimum theoretical value needed to secure ongoing capacity in the market by reflecting the capacity costs of the cheapest form of capacity in the market, a Best New Entrant (BNE) Open Cycle Gas Turbine (OCGT).

The predictability of remuneration required for longer-term investment in capacity is a key factor in providing investors with the certainty required to proceed with projects. As such the key components of the mechanism, the annual capacity requirement and the fixed costs of the BNE peaking plant must be determined in an appropriate, transparent and consistent manner. It is also important that any assumptions are validated on a regular basis if erosion of confidence in the long-term investment signal is to be avoided.

The EPWG is concerned that the Regulatory Authorities approach to determining the annual capacity requirement does not reflect the actual capacity available as determined by the Transmission System Operators (TSO's), and is likely to add significantly to the level of regulatory risk impeding investment decisions. The capacity requirement must reflect the generation adequacy of the system at present and should be determined by the TSO's as both expert and independent observers of the capacity required to meet the selected security standard.

One of the more critical elements in the ultimate determination of the annual capacity requirement is the assessment of Forced Outage Rates. The Group is of the opinion that historical forced outage rates must be used to accurately reflect system availability given the age profile of the plant currently installed on

the system. To do otherwise would likely lead to an under estimation of the capacity required to ensure the security standards are achieved through appropriate investment in new plant.

The EPWG is also concerned that the CPM is subject to significant risk as a result of the contributions calculated from revenues projected to be received from the energy and ancillary services markets. The difficulty and subjectivity in determining such potential revenues, will likely introduce volatility and complexity into the calculations, eroding investor confidence in the mechanism.

Research conducted by members of the EPWG has shown that investments in peaking plant are most sensitive to adverse variations in the Capacity Payment Mechanism (CPM). For these types of generators the CPM forms the primary remuneration for the recovery of investment capital.

The adverse variations can arise from a number of separate market scenarios, of which the two main variants are:

1. BNE OCGT equipment prices reduce in the future. A peaking investment today, based on a falling CPM value in the future, would fail to make an adequate return and thus not be an attractive investment option.
2. The BNE OCGT equipment prices continue to rise but this results in an over build of generation capacity in the market, perhaps as a result of excessive CCGT build triggered by high infra-marginal rent. It is difficult to envisage how Regulatory Authorities could justify continued higher capacity values in the event of excess capacity in the system. In the event that the Regulatory Authorities intervened and cut the capacity payment, then a peaking investment today would fail to make an adequate return and thus not be an attractive investment option.

In its deliberations the EPWG reached consensus that there are significant risks for future generation investments given the current capacity mechanism. The group discussed how the mechanism could be enhanced, without radical change to the current arrangements and examined the following options:

- I. **Five year rolling average.** Such an approach would stabilise the income to all generators by smoothing the market variability inherent in a BNE OCGT yearly price. This arrangement would protect an investor against most of the risk of a falling equipment price scenario. It would however result in shortfalls in capacity in a rapidly rising equipment price scenario because of delay in a five year rolling average to respond to this increase. The latter rising price scenario could be addressed by a "ratchet" arrangement where the price was only averaged on a fall, not on a rise.
- II. **Fixed price for new entrants.** A different approach would be to leave the current capacity mechanism unchanged for existing generators, but allow new dispatchable generators (eg. generators who are not allowed to be price takers) to lock-in the value of capacity for ten years. We suggest that the lock-in needs to be based on a firm commitment to build such as signing a connection agreement. The value of capacity in the year when they entered into a connection agreement to build the facility would then set the revenue for this generator for the next ten years. The volume available to lock-in could be set by the system operators based on system security standards. The payment for new entrants could be from the existing capacity pot.

In conclusion, IBEC is concerned by the lack of stability and uncertainty surrounding the current SEM capacity mechanism and the impact this has on investor confidence particularly future peaking generation investments. We ask the Regulatory Authorities to consider the opinions and alternatives presented above with a view to opening industry discussions on a review of the current mechanism.

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As always IBEC is committed to working along side the Regulatory Authorities to deliver a stable and competitive electricity market in Ireland. We would welcome the opportunity to further explore the contents of this letter and invite you to contact david.manning@ibec.ie, tel: 01 6051689 to organise a meeting.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'G. Blaney'.

Garrett Blaney
Chairman, IBEC Energy Providers Working Group