

# CPM Medium Term Review – Draft Decision

Synergen's response to SEM-11-088

## 1 Introduction

This paper is Synergen's response to the consultation paper "CPM Medium Term Review – Draft Decision (SEM-11-088)" published by the SEMC on 15<sup>th</sup> November 2011. Synergen has no objection to this response being published.

## 2 Opening Observations

Synergen notes the extensive scope of the Medium Term Review, a process that has taken two and a half years to reach the draft decision stage. Synergen has responded to each of the three main consultations covering the ten work packages on which draft decisions have now been reached. It has been Synergen's position that undertaking the review in distinct work packages has made it difficult for participants to respond options in a holistic manner – indeed the draft decision is the first time that a suite of options and potential changes have been presented together. The interactions between these various elements is important when considering changes to the CPM, where it is vital to strike the right balance between: risk and reward; stability and targeted signals; long term and short term availability considerations; and the equitable reward of disparate plant types on the system.

In this response, Synergen comments on the suite of proposals presented by the RAs. Whilst Synergen had (in its response to the earlier consultations) reserved the right to change its position on specific issues in the light of later information, it considers that its position on the main issues under consideration remains consistent with its earlier consultation responses.

In its previous responses Synergen has raised issues of data analysis and the interpretation of data presented in the RA's consultation papers. We are disappointed that the analysis set out in the original consultation papers on the Medium Term Review has not been updated and presented within this paper. Synergen believes that this would have been beneficial to the consideration of the suite of draft decisions that are presented in the paper. In particular, it would have provided assurance that the issues of data accuracy and analysis that have been queried by participants have been addressed and that the SEMC's position is based upon the best available data<sup>1</sup>.

This response comments on each work package in order of original publication date. References are to the contents of SEM-11-088, unless otherwise stated. In places, this response also draws upon SEM-10-046, SEM-10-068, SEM-11-019 and Synergen's responses to these papers.

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<sup>1</sup> Synergen raised issues of the issue of ACPS volatility in its response to SEM-10-068, and its response to SEM-11-019 and SEM-11-019a included a section on inconsistencies and errors in the analysis presented by the RAs.

### 3 Work Package 1 – historic analysis of the SEM

Synergen notes the SEMC decision to continue to carry out analysis of the CPM on an on-going basis and its effectiveness in meeting its objectives.

### 4 Work Package 2 – Review of Capacity Requirement

In SEM-10-046 the RAs considered issues of:

- The transparency of the calculation process of the CPM;
- The use of FOP figures;
- The derivation of implied margin; and
- The treatment of wind and the “capacity credit “used for it.

These issues are considered in turn.

#### 4.1 The transparency of the calculation process of the CPM

**Synergen supports the RAs position that key drivers for the Capacity Requirement Calculations are published as part of the BNE calculation papers.**

Synergen also supports these parameters being determined by the TSOs as this is, pragmatically, the most independent and neutral method of determining the such figures, given (a) the TSOs financial neutrality to the outcome, and (b) the need for the TSOs to consistently utilise estimates of demand growth and profile within its system planning role.

#### 4.2 The use of FOP estimates

In this section we use the term Forced Outage Rate (FOR) when referring to historic/outturn data, and Forced Outage Probability (FOP) when referring to estimates of future outage rates.

##### 4.2.1 Target vs dynamic FOP

Since the start of the SEM the FOP used in the calculation of the capacity requirement has been set at 4.23%. This figure was determined by RAs to represent a target, or best achievable plant availability for generation on the Island of Ireland. It was recognised at the time that this figure was below the historic average rates achieved by plant within the SEM. The use of the target figure was thus intended to act as an efficiency incentive within the SEM to drive improvements in plant availability.

Synergen (and most other stakeholders) have consistently argued against both the principle of the incentive based FOP and that, even if such an approach is adopted, the figures utilised to date have been too low. These issues are addressed in turn.

**Synergen does not support** the target based approach to the setting of FOPs for the calculation of the capacity requirement. In SEM-11-088 the RAs state that “.....it is essential that the CPM does not over-value capacity. The SEM Committee are of the view

*that a targeted FOP should be used in the calculation*". This statement is not supported by analysis to demonstrate that alternative approaches would "over value" capacity, indeed the data presented in Figure 6.1 of SEM-11-088 indicates that generators are a long way from being over-rewarded as a result of the FOP approach that has been adopted to date.

#### **4.2.2 Does a target FOP achieve efficiency benefits?**

Synergen does not consider that it is demonstrated that the use of a target FOP improves plant availability rates. In SEM-10-046 the RAs commented that FORs had improved since the start of the SEM. Despite the increases in FORs driven by the outage at Turlough Hill in particular, there still appears to be a general downward trend. However, for the target approach to FOP to be valid, there should be a demonstration that it leads to improvements in availability. Synergen considers that (a) FOPs are variable as they are driven, in part, by unforeseeable events, and (b) that other factors than the reflection of FOPs in determination of ACPS are a more likely explanation of this downward trend (change in plant type, age of plant etc).

The energy and capacity revenue loss to generators from forced outages far outweighs the impact on capacity payment level of applying unrealistically low FOPs to the calculation. The latter, like the TSO's penalties, is an additional penalty when generators already have a considerable incentive to minimise forced outage rates as much as is possible for their individual plants. It would appear that the use of target FOP is more about suppressing capacity payment levels than incentivising availability.

As the benefit of a target FOP is not demonstrated, and to date in the SEM assumed FOPs have been significantly below actual levels of FOR, then the target approach should be replaced with a dynamic calculation of FOPs based on actual plant performance.

#### **4.2.3 The under-recovery issue**

Synergen considers that the historic 4.23% target has been inappropriate. It was imposed as an incentive based target but has clearly been over-optimistic. The end result has been a discontinuity between CMP revenue drivers and market reality, leading to a material under-estimation of the required level of ACPS. Synergen welcomes the move to correct this CPM suppression.

Further to the above, Synergen has on a number of occasions raised the issue of one-sided terminology within the RAs papers – the key requirement of the CPM is that it correctly rewards plant or other capacity providers and Synergen requests that RAs adopt a neutral approach to issues of under / over reward as there are clearly areas of under-recovery within the CPM mechanism at the present time.

#### **4.2.4 The use of a dynamic FOP approach**

In its response to SEM-10-046 Synergen proposed that the FOP should be based on a rolling average of historic FORs. This would ensure that:

- The process of setting the value would be transparent;
- The process for setting the value was mechanistic, and could not therefore be subject to ad-hoc changes; and

- The values utilised would reflect actual rates (over time) even though the within year FOP would be unlikely to be the same as the outturn FOR that occurred during that year.

#### 4.2.5 Transparency and derivation of a target figure

Synergen is concerned that the decision paper neither explores the merits of alternative (non-target based) approaches to the setting of the FOP, but that the rationale and supporting data to support the proposed new value of 5.91% is not set out. This lack of transparency is exactly what Synergen believes should be avoided in the determination of key CPM calculation values.

Synergen also notes that only in one year since the start of the SEM was the outturn FOR below the proposed target value of FOP of 5.91% (around 5% in 2009) whilst in other years the figure was significantly higher. Consequently, Synergen assumes that the target 5.91% FOP figure proposed is a figure based on some observed historic FOR values with some downwards adjustments. A FOP of 5.91% appears likely to continue the existing under-recovery of CPM monies by generators, albeit the scale of this under-recovery is reduced.

#### 4.2.6 Summary – FOP assumptions

**Synergen does not support a target FOP rate. Synergen supports the adoption of a 3 year historic rolling average rate (including all generation units and the interconnector) as the FOP input into the capacity requirement calculations.** Over time, this would provide the most accurate reflection of actual system conditions and margin requirements, even if there are some temporal inaccuracies. It is implausible that any generators would have any rationale to distort this figure given the commercial implications of being unavailable. The use of full historic FOR data is thus transparent, accurate and neutral in its application and should be adopted as the approach. Should major elements of the CPM be fixed over a 3 year period, this would require that the rolling average FOR element of the FOP assumption was not one of these fixed elements.

### 4.3 The derivation of implied margin

Synergen accepts the approach taken to the determination of LOLE, and that an 8 hour loss of load expectation is reasonable given other international practice.

### 4.4 The treatment of wind and the capacity credit used for it.

**Synergen supports the RA position that the existing approach to the contribution of wind generation to capacity adequacy is satisfactory, and that this should be kept under review.**

## 5 Work Package 3 – Deduction of IMR and IS and BNE Plant Options

### 5.1 Participant views

We do not believe that Synergen's position on the options around IMR deductions from the BNE peaker costs (as discussed in section 7.5 of SEM-11-088) is accurately categorised.

In its responses to SEM-10-046 Synergen rejected Option 1, and stated that it was possible that Option 2 and Option 3 could be equivalent over time, and that this required further investigation. However, this does not equate to support for Option 2. Synergen has discussed this matter with the RAs<sup>2</sup> and is happy to accept the RAs' offer of correcting this classification in any final decision document, and to include comment in that paper as to Synergen's objection to its response being classified as supportive for Option 2.

Synergen's assessment of the other 8 responses to SEM-10-046 also leads us to conclude that other party's opinions on Options 1-3 were not fully reflected in the table presented by the RAs. Respondents' views have been clarified in NEAI discussions and it is clear that:

- Option 1 was widely regarded as inappropriate;
- There was no support for Option 2 in the form presented by the RAs<sup>3</sup>;
- Option 3 was supported by three parties; and,
- Those parties that argued for no IMR deduction of IMR would, between Options 1-3, prefer Option 3.

## 5.2 Synergen's observations on Options 2 and 3 – the deduction of IMR

Synergen has concerns regarding:

- The economic rationale for Option 2 – notably whether “equilibrium” as described as correctly conceived;
- The equivalence, or otherwise, of Options 2 and 3;
- The principles of utilising fixed and dynamic values within the determination of ACPS; and
- The inconsistency in approach of moving to Option 2, when in other areas of the Medium CPM Review the SEM Committee is explicitly adopting a principle of “no major change”.

These are addressed in turn.

For the avoidance of doubt, the arguments set out in Sections 5.2.1 – 5.2.4 are self-standing. They do not depend on the veracity of each other. Each individually is sufficient reason for Option 2 to be rejected. Consequently, the onus would be on the SEMC to demonstrate beyond reasonable doubt that all four are incorrect if they intend to pursue option 2.

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<sup>2</sup> Conversation with Utility Regulator on 16<sup>th</sup> November 2011

<sup>3</sup> One party (ESB PG) considered that IF the IMR calculated under Option 3 were to become volatile then a variant of Option 2 could be considered, whilst another (Synergen) observed that in the long-run Options 2 and 3 could be equivalent.

### 5.2.1 The equilibrium argument

In Section 7.2 of SEM-11-088 the SEM Committee (SEMC) sets out that “a key point in the selected design of the CPM within the broader theory of remunerating generators in the SEM is to consider the circumstances in which the market is **at equilibrium.**”

In Section 7.5 of SEM-11-088, “SEM Committee’s Response”, the SEMC clearly sets out the underpinning rationale to support their preference for Option 2, essentially to deduct 8 hours of IMR at an assumed PCAP level. It is thus critical that the SEM Committee’s approach is economically sound, and correctly reflects the SEM design in general, and the CPM design in particular – as set out in the Trading and Settlement Code. The following two SEM Committee statements are therefore central to understanding its rationale for equilibrium:

- “As was stated previously, a key point in the design of the CPM within the broader theory of remunerating generators in the SEM is to consider the circumstances in which the market is in equilibrium. At equilibrium the BNE peaker will set the market price (whenever it is scheduled) as it has the highest variable costs. Also within this system:
  - ***There must be some hours with non-served energy and a marginal price equal to VoLL, since otherwise the system cannot be in equilibrium.*** [Synergen bold]

The SEM position is thus explicitly that equilibrium only exists if there are hours of unserved load (assumed to be 8 hours) **and** that marginal prices equal VoLL (presently set at €10,519.75). If equilibrium does not exist as described, it is Synergen’s contention that the entire basis for Option 2 as described by the SEM Committee falls away, indeed as we read it, this would also be the position of the SEMC.

Synergen believes that equilibrium as described is not possible given the existing SEM and CPM designs. It considers that:

1. It is not possible for the SEM to deliver a price for unserved energy and a “marginal price equal to VoLL”. Energy prices are capped at PCAP, and thus by definition within the market rules, unserved energy cannot be priced at VoLL.
2. It is not even possible for the market price (SMP + CPM) to reach VoLL. This arises because of:
  - i. The adoption of PCAP, which limits the energy payment available in any trading period.
  - ii. The CPM payment mechanism itself. The allocation of CPM payments into ex-ante and ex-post revenue streams by month and current value of BNE costs contrasted against the level of VoLL makes it infeasible for the CPM regime to allocate sufficient CPM rewards into a single trading period to give an overall price outcome where  $SMP + CPM = VoLL$ .

Consequently, a VoLL price is not achievable under the SEM either in the manner described by the SEM Committee or as a result of SMP + CPM monies calculated for a trading period under the Trading and Settlement Code. Option 2 should thus be rejected.

### 5.2.2 The equivalence argument – and the application of a long term equilibrium over a short term timeframe

Synergen has considered the issues associated with the possible equivalence of Options 2 and 3, and has the following observations:

- The SEMC's assessment of the options within the decision paper appears particularly light. The issue of long-term equivalence between Options 2 and 3 is limited to the reference to the equilibrium state of the market. The SEM Committee have not assessed the extent to which Options 2 and 3 are equivalent. Given our observations on equilibrium<sup>4</sup>, Synergen considers it implausible that Options 2 and 3 would be equivalent over time under the existing market rules. The SEMC do not explicitly comment on equivalence (despite Synergen's explicit request for this to be investigated<sup>5</sup>). Given that the SEMC does not believe that there should be substantive changes to the SEM<sup>6</sup> it is implicit that the outcomes of Option 2 and Option 3, over time would be equivalent.
- Notwithstanding the above, an economically neutral application of Option 2 (i.e. where it is equivalent or even similar to Option 3 over an investment timeframe) would assume that the market design, and the CPM in particular, would run unchanged over that period. It is not plausible that this would be the case, notably given the uncertainty around 2016. **It is thus inappropriate to apply a long run theoretical equilibrium position to a limited time window of the investment horizon.** This would inevitably cause mechanistic under or over recovery. Where arrangements are more fluid, as is the case with market designs in general and the CPM at this time in particular, a more dynamic assessment of the IMR is more appropriate.

### 5.2.3 The consistency of fixed and dynamic values within the calculation of ACPS

The CPM as conceived takes some values and assessments that are theoretical as inputs to the determination of ACPS. These are limited, and are utilised as they are existing metrics within the SEM arrangements. The use of a LOLE of 8 hours per year is a notable example of this. As a general principle, the CPM utilises up to date values in determining the ACPS. Parameters associated with the BNE peaker are assessed on an annual basis – this including both its assumed costs and revenues<sup>7</sup>. This reflects the changing nature of the potential BNE plant, its financing costs and its market costs such as TUoS. It is, in principle, incorrect to adopt an approach to the BNE in which revenues are fixed, whilst costs are variable.

<sup>4</sup> As set out in Synergen's response to SEM-10-046.

<sup>5</sup> Synergen's response to SEM-10-046.

<sup>6</sup> Section 2, SEM-11-088

<sup>7</sup> Notwithstanding the RAs preference for a 3 year fixing of the BNE, this principle still broadly applies.

#### 5.2.4 Is there a demonstrated need for change?

The SEMC position in determining the approach to take on the CPM Medium Term Review, is that now is not the time for significant changes. Synergen considers that the move from Option 3 to Option 2 would represent a significant and material change to the CPM, and is thus inconsistent with the SEMC's overall policy direction of "minimum change". There is no evidence that Option 3 has not functioned as intended to date, or that it is conceptually flawed. However, as noted earlier, Option 2 is unsound in principle given the existing market rules. Whilst well founded changes to the SEM are to be expected, and are desirable, changes such as the one proposed give rise to significant regulatory risk as they demonstrate the underlying nature of the SEMC's decision making.

The SEMC appear to be proposing to suppress CPM, not set it at the correct level that would result from a neutral application of the principles of the CPM. Synergen can only conclude that the SEMC wishes for the CPM to be lower as a matter of policy choice, and Option 2 is being proposed by the SEMC on this basis. Synergen doubts whether, if the BNE peaker were earning significant levels of IMR under the existing approach, the SEMC would be as keen on adopting Option 2.

**In summary, Synergen believes that:**

- 1. Option 2 cannot deliver the equilibrium described by the SEMC. It should thus be rejected.**
- 2. Options 2 and 3 are not equivalent over time – notably because of the workings of the Trading and Settlement Code rules including those associated with PCAP levels, and the determination of CPM payments for any given trading period.**
- 3. Even if Options 2 and 3 were equivalent over time, the application of any long run equilibrium approach to a time limited period within an investment timescale is fundamentally flawed, and will lead to an artificially suppressed CPM at this point of the capacity cycle.**
- 4. The approach to a static value is inconsistent with the broad approach within the calculation of ACPS where static values are only used in the absence of periodically calculated costs and revenues.**
- 5. There is no demonstrated case that Option 3 is not operating as intended.**
- 6. Moving to Option 2 is a radical change in the context of the CPM, and contrary to the RAs preferred "minimum change" approach adopted in other areas.**

## 6 Work Package 4 – BNE Peaker Plant Fuel Options

Synergen notes the decision to continue with the assumption that, at this time, the BNE peaker should be assumed to be gas fired. It also notes the issues raised regarding the purchase of gas capacity by the peaker. Synergen's only observation in this regard is that there continues to be uncertainty around the costs faced by the BNE peaker and that it is



important that the CPM is able to reflect these costs accurately in order to ensure that the ACPS is set as close to its true value as can be reasonably calculated ex-ante.

## 7 Work Package 5 – Exchange rate for CPM

In its response to SEM-10-046, Synergen supported the RAs' position that the exchange rate should be fixed annually, and that there should be no segmentation of the CPM into jurisdictional pots and this position remains unchanged.

Synergen did raise the issue of methodology flaws in the CPM around the allocation of monies into monthly pots (e.g. the disproportionate allocation of monies in February), and that this fails to reflect the different number of days between months. Synergen is disappointed that the RAs do not appear to have considered this straightforward issue within the draft decision document. Synergen requests that the RAs give due consideration to this matter prior to a final decision on the CPM Medium Term Review.

## 8 Work Package 6 – Treatment of Generator Types in the CPM

In its response to SEM-11-019 Synergen commented on the capacity credit scenario, and a wind specific capacity credit scenario.

It was Synergen's view that the intent of these proposals was broadly sound and would be consistent with the SEMC position "*that the market should reward all generators .....equitably for the contribution to adequacy*". However, Synergen considers that the proposals as set out were insufficiently targeted to meet this objective and that a plant specific weighting based on proven availability should be considered. It is disappointing that the merits of such an approach have not been considered – the RAs have discounted the Capacity Credit approach generally on the grounds of complexity.

Synergen does not accept that such an approach is complex and notes that similar approaches were adopted in the old England and Wales Pool in the early 1990s. Adjustments to CPM revenues are not as complex, or we assume as costly, as changes to the central market systems for energy payments, and there is no examination in the RAs' draft decision of the costs and benefits of such an approach or indeed the Capacity Credit approach generally. The arguments against the Capacity Credit approach around uncertainty and subjectivity around the determination of capacity factors by plant type do not apply if a plant specific approach based on existing market availability metrics is adopted.

In short, Synergen does not believe that the RAs have given due consideration to a plant specific capacity credit and there is no evidence presented that they have considered whether such an approach is "complex". Our assessment is that such an approach is relatively straightforward, although there would clearly be system changes and consequential costs to deliver it. Further, Synergen does not accept that "complexity" is a valid reason for rejecting options that appear to further the broader objectives of the market, and are in line with the CPM's objectives. The aim is to have an efficient allocation of CPM monies in line with the contribution plant makes to **adequacy**, and this does not amount to a requirement that the arrangements are simple.

However, Synergen accepts that whilst the REM arrangements for the SEM are being developed the existing CPM arrangements should be maintained unless there is a

demonstrable case for making changes to them. Whilst Synergen continues to believe there is merit in plant specific “capacity credits” it believes that it is pragmatic at this time to maintain the existing arrangements. Once the market design of the SEM to meet REM requirements is underway, there would be merit in re-examining the merits of introducing a plant specific capacity credit regime.

## **9 Work Package 7 – BNE calculation methodology**

### **9.1 The approach to setting the BNE**

In its response to SEM-10-068 Synergen commented in detail on:

- The RAs’ analysis, and the RAs’ assessment of the volatility of ACPS;
- The broad choice of a LoLP/VoLL calculation or the existing BNE approach (section 4 of SEM-10-068); and
- The options for fixing/smoothing of elements of cost under the BNE “bottom up” approach.

These are addressed in turn.

Synergen’s response demonstrated statistically that ACPS variations cannot be defined as volatile – indeed our assessment of the coefficient of variation for ACPS during the years referenced was 0.12, compared to a value in excess of 0.5 for SMP. As there is no volatility to address, “solutions” to a “volatility problem” are based on an inaccurate (and at worst misleading) premise.

Regarding the options for the calculation of ACPS under the BNE approach, the RAs’ original consultation presented six options, of which the RAs decided only to consider three options, notably Options 2, 5 and 6. At the time of writing SEM-10-068 the RAs rejected Option 1 (the existing approach involving a evaluation of all BNE costs in an annual basis). Synergen noted in its previous response that there was no basis for this decision being taken by the RAs and that Option 1 should be fully considered. Synergen supported this position (as noted above) with evidence that the existing approach was (a) not volatile, and (b) on a correct analysis of the relative volatility of options, Option 1 was relatively stable.

Having presented a sound case for the re-evaluation of Option 1, Synergen is extremely disappointed that the decision paper concentrates merely on Options 2, 5 and 6. Synergen believes that the RAs have failed to show due process in evaluating all of the options in a transparent and objective manner. There has been no evidence presented that the existing annual calculation of costs and revenues is (a) volatile, or (b) that the year-on-year variations to date, which are intended to reflect underlying changes in cost drivers, do not represent an appropriate balance between cost reflectivity and stability. While any ex-ante determination of ACPS will contain some inaccuracies, fixing the pot for three years exacerbates this, and there is a real risk of material under or over-recovery by generators if underlying cost and revenue drivers for the BNE are not re-assessed on an annual basis.

**Synergen concurs with the SEMC decision to retain the BNE approach at this time.**

**Synergen continues to oppose measures to fix elements of the BNE across multiple years. The decision is not well founded, and lacks supporting evidence. Consequently, it is incumbent on the RAs to reconsider their decision in favour of fixing most the BNE costs for a 3 year period.**

## **9.2 The calculation of WACC**

As part of the discussion on Work Package 7, the RAs make observations on the impact of the options for the assessment of the BNE on WACC calculations. Whilst Synergen notes that the RAs' comments are in the context of the 3 year fixing of the BNE, it is critical to establish a robust approach to the calculation of WACC and that the WACC figure used should be reflective of the costs that would be faced by a new entrant BNE locating in NI or the RoI **and** trading within an all-island market.

Synergen fully endorses the comments of respondents to the CPM Medium Term Review which have been critical of:

- The approach taken to determining a WACC; and
- The transparency of the WACC assessment.

Synergen notes the SEM Committees' response to participants' concerns (i.e. that they have been noted) and the statement of intent to make the future BNE calculation as transparent as possible.

Synergen believes that the WACC assumption is a critical determinant of the level of ACPS. It is also demonstrably a parameter where the selection of a value that is below any achievable rate for a putative BNE project can be selected by the RAs and subject only to limited challenge and scrutiny. The RAs make several references (indeed state in most paragraphs of the SEMC response section) that the WACC calculation is transparent. . Despite detailed arguments in favour of utilising rates other than a vanilla GB rate, the rationale for the SEMC reasons to utilise a standard GB WACC for a NI based BNE is not explained, despite strong evidence from various participants that an alternative approach would be how, in reality, a new generation project was assessed by debt holders.

**Synergen considers that there needs to be a fundamental re-assessment to the calculation of WACC within the BNE calculation.** This should be based on:

- The full reflection of differences between a NI WACC<sup>8</sup> and a GB WACC; and
- A full reflection of the cross jurisdictional nature of the market that the BNE participates in, and how this drives the WACC.

In its response to SEM-11-025 Synergen noted that:

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<sup>8</sup> Synergen provided data on this within its response to the last BNE peaker calculation consultation (SEM-11-025), and refers the RAs to that response.

*“Synergen does not believe the assessment of the NI WACC is prudent, and that a number of elements of the WACC treatment are inappropriate given the assumed nature of the investment and the cross-jurisdictional nature of the SEM, including common market arrangements and a common regulatory regime. For example, a generator located in NI has the same exposure to a supplier default in the RoI as is faced by a generator in the RoI.*

1. *Within SEM-11-025, the WACC assumptions are locational based on country specific assumptions. However, the required returns are higher in NI compared to the rest of the UK given the region’s risk profile, as noted in a current British Government consultation which states “... it is clear Northern Ireland faces a greater challenge than most other parts of the UK in competing in a global market, and attracting investment to grow the private sector and drive economic growth.”<sup>9</sup>.*
2. *the cost of debt may (theoretically) may be considered on a jurisdictional basis, and for a network business this may be realistic. However, it’s the risks and rewards for a generation entity are market wide as the SEM operates on the basis of common market and regulatory arrangements across jurisdictions.*
3. *The assumed level of required reward appears unrealistically low given the interest rate for recent NIE bonds (May 2011) was 6.375%. Clearly a merchant BNE would have a higher cost of borrowing than a network related business owned by the Irish Government.*

*Synergen thus believes that the wide differences in risk free rates between jurisdictions are not realistic in considering the BNE Peaker. On this basis, the RAs should re-visit the WACC assessment”.*

This remains Synergen’s view and it urges the RAs to ensure that the next WACC calculation is based upon assessments of cost provided by financing institutions for the BNE proposed. There should be 3 such quotes, and Synergen proposes that taking the arithmetic average of these provide an unbiased and realistic assessment of the WACC.

**Synergen supports the views put forward in the NEAI response on the treatment of WACC.**

## **10 Work Package 8 – Incentives for Generators**

### **10.1 Ancillary Services and the CPM**

**Synergen supports the RA position that Ancillary Services and the revenues to a generator under the CPM are separate and reflect different services.** On that basis, targeting CPM payments to reward “flexibility” is not appropriate and Synergen supports the RA decision to not to seek target CPM payments to “flexibility” services.

### **10.2 Penalties**

Synergen finds the suggestion that there may be further consideration of the issue by the SEMC in the context of Generator Performance Incentives (GPI) to be inappropriate. The

<sup>9</sup> [HM Treasury : Rebalancing the Northern Ireland economy – March 2011](#) – Section 1.3.

penalties under the GPI are clearly separate from the operation of the CPM given their assessment under the Grid Code. Synergen does not consider that this is a clear route to address the non-provision of capacity, nor does it see that it would be any less complex or costly to make any changes through the GPI arrangements instead of the central market arrangements. Fundamentally, Synergen is concerned that there is a significant tightening of the requirements on generators through the Grid Code, and that this can impose significant costs of compliance or GPI penalties on generators. In this context it is difficult to understand why the RAs are not prepared, at least incrementally, to appropriately reward plant that has proven availability and thus improves the available level of capacity on the system.

**Synergen believes that some limited recouping of CPM monies from generators that are not able to reasonably demonstrate that they are available when in receipt of CPM payments would be appropriate.**

### **10.3 The new entrant scenario**

The SEMC draft decision is that there should not be a targeting of the CPM to all, or some, new entrants. Whilst Synergen supports the RA decision it does not agree with the RAs' reasoning on this issue – it does not concur that the proposal had any merit, and considers that it was inherently inequitable, discriminatory and contrary to the principles of the CPM design.

**Synergen supports the RAs rejection of the various forms of “new entrant scenario” set out in SEM-11-019.**

## **11 Work Package 9 – The Timing and Distribution of Capacity Payments**

The draft decision set out in SEM-11-088 is that:

- The existing split between the capacity payment pots should be maintained at 30:40:30; and
- The flattening power factor should be increased to 0.5 from its existing level of 0.35 so that LOLP would become more ‘spikey’ that it is at present.

In reaching this decision, the SEMC recognise the need for stability in the long-term signals, and consider that the existing split of CPM monies between the three pots in the existing ratio is the “...*best fit to the objectives of the SEM...*”. In relation to the flattening power factor, it is argued that decreasing the dampening effect on LOLP can be useful in targeting payments to generators that were available at times of tighter margin.

Synergen’s reservations about increasing the ex-post pot ratio, and increasing the power factor are broadly the same. In both cases it considered that targeting the payments at times of tighter margin would not change the availability of a generator at any given point of time, and would increase the lottery effect of payments. Consequently, Synergen is surprised that the RAs have chosen to give weight to the “stability” argument with respect to the distribution of payments between ex-ante and ex-pots pots, but not to apply the same rationale to the flattening power factor assessment. Synergen also notes that of the

20 public responses that commented the ex-ante : ex-post split and/or the flattening power factor, only four expressed any support for either. Increasing the ex-post component of the CPM, or making it more spikey through changes to the flattening power factor are both measures that attract little support from a large majority of the major providers of capacity to the system.

Synergen's position in its response to SEM-11-019 was that the ex-ante ratio should be increased and that the objectives of the SEM would best be met by maintaining, or reducing, the flattening power factor. This remains its position. However, in the context of the SEMC's decision to not make major changes to the SEM<sup>10</sup>

**Synergen supports the decision to maintain the existing CPM distribution ratios and opposes the decision to increase the flattening power factor.**

## **12 Work Package 10 – The impact of CPM on suppliers**

Synergen notes the RAs' consideration of the issues associated with aligning supplier charges with generator payments for each trading period.

**Synergen supports the SEMC view that the existing (non-aligned) approach should be maintained at this stage.** However, as a matter of principle, if there are further moves to specifically target the CPM at times of tightest margin, there will be an increasing case to reflect the contribution of both demand and supply sides of the market to the generation margin.

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<sup>10</sup> Whilst Synergen notes that it is the SEMC position, it does not believe that the adoption of the fixed IMR in the determination of BNE peaker revenues is consistent with this broad SEMC approach.