SSE Renewables - Response to

Consultation on Relevant Considerations in Relation to the Possible Cancellation of Generating Unit Agreements in Northern Ireland

27 January 2010

Airtricity Ltd, Airtricity House, Ravenscourt Office Park, Sandyford. Dublin 18

Consultation on Relevant Considerations in Relation to the Possible Cancellation of Generating Unit Agreements in Northern Ireland

Introduction

SSE Renewables is pleased to have this opportunity to respond to the Authority's consultation on the future of the generating unit agreements in Northern Ireland. In the past these contracts have been blamed for high retail electricity prices in Northern Ireland and although they are currently perceived to be generally performing, major contributions from the PSO for capacity buyout, as well as FGD costs, should not be forgotten. Customers have paid a heavy price for these contracts and it is by no means clear that a simple assessment of forecast Pool revenue vs contract cost provides a sufficiently holistic picture of the economic value (or otherwise) they offer going forward.

In this response, we argue that the additional liquidity these generators could provide to the market as independent traders would offer greater value to customers than maintenance of the status quo. Competitive innovation delivers more than increasing the efficiency of a sub-optimal activity.

Response to Consultation Questions

<u>Question 1</u>

Would cancellation of the GUAs (or any particular GUA) be likely to help further the principal objective of (a) the Authority and (b) the SEMC?

We believe that the principal objectives of the Authority and the SEMC can be summarised as follows;

- to protecting the interests of consumers by
    - ensuring demand is met,
    - ensuring licence holders can finance themselves and
    - not discriminating between licence holders.

We consider each of these in turn.

<u>Protecting Customers' Interests</u>

At present customers are the ultimate holders of GUA risk. Change-of-law costs, no matter how extreme, are passed directly to customers through the PSO. This is an unreasonable imposition on customers and therefore fails to meet the objectives.

Any reduction in GUA running hours increases average energy costs, whether the reduction is due to falling demand as a result of recession, relative fuel price changes, or for any other reason. This cost risk passes directly to customers through the PSO. This is an unreasonable imposition on customers and therefore fails to meet the objectives.

Risks should be carried by those best placed to manage them; the generators. If they carry their own risks, generators will have the correct incentives and the optimum means to manage risk at reasonable cost. The FGD costs are an example of how these contracts can impact customers. A 20-year investment cost was recovered over a quarter of the optimal time, to avoid a stranded cost extending beyond the original cancellation date. How would similar future costs be recovered when GUA contracts may operate only year-to year? How would such investment be recovered in the event of an old generation plant suffered a significant and permanent failure?

In summary, we do not believe that the interests of customers are best served by misallocation of risk, including risk of plant running regime, potentially inefficient plant investments, SEM plant mix, increasing renewable generation driving down SEM prices or change of law provisions that may require material investment close to the end of a plant's economic life. If anything, this open-ended guarantee distorts incentives and could be a real barrier to rational economic investments that would be in the customer interest. We therefore conclude that the interests of customers are not intrinsically protected by the GUAs, although they may provide benefit from time to time.

<u>Ensuring Demand is Met</u>

Prior to introduction of the SEM, Northern Ireland had to be largely self-sufficient in generation. With the advent of the SEM and increasing development of both renewable and conventionally-dispatchable plant, in addition to improving interconnection, the interests of customers are now better served by the diversity of plant and sources of supply now available to meet demand on an all-island basis; particularly once the new North-South interconnector is commissioned. Eirgrid's new East-West interconnector will further improve the island's energy security, when it is commissioned in 2012. We therefore conclude that, in future, the GUAs will provide no additional assurance that electricity demand can be met.

<u>Ensuring Licence Holders can Finance Themselves</u>

The Authority does not have an absolute obligation to ensure all licence holders can finance themselves, otherwise all suppliers would be given a revenue guarantee and all market participants would be protected from the consequences of unwise or inappropriate investment. We believe that the Authority's obligation, in regard to licence holder financing, is to provide a stable trading regime, with cost-reflective pricing, in which efficient participants can obtain capital in private capital markets on the prospect of market expectations for risk-adjusted returns on investment. Less-efficient licence holders, or those who fail to obtain such investment capital, therefore face a rational incentive to exit the market and vice versa.

We do not therefore believe that the GUAs are necessary to justify, or provide, special consideration to particular market participants, in regard to their ability to raise finance for themselves. Indeed there is a risk that continuing existence of the GUAs might only serve to reduce the availability of private capital to the market as a whole.

Not discriminating between licence holders

In freeing GUA counterparties from some aspects of normal economics, for example the tradeoff between scale of change-of-law-driven investments and remaining economic life of the generator, it is clear that the existence of GUA Agreements gives these generators an advantage. Skewing the market in this way is distortionary and the existence of GUAs is therefore discriminatory in the between generator licence holders as a group.

Question 2

What are the kinds of effects, whether positive or negative, (if any) that a decision to cancel the GUAs (or any particular GUA) are likely to have on matters to which the Authority/SEMC must have regard? There may, for example, be particular effects of which respondents are aware that they might wish to bring to our attention ...

Impact of GUAs on SEM Competitiveness

One of the perennial issues facing suppliers in the SEM is the lack of a liquid market for hedging contracts. One of the reasons for high retail electricity prices in 2009 was the rigid contract mechanism that managed to lock in the peak energy prices in May of 2008. By taking a calculated (and approved) gamble on the direction of energy prices subsequent to May 2008, PPB was able to deliver a material saving on costs to customers through the PSO. However there are consequences to all interfering in markets when the intervention unwinds, however well-intentioned the initial action was.

There needs to be more than just two major generator blocks traded in the SEM, otherwise the market will never be able to move easily from its current arthritic state, towards the flexibility that characterises truly competitive markets. If the GUA generators are freed from PPB and able to contract on the basis of normal commercial behaviour, then they are very likely to develop a portfolio of contract products of varying durations. DCs and NDCs are hardly world-leading products; they have demonstrable failings that were entirely predictable. Current arrangements provide zero incentive to change in a way that will facilitate more cost-reflective retail pricing and allow the market to break free of May hedging, so that the benefits of wholesale market competition to feed through to customers.

GUAs inhibit the emergence of innovative competitive behaviours that will ultimately benefit customers and should be terminated. However termination should be carried out in a controlled manner.

In the absence of a liquid forward market against SMP it would be unreasonable to drop the generators into an un-hedged position on the day after termination. The generators would need to decide the level of contract cover with which they would be content on Day 1 and counterparties would need to be contracted. It will obviously take some time to set up the necessary trading paraphernalia (including contracts and counterparty credit). In summary, we believe it would be in the interest of the market as a whole to develop a controlled termination of the GUAs, to ensure the generators are given an opportunity to manage their forward positions and suppliers have the opportunity to negotiate arrangements that suit their customer portfolios.

Impact on Retail Prices

The consultation points out that all bar the Kilroot GUAs have been net contributors to the PSO since the start of the SEM. However it goes on correctly to point out that it is future value that counts. We have already pointed out changes in running regimes that could reverse the recent positive GUA benefit, the blunting effect these contracts have on economic signals (even in the absence of economic forecasting errors) and the huge risk exposure the contracts place on customers. We argue that these distortions are only part of the picture and that the effect of GUAs on the development of competition cast further doubt on the benefit they actually deliver to customers.

At a recent NIAUR seminar, Professor Littlechild pointed out that administered pricing arrangements aim to provide the same service more efficiently, but competition delivers innovative services at better value. We believe that the analysis of GUA benefits, as described in the consultation, have focused on the "efficiency" aspect of the existing model while ignoring the more difficult quantification of the potential benefits of innovation.

Question 3

Do respondents believe that:

- **There are any other particular facts or circumstances known to them which the Authority/SEMC should take into consideration in determining whether the exercise of the relevant function would be likely (or not) to help further the relevant principal objective and duties of (i) the Authority and (ii) the SEMC; and**
- **The Authority/SEMC should give particular attention or attach particular weight to any of these facts or circumstances when it makes that determination.**

Unreliability of Forecasts and the Need for More Holistic Assessment

The consultation is unclear as to whether continuation of the GUAs past their ECDs is likely to be based on running them to full term or continuous assessment of their forecast value on a year-to-year basis. With economic forecasts, as it is always a case of by how much, rather than if, they are wrong. The impact of 2008 fuel price curves on SEM forecasts and customer prices was only mitigated by a courageous gamble that the forward curves were wrong. We believe that other factors, such as the competitive development and market effectiveness issues described earlier, should carry at least an equal weighting in the Authority's deliberations on whether or not to cancel the GUAs.

Special Benefit to NIE Supply

As PPB passes through GUA gains and losses to customers via the PSO, these contracts differentiate NIE Supply from other suppliers who have to internalise their gains and losses from purchasing decisions and who generally have to pay a premium for the limited supply of NDCs that are made available. We ask that the Authority carefully considers whether the GUAs provide a comparative advantage to NIE Supply and by distorting the market, therefore discriminate in favour of the incumbent.

Summary

SSE Renewables believes that the Generating Unit Agreements in Northern Ireland were relevant to the circumstances of the time, but that in the market environment of the SEM they are an anachronism that distorts the market and inhibits development of a more liquid wholesale contract market. Their value, or otherwise, going forward must be assessed against wider criteria than just their cost vs Pool revenue. In conclusion, we believe that termination of the GUAs is more compliant with the Authority's and SEMC's principal objectives than retention.