Position Paper from Manufacturing NI on the Utility Regulators view on the "Possible Cancellation of Generating Unit Agreements in Northern Ireland"

The ETI Committee have expressed an interest in proposals from the Utility Regulator on the "Possible Cancellation of Generating Unit Agreements in Northern Ireland" and had written to MNI asking us for our views.

The original consultation was issued on 19 March - http://www.uregni.gov.uk/uploads/publications/2014-03-19_GUA_Consultation_Paper_v1_0.pdf

On 31 July, the regulator issued an update (and published responses to their consultation) confirming their intention to propose a cancellation of the contracts to their September Board meeting - http://www.uregni.gov.uk/uploads/publications/2014-07-31_GUA_Market_Update.pdf

In their update report, the Regulator says that "Manufacturing NI did not indicate any strong preference." This does not represent the view that we expressed in our response or verbally when we met the UR Executive and Board. We wish to make it clear that in our view the Ballylumford GUAs should not be cancelled at this point on the basis of the evidence provided. What we have read in the Regulator's decision note (including the published responses of other parties) and further professional advice we have sought have re-enforced this view.

As the Committee know, we are very interested in this matter because our members pay the second highest electricity prices in Europe. It is very important therefore that every decision that will affect prices is robustly scrutinised in advance. We do not have the internal resources or datasets to be able to make an intimately informed view, so we rely on the Regulator and from time to time the support of our own expert and professional advice. **The commentary below reflects our current understanding having taken this professional advice on current, future and historical matters of relevance.**

We are suspicious as to why AES is so keen to see these contracts cancelled. This contrasts with previous AES arguments that the Kilroot GUAs should not be cancelled. Cancellation of GUAs, for AES therefore, has nothing to do with promoting energy policy or competition. It could be suggested that AES wants to see the Ballylumford GUAs cancelled as it knows that the CCGT plant is much more valuable in a market than under contract to PPB.

There is, perhaps, a very good reason why AES holds this view. The Ballylumford GUAs are very different to all other GUAs. This is because they were re-negotiated by the Regulator in 2003. The new contract back-end loaded the value for consumers with the capital cost of the new CCGT recovered from consumers over 9 years from 2003-12. From 2012, the Availability Payments in the contract reduced **by 60%** so that only operational and maintenance costs would be recovered after that until 2022. Therefore customers would only realise the value of these re-negotiated contracts from 2012-22.

From 2003-12, customers pre-paid for the capital cost – it was recovered over 9 years, rather than the usual 20 years. If the contracts are now cancelled, customers would pay again. The consultation paper makes no reference to this important background.

AES is a member of CBI, and therefore this is likely to have dampened its response, although they still expressed concerns. SSE is "short" on generation on the island of Ireland and would therefore value more AES plant enter the market and prefer to enter into contracts directly with them rather than enter into contracts with PPB. The latter would retain the value (and the pre-payment) for NI customers, the former outcome would transfer this value to AES and SSE – customer losing out!

Concern have been expressed in the responses about the methodology in the economic analysis its reliability due to input errors – indeed, in its update paper the Regulator does make some amendment. Regardless of this, we are advised that the Regulator has used forward commodity curves, based on a 3 day window, and applied this to the current SEM rules. We understand that this is highly unreliable as commodity prices are volatile and several points in a time series are necessary for a reliable prediction; and, the current rules will change under the ISEM project.

There are very helpful market benchmarks, which again, the consultation paper does not refer to. With ballpark calculations, it could be concluded that the contracts should not be cancelled:

- Other new CCGTs are presently being constructed to enter both the Irish and GB market. Investors are clearly forecasting that they will be able to recover the full cost of their investments in these future markets. Current CCGT capital costs average £750/KW with an expected recovery period of 20 years. Given that the expected remaining life of the Ballylumford CCGT is at least another 8 years, they could expect to earn at least £180m in the market until 2022, just to recover capital cost, and ignoring return on capital (which would materially increase this number). It is very easy to see why PPB consider that cancelling the GUAs would cost NI consumers c£200m.

- NI consumers have made a pre-payment because the capital was paid back over 9 years rather than 20 years. Assuming a modest capital cost in 2003 of £600/KW, and ignoring the cost of capital, this capital pre-payment amounts to c£198m. Most of this is lost to NI consumers if the contracts are now cancelled.

- In 2010 the Ballylumford plant was sold to AES for £99m. For 1200 MWs of capacity, this was considered cheap at £83/KW. About half of this site was old inefficient plant. Even if we were to assume that these parts were valued at zero, this still put a value on the CCGT of only £166/KW. It's been suggested that the low valuation (compared to new-build cost of £750/KW) was due to a market expectation that the GUAs would never be cancelled. Therefore the market was simply valuing an operational and management contract. If the GUAs are now cancelled the valuation for shareholders completely changes and the value is lost for consumers.

From a NI policy perspective, if we accept the analysis, it is predicted to have very tight capacity margins from 2016. We will also be in a new electricity market from 2017. If cancelled, AES will be in a dominant position (with 80% of the market) and able to benefit from any capacity scarcity. Despite assurances from SONI and others, it is unclear how this dominance will be managed in the new market where the rules must be consistent with the GB market and not yet agreed.

The ability to promote effective competition and provide solid consumer protection must therefore be undermined or indeed damaged in this scenario. However, retention of the GUA provides market power mitigation as the price AES can charge is effectively capped. Consumers effectively have a one-way hedge and an option to cancel at any time. We believe this is not that different to the Contracts for Differences that are being proposed in the iSEM high-level design.

We do not understand how the retention of the GUAs will complicate iSEM. They can actually be an integral part of the design, consistent with the high level design and can provide a valuable mitigation against market power abuse. We understand that there are similar contracts, in both jurisdictions, in SEM and they have proved to be a good market facilitator, rather than complicating matters.

A number of respondents have expressed concerns about the analysis employment in that the result flipped and changed significantly over data points from 2012-2014. Indeed, the gap between the PPB and UR valuations has not been quantified or explained, when there has not be a coal/gas flip in the merit order. We note that the UR analysis does not appear to have modelled gas transportation costs.

It is worth noting that coal generators, usually, receive the gas price. This is at a time when the price of coal has collapsed. Despite this significant drop in input cost, we don't believe that this is passed through to customers.

The next PPB price control is in 2015. This provides an opportunity for PPB to demonstrate a reduction in its costs or even further strengthening customer protection as suggested in our initial response to the consultation. The timing is also good as we will know a lot more about the new iSEM and will be able to understand the value or otherwise of the GUAs more realistically. The Utility Regulator should also consider the PPB price control with Power NI's price control. After all, both businesses operate under the same licence. Merging the businesses would reduce costs.

In conclusion, we remain very concerned as to why the Utility Regulator would take a decision to cancel these GUAs at this time. There appears too much uncertainty and continued concern about the robustness with the analysis. Regardless, NI customers still deserve to get their pre-payment back – finally seeing some long-term gain for the short-term pain often used in the energy debate!

In summary, on the face of it with the need to recover the original capital costs now removed, it would seem logical to expect this plant to make a surplus which is recycled as per the contract for the benefit of customers. Our view is that all possible options to de-risk the customer are exhausted and a commitment from the Regulator to publish an ongoing analysis demonstrating if customers are winning or losing.

The decision states that "there is a strong case for the cancellation of the remaining GUAs". We don't believe, from what we have read and been told, that this is supported by the evidence. We are concerned that the purpose of the Regulators note is rather to send a strong signal to AES as the negotiations on security of supply reach a conclusion. Perhaps already seeing the influence of market dominance?

We repeat that the above is our understanding given additional advice we have sought. Other will have their own understanding. We have asked the Regulator to ensure our updated response is brought to the Board alongside their recommendation. We have also advised that we would be providing information to the ETI Committee as you have requested.