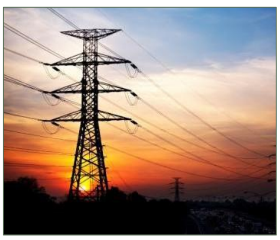
Possible Cancellation of Generating Unit Agreements in Northern Ireland

Market Update
31 July 2014


1. Market Update

1.1. In March 2014, we published a consultation paper on the potential cancellation of the two remaining Generating Unit Agreements (**GUAs**) in the Northern Ireland electricity market[1].

1.2. These contracts are managed on behalf of consumers by Power NI Energy Limited's Power Procurement Business (**PPB**) and relate to two generating units at Ballylumford power station that are owned by AES. They have a combined capacity of 595MW.

1.3. Based on detailed economic assessment and consideration of relevant policy matters, our consultation paper contained a draft decision to instruct the cancellation of the two remaining Generating Unit Agreements for effect in December 2014.

1.4. Eight responses were received to the consultation paper. These were from:

AES	Power NI
CBI	Power NI Energy Limited (PPB)
Consumer Council	SONI
Manufacturing NI	SSE (Ireland)

1.5. The responses are published in full alongside this market update and a brief summary of responses is included in Appendix A.

1.6. Since the consultation period closed we have considered these responses in detail and requested additional information from both AES and PPB. We have also met with PPB to discuss differences between our assessment and their assessment.

1.7. We have updated our economic analysis to take account of a number of factors, including:

- More recent fuel, carbon, demand and exchange rate assumptions;

[1] http://www.uregni.gov.uk/uploads/publications/2014-03-19_GUA_Consultation_Paper_v1_0.pdf

- updating our *Plexos* modelling to better reflect the actual bidding structures of certain generators;
- taking on board a number of points raised by both PPB and AES in their consultation responses, e.g. we revised our assessment of PPB's ancillary service revenue.

1.8. Our latest analysis indicates that while the GUAs in their own right are of financial benefit to consumers, the administrative cost of PPB means that the overall impact to consumers of retaining the GUAs is expected to be an economic burden.

1.9. In addition to a 'base case' forecast model we have also carried out sensitivity analysis as there are potential outcomes that could either favour or counter a decision to cancel the remaining GUAs. These will be further considered and included in updated modelling that will inform any future decision.

1.10. Based on the economic analysis to date, on balance we are of a view that unless PPB are able to substantially reduce their annual operating costs, the outcome of our updated analysis would continue to indicate that there will be a net consumer cost of retaining the contracts beyond Q1 2015.

1.11. We have also reviewed our assessment of key policy considerations: the promotion of effective competition; market design and the new target model; security of supply; diversity of supply and environmental sustainability.

1.12. Overall our policy assessment has not changed from that set out in our consultation paper. It is also worth noting that the consultation responses strengthen many of the arguments made in the consultation paper.

2014-15 PSO Tariff:

1.13. The net economic effect of the GUA contracts and PPB's operating costs is on consumers through an increase or reduction to the Public Service Obligation (PSO) tariff element. It is expected that this element of the PSO tariff for the twelve month period commencing 1 October 2014 will be negative and therefore a benefit for consumers.

1.14. This is largely driven by PPB earning more revenue than expected in the current tariff year and this additional revenue being returned to consumers through a ‘k-factor’ adjustment. However, much of this higher revenue was due to unexpected outages of other key generation plant that led to higher than expected levels of running for the GUA contracted units. This is not forecast to occur on an ongoing basis.

1.15. In addition, PPB’s tariff submissions consider the benefit PPB receives from holding and using their allocation of free carbon allowances (under the European Union’s Emission Trading Scheme). This is a benefit that is captured for consumers whether cancellation takes place or not. It is therefore not considered a factor for the economic assessment in relation to cancellation.

Conclusions:

1.16. The economic analysis highlights that while the GUAs in their own right are expected to be of value, the additional overhead costs of PPB (which is not expected to be required should cancellation take place) means the impact of retaining the GUAs is forecast to be a net consumer cost.

1.17. We believe that the policy assessment set out in our consultation paper has been supported by responses to the consultation. In particular in relation to promoting competition and contract liquidity as well as facilitating the efficient functioning of the new I-SEM market.

1.18. Given the results of our overall economic assessment to date and taking account of key policy considerations, on balance we are of a view that unless PPB are able to substantially reduce their annual operating costs, the most likely outcome is that there will be a net consumer cost of retaining the contracts beyond Q1 2015.

1.19. In light of the above conclusions and from a strategic perspective there is a strong case for the cancellation of the remaining GUAs.

Next Steps:

1.20. Over the coming weeks we will continue to engage with PPB and other interested parties to ensure that any decision on whether to issue notice of our intention to cancel the remaining GUA contracts is in consumers' best interest.

1.21. We will also continue to monitor trends in underlying assumptions used and update our economic modelling so as to further enhance our overall assessment and recommendation to the Board in September 2014.

1.22. A further update on this issue will be provided following our Board meeting in September 2014.

1.23. Should our Board's decision be to cancel the remaining contracts, a 180 day notice of intention to cancel is required. Cancellation would not therefore be expected take effect until 31 March 2015 at the earliest.

1.24. With any decision by the Board a subsequent decision paper will be published. This will contain results of our economic analysis and will address key points raised in responses to the consultation in greater detail.

2. Appendix A: Summary of Consultation Responses

2.1. A brief summary of these responses is set out below and all responses are published in full alongside this market update.

2.2. From our review of the responses, AES, SONI, SSE and the Consumer Council were generally supportive of our minded to decision to instruct cancellation. CBI and Manufacturing NI did not indicate any strong preference but highlighted a number of points for clarification. PPB and PowerNI were against cancellation.

PPB

2.3. PPB were critical of our economic analysis and highlighted a number of areas where they felt that we had over-stated costs, under-stated revenues and where we failed to take account of certain revenues and avoided costs.

2.4. PPB also highlighted that our results are different to the analysis we included in our 30 April 2012 decision paper.

2.5. PPB has made a number of points in relation to policy considerations. These include considerations in relation to the new I-SEM design, contract liquidity, market power, and to a lesser extent security of supply, diversity of supply and environmental sustainability.

AES

2.6. AES broadly supported our analysis but highlighted a number of factors they feel we should update in our analysis. They suggested that taking account of the recommended adjustments would increase the cost to customers.

2.7. AES also suggested that for a relatively low dispatch plant such as the Ballylumford CCGTs, the combined capacity/ancillary service income is likely to reduce. They largely support our policy analysis assessment.

CBI

2.8. CBI raised concerns between the difference in our modelling and PPB's, although they note that other members consulted by them have different perspectives, and in some cases have concluded that the current UR analysis is broadly correct.

SSE

2.9. SSE is supportive of a decision to cancel the remaining GUAs. They believe the existence of the GUAs (mis)allocates some significant risks to consumers in Northern Ireland. Their arguments focused on the policy considerations; in particular they saw the existence of the GUAs as having negative implications in relation to the market redesign, contract liquidity and security of supply.

Consumer Council

2.10. Overall the Consumer Council were broadly supportive of a cancellation decision but raised some questions in relation to the difference between our analysis and that we consulted on in 2012.

SONI

2.11. SONI supports our draft decision to instruct the cancellation of the remaining GUAs. SONI's assessment focused on the policy aspects and in particular a view that cancellation would simplify and increase transparency in the SEM and I-SEM.

Manufacturing NI (MNI)

2.12. MNI are broadly neutral but raised a number of question in relation to the wider implications of cancellation.

Power NI

2.13. PowerNI are against cancellation and do not agree with our economic assessment. They also highlight a credit cost benefits which PPB provides to Power NI.