

# Response to Eirgrid Fast-Build Consultation Paper

9 November 2007

By Seán Lyons, John Fitz Gerald, Laura Malaguzzi Valeri and Richard S.J. Tol<sup>1</sup>

Economic and Social Research Institute  
Whitaker Square  
Sir John Rogerson's Quay  
Dublin 2  
Email: [sean.lyons@esri.ie](mailto:sean.lyons@esri.ie), Tel: 01 863 2109.

## General comments

Our response focuses on the first of the questions you have posed: “Do you believe that the proposed funding and commercial models are of sufficient interest to you to merit further enquiry?” Although we do not represent potential bidders for a fast-build contract, we consider that there are significant problems with the models.

We understand that since the value of lost load is high,<sup>2</sup> the government wishes to avoid the contingency that demand will outstrip capacity for an extended period. The design of the SEM already includes incentives for participants to make adequate capacity available – the capacity payments mechanism. It is too early to tell whether or not this mechanism will be successful. The investment incentives in the SEM are particularly reliant on regulatory credibility, because the payoffs to investors in mid-merit and peaking capacity depend heavily upon expectations about capacity payments, which are ultimately under regulatory control.

The fast-build option set out in the consultation paper will compete with the capacity payments mechanism in providing peak capacity. Therefore, the possibility that a fast-build option will be employed may have serious detrimental effects on investment incentives for market participants, potentially undermining the ability of the SEM to deliver an efficient level and mix of capacity. The presence of a fast-build mechanism is likely to reduce the net present value of proposed generation investments, increasing the likelihood that future supply margins will be tight, raising the cost of obtaining sufficient generation capacity and damaging the prospects for bringing about effective competition.<sup>3</sup>

Any fast-build plan should take these unintended effects into account. First, the projected benefits of a fast-build plan in reducing the expected loss of load should be compared to its costs: both direct costs of administering and constructing the scheme and indirect costs on investment and competition via weakening of the SEM's peak capacity incentive properties. If the benefit-cost balance is still found to be positive, the fast-build arrangements should be designed to minimise damaging effects. The most sensitive features of the design in this respect will be its transparency, credibility, threshold for intervention and time taken in finalising the rules.

Transparency and credibility are vital because they will determine how potential investors in the SEM react to the presence of the scheme. Unless investors are

---

<sup>1</sup> This consultation response reflects the views of the authors, but it does not necessarily represent the views of the Economic and Social Research Institute.

<sup>2</sup> See Tol, R., 2007, “The Value of Lost Load”, ESRI Working Paper No. 214, October.

<sup>3</sup> These issues are discussed in Lyons, S., Fitz Gerald, J., McCarthy, N., Malaguzzi Valeri, L., Tol, R., 2007, “Preserving Electricity Market Efficiency While Closing Ireland's Capacity Gap”, *ESRI Quarterly Economic Commentary*, Autumn.

confident they understand precisely when and why the scheme will be activated and how it will affect capacity payments, as well as being confident that the scheme will not be used as a way to reduce capacity payments arbitrarily, investment in peak capacity is likely to be strongly deterred by the presence of the scheme.

The level of the threshold for activating the scheme is very important as well. The investment disincentive effects are likely to be inversely proportional to this threshold, so the threshold should be set higher than it would in the absence of such effects. Finally, if there is an extended period during which the market is uncertain about whether the scheme is going to be applied or about these key parameters, this will have a chilling effect on investors' willingness to make investments in the SEM. The fact that the capacity payment mechanism is being complemented during its inception phase further adds to the regulatory uncertainty that the investors face.

We do appreciate that electricity supply will be tight for the foreseeable future, and that measures need to be taken. If the capacity payments mechanism is not deemed adequate to deliver sufficient peak capacity, we recommend that the regulator strengthen the mechanism rather than putting in place a parallel instrument that provides contradictory incentives. If additional intervention is needed to remove institutional barriers that delay the rapid planning and building of peak capacity, this could be the focus of a "fast-build" initiative that does not undermine the incentives in the SEM.

### **Specific comments**

On p.4, the consultation paper suggests that the model would be designed to "let the market work" and that it should "not interfere materially with the market pricing arrangements for other generation". This goal is apparently to be met by exempting the new plant from constraints and capacity payments. However, pricing behaviour in the market is not the real concern; the market is subject to bidding principles that should presumably not be affected by the presence of a fast-build plant. Whether or not the plant is paid constraints or capacity payments, **its presence is likely to affect the capacity payments received by other plants**. Even before the fast-build programme is triggered, this effect will reduce the incentive for other operators to build new capacity, since it will increase the margin between the load and available generation. Moreover, it will particularly decrease incentives to build mid-merit and peaking capacity, because the profitability of such projects relies heavily on capacity payments.

The exemption from constraints and capacity payments will, as the paper suggests, make the plant unprofitable in the absence of external support. However, the public subsidy is to be combined with a clawback mechanism. **The clawback mechanism will give the scheme poor incentive properties**. Together with the exemption from capacity payments, taking back all the revenue earned when the fast-build plant runs will mean its operator has no incentive to make the plant available. Moreover, simply paying the operator a normal return on capital gives no incentive for efficient operation. Other options for control of reserve plants have been used internationally, and one of these might be preferable. For example, construction of the plant could be tendered, but its operation could reside with the system operator. The system operator could then contract-out operating activities, employing suitable performance incentives.

On p.12, the consultation paper discusses the technologies that are appropriate for peaking capacity generation. The regulator should provide incentives to investors in peak capacity, but **leave the choice of technology to the market** (subject to existing laws and regulations).