Capacity Remuneration Mechanism in I-SEM

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On 16 December 2015, the SEM Committee published the I-SEM Capacity Remuneration Mechanism Detailed Design Decision Paper (SEM-15-103) (the "CRM Decision"). The CRM Decision sets out the SEM Committee's determinations on the first phase of the detailed design of the I-SEM Capacity Remuneration Mechanism (the "CRM").

In 2007, when the SEM was set up, a capacity mechanism payment (the "CPM") was introduced in response to concerns that the small size of the market, the market power of the dominant companies and the inherent regulatory and political risk, would deter investment in generation capacity. In the I-SEM High Level Design (the "I-SEM HLD"), it was acknowledged that a form of capacity payment should continue as a means of supporting investment in generator capacity and ensuring security of supply.

In the current SEM, a pot of money is made available to eligible generators participating in the market to cover the CPM based on the predetermined fixed costs of a prescribed generating plant (the best new entrant). This money is then distributed by way of an "annual capacity payment" determined by the CER and the NIAUR. The I-SEM HLD provides for the payment of an upfront Capacity Remuneration Mechanism (the "CRM") through a completive process, such as an auction.

The following are the five key steps for the determination of the CRM:

1. Determine Key Requirements

This involves an assessment of the I-SEM capacity requirements to establish:

- the level of capacity required to maintain security of supply in future years; and
- the degree to which each generator contributes to that requirement for capacity.

2. Qualification

This involves identifying credible capacity generators. Those providers then "qualify" to participate in the subsequent auction process.

3. Auction

The auction is a competition between qualified capacity providers to be awarded "reliability options" for the provision of capacity. The reliability option is in essence a one way contract for difference, with a strike price and a market reference price.

The CfD will operate like a financial call option in that:

- the option holder (i.e. the qualifying generator) bids to receive a capacity payment (i.e., the "Option Fee") from the option counterparty (i.e. the Transmission System Operator);
- when the market reference price exceeds the strike price the option holder will be required to pay a sum equal to the market price less the strike price to the option counterparty (the Difference Payment"); and
- the option counterparty then pays the net difference between the Option Fee paid out and the Difference Payment received from suppliers.

The auction will allot sufficient options to meet the key requirement identified in step 1 above.

4. Build

When capacity is awarded to new capacity generators, the new capacity will be required to be built within the necessary timeframes. This is one of the key issues for generators and their funders at the moment; the contract (and certainty around the terms of that contract) is needed to underpin the investment).

5. Operate

This phase involves the payment of:

(i) the Option Fee to the capacity generator;

(ii) the Difference Payment from the capacity generator at times when energy prices are high (above the strike price);

(iii) payment from suppliers to cover the Option Fee to capacity generators; and

(iv) payment to suppliers at times when energy prices are high (above the strike price).

The CRM Decision sets out a number of decisions in relation to the 5-step process above, in particular in relation to the "Operate" phase. It also acknowledges the requirement for any proposed CRM to comply with the European Commission (the "EC") State Aid Draft Guidelines 2014 (the "Guidelines"), which set out high level criteria for justifying CRMs under State aid rules.

While the requirement to adhere with the Guidelines has been a key consideration in the development of the CRM, the launch of the recent Commission State-aid inquiry into capacity payments in 11 European markets has served to focus the mind on capacity mechanisms generally for funders and investors in the Irish market. To date, the inquiry appears to largely be a fact finding mission. While the information obtained could be used by the Commission in State aid enforcement proceedings against individual Member States, including Ireland which could result in sanctions of up to 10 years' worth of 'unlawful aid' (plus interest) being 'recovered' it is, in our view, more likely that the information obtained will be used to inform and frame the Commission's policies and principles for electricity market design and capacity payments. In the period up to I-SEM Go-Live, the development of the CRM rulesets will be watched in the market with interest.