ESB PES TARIFFS AND THE TRANSITION TO THE SEM

Report on the Consultation and Draft Decision Paper

CER/06/022

3 March 2006
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Executive Summary

On 16th January the Commission published a consultation document [06/002] on the question of ESB PES Tariffs and the Transition to the SEM. The consultation paper set out four options for conducting the revenue reviews. Two approaches involved setting a single ESB PES tariff schedule for a full year, beginning 1st January 2007. The other two approaches required two separate tariff decisions (for the period January to June and then July to December). Each option was evaluated against a number of criteria including the likely impacts of the option on generators, suppliers and customers, as well as any possible legal considerations and further specific implications. Comments were invited on these options and interested parties were invited to suggest any other approach.

The Commission has reviewed the responses and any alternative approaches suggested and now proposes to implement the following approach:

a. Two PES tariffs will be set for 2007, one for the period January to June and a second for the period from July to December.

b. Tariffs for the first period of 2007 will be determined on the basis of the latest cost information available in summer 2006 in accordance with the standard timescales. In the first instance the same approach will be taken to calculating costs as adopted in 2005.

c. Tariffs in the first period may, where appropriate, include a fuel variation clause.

d. Tariffs for the second period of 2007 will be linked to PES’ third party contracts, residual purchases from the pool and other market charges. Tariffs for this period will be determined over quarters 3 and 4 of 2006 and published in quarter 1 of 2007.

e. The methodology for calculating the PSO for 2007 will be the subject of a separate consultation paper to be published shortly.

f. Notwithstanding (a) above, the Commission may consider extending the second tariff period beyond 31st December 2007, if necessary, in order to facilitate alignment of the retail tariff years in Ireland and Northern Ireland.

Any comments on this final proposal should be forwarded by 17:00 on Friday 10th March 2006, preferably in electronic format, to:

Kieran McNamara

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1 In this case, the Commission will consult separately on the premise fuel price adjustment mechanism.
Commission for Energy Regulation  
Plaza House  
Belgard Road  
Tallaght  
Dublin 24  
E-mail: kmcnamara@cer.ie

Comments submitted will be published on the Commission’s website, www.cer.ie. If respondents submit confidential information which they do not wish to be published, this should be clearly labelled as such and included in a separate section.
1 Background

1.1 Consultation Paper
The planned implementation date for the Single Electricity Market (SEM) is July 2007. This poses a number of challenges for setting ESB Public Electricity Supplier (PES) tariffs. If PES tariffs are set for the calendar year 2007, the Commission is required to take a number of pricing related decisions in the period July to October 2006. These include decisions on a Best New Entrant price, ESB Power Generation revenues, Public Service Obligation charges, PES revenues, networks’ revenues for 2007, first and second tier top up prices and tariffs for PES and networks. If these decisions are to reflect the operation of the SEM from July 2007, a number of key elements/decisions arising out of the SEM work programme have to be available in time to meet the annual tariff round.

On 16th January the Commission published a consultation document [06/002] on the question of ESB PES Tariffs and the Transition to the SEM. The consultation paper set out four options for conducting the revenue reviews. Two approaches involved setting a single ESB PES tariff schedule for a full year, beginning 1st January 2007. The other two approaches required two separate tariff decision (for the period January to June and then July to December). Each option was evaluated against a number of criteria including the likely impacts of the option on generators, suppliers and customers, as well as any possible legal considerations and further specific implications. Comments were invited on these options and interested parties were invited to suggest any other approach.

1.2 Consultation Process
Respondents were invited to comment on the proposals set out in the document by February 8th. A total of 11 responses were received from the following:

- Airtricity
- BOC Gases
- Bord Gáis Energy Supply
- ESB Independent Energy
- ESB Customer Supply
- ESB Power Generation
- ESB National Grid
- IBEC
- Northern Ireland Electricity
- Synergen
- Viridian Power & Energy
These responses will be available from the CER website [www.cer.ie).

Section 2 of this paper summarises the substantive comments received and section 3 sets out a summary and evaluation of an alternative suggestion received from respondents together with the Commission’s decision on the approach that will be adopted.
2 The Options

This section sets out a brief summary of the four options included in the consultation paper and the comments received. Section 3 contains an alternative option suggested by a number of respondents, the Commission’s proposed approach and a summary of other issues introduced during the consultation.

Overview of Preferences:

|----------|-----------------|------------------------------------------------------|--------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------|

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<th>Option C</th>
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2.1 Option A - Hybrid Approach

Under this option, ESB PES tariffs would be set in 2006 for the full calendar year of 2007. They would be set on the basis of regulated costs (including ESBPG and PSO contract costs) for the first six months of the year; and a modelled system marginal price (SMP) and capacity payments/receipts for the second six months.

2.1.1 Respondents’ Comments

One respondent suggested that customers may not wish to contract in the normal manner (12 months) if this option was implemented. The same respondent also thought that this approach highlighted to suppliers and the market in general the need for/timing of hedge contracts in 2007.
Another respondent noted that while Option A meets many of the requirements for stakeholders it ‘may not be robust to SEM slippage’ and could impact on the SEM work programme given that hedge contracts would have to be made available by August 2006 at the latest.

One respondent noted that the misalignment between an annual tariff and the seasonal cost may lead to unexpected and undesirable consequences that impact on ESB Power Generation (ESB PG) recovering its allowed revenue. The same respondent suggested that ESB PG needs to ensure it can manage the commercial risks of the SEM. Therefore the System Marginal Price algorithm needs to be fully understood before any detailed analysis can begin. Independent suppliers would, in the respondent’s view, face the same difficulty as ESB PG under this option.

One respondent noted that this option may require a change in legislation for the purpose of amending the Public Service Obligation charge (PSO) and was concerned that legislation may not be enacted with in the time available.

Another respondent noted that of the four options presented only Option A is viable but its implementation is not straightforward given concerns about market price modelling. A further respondent commented that Option A has the most to commend it as it reflects the underlying reality of the trading arrangements at any one time and allows an initial, administered regime to temper the impact of any volatility in the early implementation of SEM.

### 2.2 Option B  Tariffs based on market-based approach for all of 2007

Under this option, tariffs are set on the basis of PES purchasing its residual requirements (after fulfilling its obligations under Alternative Energy Requirement and Economic Purchase Obligation contracts) at a forecast pool price/capacity payments scheme for the whole of 2007 (or some combination of pool price/capacity and Contract for Difference prices).

#### 2.2.1 Respondents’ Comments

One respondent suggests that Option B introduces a significant risk of tariffs not being cost reflective in 2007.

Another respondent stated that it would be difficult for a single tariff to be set at the beginning of the year as it would be formed on the basis of different information sets. This misalignment between an annual tariff and the seasonal cost may lead to unexpected and undesirable consequences that would impact on ESB PG recovering the regulated allowed revenues. The same respondent notes that reliable SEM price forecasts are not yet available and, “given the absence of a robust timetable” the prudent option is to avoid tariffs based on unreliable cost estimates. This option poses unacceptable levels of financial risk for all market participants.
Another respondent suggests that Option B provides stability for market players in a time of transition / uncertainty since tariffs are set for the standard 12 month contract period while simultaneously being reflective of the underlying wholesale structure. This will reduce the level of uncertainty faced by customers when renewing contracts with suppliers. At the same time this option will also provide an indication to suppliers and the market in general as to where hedge contracts will trade / need to trade in the year of 2007.

One respondent suggested that this option has a number of advantages in common with Option A. It is compatible with the processes that will be required from 2008 onwards and requires only a single tariff-setting exercise for the year. However it is more risky than Option A, in that it represents a "big bang" implementation of a forecast market without any direct connection with the underlying costs of ESB PG or ESB PES.

The same respondent notes that time and resources will be required to design an effective method of adjusting the existing top up/spill regime to enable it to map to the market-based approach and this work will have to be undertaken and consulted on, prior to designing and implementing changes to the supporting settlement systems.

2.3 Option C - Tariff period extension – extend 2006 tariff decision until SEM commences in July 2007

This option would involve extending 2006 tariffs (and the PSO) for six months to end-June at existing level; and setting new tariffs from mid-2007 for the rest of 2007 on the basis of a modelled market price.

2.3.1 Respondents’ Comments

Extending the 2006 tariffs for the first six months of 2007 causes difficulties for the independent sector said one respondent. PES tariffs act as a benchmark and the present tariffs were set using summer 2005 gas price estimates. These prices are significantly below real gas market prices (including the October 2005 gas contracts). Extending the current tariffs would be totally unacceptable as it ignores real input costs faced by independent generators.

Another respondent remarked that this option is completely at variance with established contracting practice in the market (12 month contracts) and clearly favours vertically integrated players. It may be difficult for a non-vertically integrated player hedge/issue supply offers to customers under this scenario. The same respondent also suggested that this approach may lead to significant price distortion in the market and also lead to the possibility of over/under recoveries.

One respondent commented that it is unacceptable that for 2006 tariffs to be extended into 2007. This is contrary to the agreed tariff setting methodology prior to SEM. It is also cannot be expected that ESB will remain at the same
level in 2007 as 2006 thus possibly exposing ESB to the risk of significant under recovery. The respondent goes on to say that costs for 2007 will be different to those in 2006 and, to recover these, the tariffs should reflect the expected costs. The respondent also suggested that tariff setting for SEM will need to be based on robust forecasts of contract and pool prices. A timetable setting out the form of the contract market or the type of regulation that will underpin it has not been established at this point.

Large energy users that responded to the paper support Option C as it is, in their view, the most likely to deliver certainty to users for 18 months and allow appropriate time to evaluate pricing the variables that will comprise PES tariffs following SEM implementation. Similarly, another large customer supports this option as it is the most likely to provide price stability against a background of severe and damaging price rises.

A final respondent noted that any delay in reflecting real-world energy cost movements into retail tariffs may result in greater tariff disturbance when the any discrepancy is eventually addressed. This problem may be exacerbated by any delay in implementing SEM and would distort competition. There is also a risk that customers would blame the SEM for any adverse tariff disturbance that may occur around the time of go-live.

2.4 Option D - Two Tariffs in 2007 – one using existing methodology until July 2007 and an SEM-based tariff for the rest of 2007

Under this option the Commission would approve, in October 2006, PES tariff proposals to apply from January 1 to June 30 2007. These tariffs would then be replaced by an SEM based tariff from July 1 to December 2007.

2.4.1 Respondents’ Comments

One respondent suggested that a methodology to apportion partial year costs is required to ensure a fair split of costs between the old and new markets. The non-fuel costs should probably be recovered in proportion to the capacity component of the PG-PES price. This may extend the timetable and risk that the 2007 tariff will not be ready for September/October 2006.

A respondent suggested that SEM contracts and an agreed model of the non-contracted income need to be in place by the end of 2006. A robust time line for these processes has yet to be established. The budget and planning process will be disrupted for 2007 as the complete 2007 revenue stream and tariff will not be finalised until after the end of 2006.
3 Alternative Proposals

There was no unanimous support, from respondents, for any of the four Options presented. Three respondents suggested another, each broadly similar, approach to tariff setting. This is summarised and evaluation below.

3.1 Proposal - SEM based tariffs in 2008

The existing PES tariff setting process is allowed to operate for the full calendar year 2007. PES tariffs for 2008 can then be based on SEM costs and contract positions. The SEM can operate, for a trial period, to the end of 2007. This period is used as a time for the pool to get established and for industry participants to become familiar with its operation.

The respondents suggest that this approach has a number of advantages:

- More informed decisions can be taken when contracting and setting customer prices for 2008. This has the advantage that all systems can be thoroughly checked and implemented prior to setting the next tariff in January 2008.

- Customers and market participants face less uncertainty. This should be a key objective for this transition period. A correction factor can be used to adjust for inevitable forecasting errors similar to that used to correct PSO forecasting errors. A forecast pool price for the full calendar year 2008 could be used as the basis for setting the PSO benchmark for 2008. It would require the extension of the Bulk Power Arrangement for a brief period.

- Market participants will face certainty for the entire year and will be able to offer tariffs from a single set of costs rather than from costs over two periods or based on two regimes which may behave very differently.

- Customers will not be subject to any impact from incorrect forecasts of the new market prices.

- There is no legal impact as the PSO will run for the entire year therefore there is no requirement for legislative changes.

3.2 Review against Criteria

The Commission has reviewed this proposal using the criteria included in the consultation paper.

Impacts on generators / suppliers / customers
• **ESB PG and ESB PES:** No requirement to apportion ESB PG or PES costs between the two halves of 2007 or to estimate pool prices and capacity payments before September 2006. This approach provides more time to finalise the details of the hedging contracts. PES is assumed to meet its economic purchase obligation. Regulatory treatment of ESB PG and PES revenues remains to be determined.

• **Independents:** Provides certainty to independents as tariffs are set on the basis of a known and understood approach. Independent generators and suppliers forego any benefit pertaining to the SEM for an additional six months.

• **Customers:** Provides certainty as customers have the opportunity of facing one set of prices for the 12 month period. PES tariffs are determined on the basis of a known timetable.

**Legal issue**

• There is a possibility that this approach could be at odds with the present PSO Notification. However, a reading of the Notification in conjunction with the 1999 Act and SI No. 217 of 2002 could be interpreted as facilitating the use of the BNE as a market price for the entire year.

**Other implications**

• **SEM:** Impacts on the delivery of the SEM project as it undermines the imperative to meet the July 2007 start date. This slippage may impact on opportunities provided to generators and suppliers in the market.
3.3 Commission’s Proposal

The Commission has considered each proposal in the context of comments received and the needs of the market. It is clear that no one option receives the level of endorsement from the market that the Commission requires in order to proceed in developing the option further.

While the Option set out above may have advantages in its simplicity, it has already been decided and agreed with the market that SEM go-live will be July 1 2007. Each option set out in the previous consultation paper has advantages and disadvantages and impacts differently on each sector of the Market. In this context, and in the absence of a suitable alternative; the realities of the tariff timetable and the availability of required information; and the need for tariffs to be reflective of underlying market conditions; the Commission has revisited each of the four Options set out in the consultation paper and has decided that Option D provides the basis for the most suitable approach to the matter.

The Option has been amended to take into account further consideration on the part of the Commission and comments received during the consultation process. This revised approach is set out below and is the Commissions preferred option.

3.4 Option E – Two Tariffs in 2007 - one using existing methodology until July 2007 and an SEM-based tariff for the rest of 2007

Under this option the Commission would approve, in October 2006, PES tariff proposals to apply from January 1 to June 30 2007. The Commission is also minded to introduce a fuel variation clause to apply to PES tariffs over this period. These tariffs would then be replaced by an SEM based tariff from July 1 to December 2007. The Commission is also considering the possibility of extending the second tariff period, if necessary, in order to facilitate alignment of the retail tariff years in Ireland and Northern Ireland.

Under this option, the PSO Order will have to be amended to provide for two PSO periods for 2007. Consultation on these issues will commence shortly.

The key points of this approach are as follows:

g. Two PES tariffs will be set for 2007, one for the period January to June and a second for the period from July to December.

h. Tariffs for the first period of 2007 will be determined on the basis of the latest cost information available in summer 2006 in accordance with the standard timescales. In the first instance the same approach will be taken to calculating costs as adopted in 2005.
i. Tariffs in the first period may, where appropriate, include a fuel variation clause. The methodology for such a clause will be consulted on during the tariff setting process.

j. Tariffs for the second period of 2007 will be calculated on the basis of PES third party contracts, residual purchases from the pool and other market related payments, Tariffs for this period will be determined over quarters 3 and 4 of 2006 and published in quarter 1 of 2007.

k. The methodology for calculating the PSO for 2007 will be the subject of a separate consultation paper to be published shortly.

l. Notwithstanding (a) above, the Commission may consider extending the second tariff period beyond 31st December 2007, if necessary, in order to facilitate alignment of the retail tariff years in Ireland and Northern Ireland.

**Impacts on generators / suppliers / customers**

- **ESB PG and ESB PES:** It may be difficult to apportion ESB PG and PES costs between two halves of a year especially given that fuel and O/M costs tend to accrue in certain months. Currently these costs are recovered on an equal basis throughout the year.

- **Independents:** Some independent sector customer contracts end in October 2006, presumably for renewal for a 12 month period. On this basis fuel and carbon hedging takes place by generators for those 12 months. It is not clear what independent suppliers and their customers would do in these circumstances.

- **Customers:** Customers would see tariff changes in July 2007 and then probably again in January 2008. It is understood that customers generally would prefer a single tariff in a year for budgetary purposes. Some customers may not be comfortable with the concept of a fuel variation clause. However, the introduction of a fuel variation clause may reduce the impact of any mid year changes to the underlying tariff.

- **SEM:** May not be robust to the SEM start date of July 2007 slipping

**Legal issue**

- SI No. 217 of 2002 does not envisage two separate PSO periods within a calendar year. Amendments to SI 217 would therefore be required.

**Other implications**

- The introduction of a fuel variation clause may require changes to the billing systems of both PES and independent suppliers and the nature
and methodology of the mechanism will need to be communicated to the market as soon as practicable.
3.5 Other Issues

In addition to inviting comment on the issues set out in the consultation paper the Commission invited comments on any other issues the market deems to be of relevance to this process. The following is a summary of comments and Commission responses (in italics) to the issues raised.

3.5.1 Respondents’ Comments

One respondent raised concerns regarding the availability of modelling data. In order to give confidence to the 2007 ESB PES tariff setting process, the CER’s SEM modelling must be both robust and transparent in terms of the chosen model and data assumptions.

The SEM market model will be presented to the industry at a forum at NIAER offices in Belfast. At this forum, which will take place on 27th February next, the results from the modelling project will be presented and discussed. Any issues relating to the modelling programme can be made in this forum.

Another respondent noted that similar issues arise in setting NIE PES tariffs for 2007/08. As progress is made in defining the transitional arrangements for NIE PES tariffs there may be merit in examining whether a common approach to the transitional arrangements is appropriate, or whether the approach needs to be tailored for each jurisdiction.

NIEAR is currently considering these issues in the context of setting tariffs in the Northern Ireland market. In addition the Commission and NIAER /OFREG, are examining the possibly of aligning PES tariffs post SEM implementation.

The same respondent also suggests that consideration be given to the removal of the requirement for PES tariffs for larger customers. However, another respondent believes that, for as long as ESB is both vertically and horizontally dominant in the market, it is necessary for the full range of tariff prices to be published.

The Commission has commenced its review of PES tariff requirements post SEM implementation. An important consideration in this process is whether PES will be obliged to offer tariffs to larger users. A determination on this matter will be made before the end of the current year.

Another respondent notes that many of the difficulties which the Commission foresees in tariff setting in the transition period stem from the possibility of removing correction factors and to use the pool price as a marker for PSO, and from its assumption that such pool price costs are un-hedged. These choices act as constraints on the options available to the Commission. All three constraints are avoidable; the respondent proposed that:
• Correction through the K factors should continue. As a low margin business this is essential to the viability of the PES.

• The requirement as we understand it is, inter alia, to use an annual price as the basis for setting the benchmark for PSO can be met by the BNE. To use the pool price for part of a year would distort this calculation as it would not be reflective of a pool price for a full calendar year as required.

• Hedging of all ESB PES purchases can be done early either through their availability by August '06 at the latest (through a forwards market) or by rolling forward the BPA to the start of SEM. This will allow costs to be set for 2007 as it is essential that costs be reasonably straightforward to forecast so that annual PES tariffs and PSO Levy can be set for 2007.

No decision has been made on the nature of ESB PG and PES revenue (and the use of correction factors) post-SEM implementation. A decision on the matter will be made as part of both the Market Power Mitigation work stream and the post and pre SEM tariff determination process. The respondent will be offered the opportunity to comment further on these matters as part of each of the aforementioned processes.

The decision on the benchmark price for the PSO will be considered as part of a separate consultation which will commence shortly.

The hedging of PES purchases is under consideration as part of the Market Power Mitigation process. A number of proposals are currently under consultation are contained in the Market Power Mitigation in the SEM paper.

A further respondent commented that global aggregation, if introduced, will provide a clear and economically rational incentive to move towards marginal pricing of tariffs on the basis of the standard settlement profiles of Non Quarter Hour (NQH) metered customers. The Consultation paper gives no indication as to whether the Commission’s previous commitment to a marginal-cost tariff basis (for wires and energy prices) will be implemented as part of the transition to SEM and the respondent welcomes clarification on this issue.

Global Aggregation is currently under consideration as part of a separate SEM work stream, Meter Data Reading, Aggregation, Communication and Storage or SIMDRACS. It is proposed that PES aggregation will take place in the Irish market at the time of SEM implementation.

It must be noted that while the Commission consulted on alternative tariff structures in July 2004 no commitment was given to the introduction of such tariffs. The matter is still under consideration and discussions regarding the proposals are ongoing.

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A final respondent asked the Commission to note that any assumption that a robust forecast of transmission cost elements will be available to it by May/June 2006, or necessarily in time for a the production of a single tariff for 2007, may be inaccurate. However, the respondent recognises this in no way precludes the Commission from setting a PES tariff for 2007 in 2006 – either for the whole calendar year, or in two parts - simply that given the inability to predict these costs with any suitable degree of accuracy consistent with the setting of that tariff would result in some level of discrepancy, and therefore market distortion, in the costs faced by independent suppliers, and by PES.

The Commission has noted the respondent’s comments and will be working closely with the system operators to ensure that any transmission related cost estimates that form part of any PES tariffs will reflect the most accurate available set of costs at that point in time.