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Re: CER consultation paper (CER/06/026)

ESB Customer Supply (ESBCS) welcomes the opportunity to comment on how any additional costs it incurs, in relation to committed PSO contracts, should be calculated and levied to the market in 2007.

Looking forward ESBCS will make payments under these PSO contracts of the order of €0.5 billion per annum. Therefore the appropriate calculation of the PSO costs of these contracts is critically important to Customer Supply and its 1.8 million customers.

Given this and the fact that the current consultation will form the basis of the Commission's decision on how PSO costs are to be determined under the SEM sufficient time should be allowed to enable full consideration of all relevant issues affecting the way the PSO amount is to be calculated and to allow for debate. ESBCS do not believe that time allowed for this consultation is appropriate for an item of such significance for not only ESBCS but the entire market. Additional time should be allowed to consider this issue particularly as greater clarity on SEM market design and tariff setting issues is required. It is also essential that the issue of how PSO's are dealt with in Northern Ireland under the SEM is considered in parallel. We therefore believe that the basis of how the PSO costs are to be derived should be subject to a further consultation once the market design and related issues are finalised.

We have nonetheless provided here, initial comments.

ESB CS looks forward to engaging with the CER on this important matter as soon as possible to ensure that a robust and enduring methodology can be developed.

Yours sincerely

Tim Keane
Manager ET&R

ESB CUSTOMER SUPPLY RESPONSE TO

CER CONSULATATION PAPER CER/06/026

Executive Summary

ESBCS understands that the results from this consultation will become the basis for how the PSO charges will be calculated under the SEM. ESBCS is projected to make payments of the order of €500m per annum under the PSO contracts it has. The PSO costs under these contracts will be seen by all electricity customers in the market.

ESBCS believe that greater clarity on SEM market design and tariff setting issues is required before an enduring decision is made on PSO charges. In addition the issue of how PSO charges are determined under SEM in Northern Ireland should also be consulted on in the parallel.

Determining a benchmark at this time for the second half of 2007 will be complicated as it will reflect a forecast of a complex matrix of market participants' behaviour, products and prices. We propose that the BNE be used for full 2007 calendar year because:

- o PSO period is defined as calendar year; the reference in the Notification to using a market based price when available can reasonably be construed to apply to a PSO period i.e. a full calendar year starting in 2008;
- o No legislative change (to allow a splitting of the PSO period into two portions with different benchmarks) would be required;
- o Modelled SEM prices including capacity payments may not be available within the required timeframe for H2 2007;
- o It will be difficult to predict pool prices in the early months of the pool as participants are only building up experience of operating in the new market.
- o The capacity mechanism payments may not be clear.

It is not prudent to set an enduring benchmark for a market-based price for PSO at this time because further work is required. There is considerable uncertainty over the appropriate benchmark to be applied to different contracts.

- o Original Notification referred to a Time Weighted Average (TWA) market price which did not specify whether this was pool or contract. This decision reflected the mix of the PSO based contracts at the time ie predominantly peat and relatively little wind generation.
- o CAP05 notification referred to an Output Weighted Average (OWA) pool price as benchmark
- o The separate capacity payment mechanism was not in place under MAE and hence was not envisaged when the CAP05 submission was made. The implications of this fact need to be taken into account.
- o The implications of the increasing proportion of wind based AER contracts must also be factored into decisions.

The principle should be that the benchmark reflects the relevant market price in relation to the type of output e.g.:

- o Thermal plant could be referenced to a baseload contract price in a forwards market
- o Wind plant could be referenced to the OWA pool price and also take into account the additional cost of hedges to cover the unpredictability of wind generation output

For 2007 we believe option 3 (a single levy based on BNE is the appropriate option.

A fuel variation clause should not be included in the PSO levy because:

- It would be inconsistent with setting the levy for a calendar year as currently specified in the Notification
- The significant volume of PSO contracts would no longer provide a hedge (within year) and hence there would be insufficient hedges available in the market for suppliers to hedge pool price exposure
- It would be very complex to administer and bill and would lead to customer confusion and queries and impact on cash flow.

ESBCS believes that for 2007 the appropriate option is to set the PSO off a single BNE. Further analysis is needed to enable an enduring solution to be developed and approved for subsequent years.

Introduction

The focus of this response is on the approach to be taken in setting PSO in 2007. More analysis and discussion is required to address the issues to be resolved in order to determine the basis to be used post SEM.

In Section 1 of this paper ESB CS will outline the concerns that it has with the current definition of the 'market price' defined in the legislation as the 'time weighted average of the electricity market price as *sold* by electricity producers' (decisions N826/01) and defined by the CER, in section 3 of the consultation paper, to be the single price originating from the Pool. Principles that need to be satisfied when determining alternative methods for defining a market price are also presented as well as the basis for some possible approaches.

In Section 2 the relationship between tariff setting and the PSO is outlined and proposals are outlined with reference to our proposal solution for tariff setting over the transition period.

In the conclusion our preferred method for the treatment of the PSO for 2007 is stated.

Background

Currently, the benchmark price for PSO is an annually adjusted BNE determined by the Commission and reflecting the most efficient and up-to-date technology that is available, which is a baseload plant of a new entrant. BNE is based on the time weighted average price. ESBCS has expressed its dissatisfaction with this approach in the past as the output from non-dispatchable AER facilities is not as valuable as that from conventional dispatchable thermal generation but this approach does not reflect this.

This overvaluation of the output from wind farm facilities in the PSO has apparently been recognised by DCMNR when designing the new REFIT scheme which is available to other suppliers and where the benchmark is set at a considerably lower level. Under the AER scheme the net cost to ESBCS of all its AER energy purchases is the BNE price (currently at €66.1/MWh). However under the newly commissioned REFIT scheme the net cost to all independent suppliers of all their REFIT energy purchases is a fixed price of €48.45/MWh.

Clearly it is important to reflect the value of the energy procured to retain two separate benchmark prices ie one for dispatchable facilities and another for non-dispatchable facilities. The CER recognised this additional cost associated with non-dispatchable facilities in their paper CER/03/253 on renewables published when MAE was being considered. These considerations are still valid under SEM.

In ESB CS's view further detailed analysis must be undertaken especially given the complexity of the new market ahead and the myriad of prices that will be available and the need to design an enduring solution given that legislative changes will probably be required. Before any 'suitable market price under the SEM' can be determined, or indeed a suitable methodology to calculate it can be established, ESB

CS believes that there is a need for greater clarity on many of the issues which will impact on the market price including:

- The duration of this methodology.
- The treatment of other markets and their prices under the SEM that are still in the consultation phase with the CER. These include the treatment of capacity payments and the requirement for a forwards market.
- How Directed Contracts will impact on market prices.
- How market data will be reported and used.
- The impact on tariff approval.

Section 1: The new markets and related market prices

The CER has published a draft proposal for the treatment of ESB CS tariffs, namely to have two tariffs in 2007. In line with this approach the CER has proposed to have two PSO levies in 2007. Our comments here focus on the difficulties in determining the correct market prices and the alternatives approaches which could be used to calculate the benchmark price.

The current legislation states that the levy should be calculated as the difference between the contracted prices and *"…the price at which ESB could have sold this electricity on the market as estimated yearly by the CER on the basis of a time weighted average of the electricity market price as sold by electricity producers in a fully liberalised Irish market"* (European Commission's State Aid decision) or "…*is the excess of the ESB's actual costs …over the revenue that could be earned by selling the electricity produced at a market price*." (PSO Notification paragraph 5.10). This moves away from the current principle of ESB CS buying the cheapest replacement energy for this PSO related contract.

ESB believes that as well as determining the benchmark price to be used which is, to some degree, defined in the above statement in that it should be time weighted, it is also necessary to review this and amend the requirement to ensure that ESB CS is able to ***procure*** replacement energy at the best available price.

Further work and discussions with the DCMNR will be needed before changes to the calculation of the PSO can be implemented.

Section 1.1: What is the market price?

In the new market proposed by the CER there will be a Pool Market with a related Capacity Payment. In addition the CER envisage that the Pool price will be hedged through a forwards market.

Under these circumstances all PSO contracted generation could be sold or bought by ESBCS in two markets:

1. Forward market - secure a price through a forward hedge contract (CfD) that allows more certainty when setting tariffs and manages exposure to pool price volatility
2. Pool market – be fully exposed to fluctuating pool prices or use it to calculate the difference payment to be made under CfD's entered in to in the forward market,

In addition, value could be earned through a capacity payment based on either capacity or MWh generated depending on the level of intermittency of generation.

As well as the possibility of different markets where electricity could be sold or bought and where different values could be obtained, prices will also be based on the different products that will be available. These products would include baseload, mid-merit, peaking products and intermittent generation, each of which would have a related price which could be different for each supplier in the market depending on the form of the forward market.

As can be appreciated a complex matrix of market participants, products and prices will interact in the market.

Section 1.2: Prices from a Forward Markets

In most Pool style markets, participants will hedge against any exposure to volatile prices that they may face. A supplier will do this to secure a steady price for energy that will satisfy the supplier's projected demand requirement and it is this price that is mainly reflected in tariffs charged to end users who would be expected to prefer stable prices.

Most forwards markets offer several types of products that can be bought to match the demand profile. Each of these products will have a price.

The price at which each supplier can buy these different products can depend on:

- the form of the forward market and whether it has a clearing price or it is pay as bid
- whether the products are standard products or bespoke
- whether the products are long-term or of different duration
- the frequency at which products can be procured on (for example) a power exchange, which can allow greater refinement of a supplier's requirements closer to the demand period where it will be realised.

Each of these product and market characteristics will mean that the prices at which CS may buy equivalent volume of PSO contracts can vary significantly.

Participants in the forwards market will only buy that volume which satisfies its risk strategy. In some cases the participants could be fully hedged, over hedged or under hedged. Where a participant is not fully hedged, there will be a percentage of energy that is exposed to the pool.

Section 1.3: Prices from a Pool Market

The Pool allows suppliers to purchase their un-hedged volumes at the prevailing market price.

The CER is correct in that there will be only one price per period arising in the Pool, however, to use a 'time-weighted average' would not give the most accurate reflection of the value that generators would see in any given half hour.

In ESB CS' view an 'output-weighted average' gives a more accurate reflection of the value of a product in any half hour in the market. The principle should be that the benchmark reflects the relevant market price in relation to the type of output e.g.:

- Thermal plant could be referenced to a baseload contract price in a forwards market
- Wind plant could be referenced to the OWA pool price and also take into account the additional cost of hedges to cover the unpredictability of wind generation output

Section 1.4: Capacity Payments

Given the current design outline for capacity payments, the CER are consulting on how these payments will be made to generators and paid for by suppliers.

This is an additional cost that would need to be included in the price that a supply business would buy its energy.

Section 1.5: What constitutes a market price?

As outlined above we have described the complexity of defining a single market price for the purposes of establishing the PSO benchmark.

We propose that further consultation be undertaken to determine the best price that should be used to calculate the price that ESB CS's customers will pay for the PSO contracted energy in their tariffs and through the levy. It is currently estimated that this will be in excess of €500m with the PSO levy rising from the current €44m.

Section 1.5.1: Principles for calculating a benchmark price

As previously outlined, defining a market price is very complicated and the price used as a benchmark should reflect certain principles:

1. The price must be that seen by the majority of suppliers for their energy purchases.

Using the price that the majority of suppliers pay for their energy will ensure that there is no bias in the forecast given due to it being calculated by a single body or party.

2. It should reflect the best price that suppliers can buy energy and not the price that generators can get from selling that energy.

This principle will ensure that all customers see the best price that they could have purchased this energy and will keep the cost of these contracts, which were introduced by Government for a number of reasons as outlined above, to a minimum when charged as the PSO Levy.

3. Any forecast price calculation should be as transparent as possible and allow accurate measurement

This principle will ensure that all parties in a market can forecast their costs. The method used for calculating the benchmark must be transparent to give certainty and retain consistency.

4. Any forecast price should be robust and keep any ‘R’ factor to a minimum.

As R factors are part of the levy charging agreement these should be kept to a minimum to ensure that customers do not see fluctuating PSO levies from year to year for this reason.

5. Any forecast price should reflect the value for a complete year and not just part of a year as the PSO period is defined as a calendar year in the Notification.

All prices used for calculating the levy would need to be for a complete year so as not to skew the charges on a seasonal basis. This is reflected in the legal requirement of the notification.

Section 1.5.2: Possible methods to calculate a benchmark price

To ensure that the size of the levy that will be imposed on the consumers of electricity is accurate and best reflects the difference between the cost and the best ‘value that could be achieved by selling that electricity into the market’, this will be translated in the new market as the most economic price that ESB CS can procure energy.

It is important that those market prices that best reflect the type of PSO contracted energy (intermittent or despatchable) are used when determining the PSO.

The benchmark price will reflect a weighted value of the following:

- Baseload/mid-merit/peaking/intermittent generators
- Percentage hedged/unhedged (forward & pool) and
- Capacity payment.

To determine which price should be used would require more in-depth analysis and greater consultation.

Section 1.6: Fuel Cost Variation

A fuel variation clause should not be included in the PSO levy because:

- It would be inconsistent with setting the levy for a calendar year as currently specified in the Notification
- The significant volume of PSO contracts would no longer provide a hedge (within year) and hence there would be insufficient hedges available in the market for suppliers to hedge pool price exposure
- It would be very complex to administer and would lead to customer confusion and queries and impact on cash flow.

Section 2: The relationship between tariffs and the PSO benchmark in 2007

In line with ESB CS's submission on the CER's proposed method for setting ESB CS's tariffs in 2007 and considering factors such as:

- Timeliness and workload implications given the SEM
- Information and Modelling affecting the ability to forecast a Pool price
- The customer's preference to seeing a single change to tariffs a year.

ESBCS believes that for 2007 the appropriate option is to set the PSO off a single BNE.

Section 2.1: Background to tariff setting

ESBCS in line with the CER's tariff approval applies the BNE price to the energy it procures from the PSO contracts and which we charge our customers through the tariffs, and the additional costs from holding these contracts are recovered via the approved PSO levy.

Any change made to the benchmark price used to calculate the PSO will also need to be adopted in the tariff setting exercise.

The two approaches (tariffs and PSO setting) have to be consistent as the data used to determine any tariff changes will need to be amended at the same time as the new PSO benchmark market price is established or changed. Therefore, either two tariffs and two PSO or one tariff and a single PSO adjustment are needed. It will not be internally consistent to have different approaches for the two calculations.

Section 2.2: Why a Pool price is not appropriate?

The majority of a supply company's energy requirement will be hedged in a forward contract to mitigate the risk that a volatile pool price will introduce.

As customers' prefer a stable prices within year, it is to be expected that suppliers will manage the exposure introduced by the volatile wholesale market prices on the customers' behalf.

As hedges are struck around a strike price based on each counterparties own view of projected pool prices, the forwards contracts that a supply company would enter into should at or be lower than their own pool price projection.

However, it is likely as the market matures that the pool and forwards market prices will converge and a steady state within which contracts can be struck will develop.

Conclusion: ESB's proposal for setting 2007 PSO

In keeping with ESB CS' preferred position on a single tariff being set for 2007 as the new market beds in, the best means that would deal with timeliness, resource management and economic efficiency would be to set the PSO off a single administered BNE price.

Further analysis is required to develop recommendations and a proposal for an enduring methodology to establish the benchmark price under SEM. It may also be necessary to use this time to seek approval from the DCMNR to get changes to the

Notification to reflect the most appropriate market price in the context of the PSO benchmark and its implications for tariffs.