ESB PES TARIFFS AND THE TRANSITION TO THE SEM

Report on the Consultation and Decision Paper
CER/06/042

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1 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 alternative approaches required two separate tariff decisions for 2007 (one for the period January to June and then a second to apply for 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 each of these options and interested parties were invited to suggest another approach.

Following the consultation on 3rd March the Commission published its final proposals and again interested parties were invited to comment. That document set out the Commission’s preferred approach as well as summaries of comments received in response to the initial paper.

Subsequently, on 24th March the Commission hosted an industry forum to which all parties that responded to the paper were invited.

While it is clear that there is not universal support from the industry for the Commission’s proposal it is also our view that there is no practical alternative available. It is on this basis that the Commission intends to proceed 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. This mechanism will be subject to a separate consultation.

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 quarter 4 of 2006 and quarter 1 of 2007.

e. The second tariff period will not extend beyond the end December 2007.
f. The methodology for calculating the PSO for 2007 is the subject of a separate consultation paper.

g. The Commission will continue to regulate PES tariffs for all customers during 2007.
2 Background

2.1 Consultation Background

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 original consultation document sets out the detailed background to this topic. In summary, 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.

Following this on 3rd March the Commission published its final proposals and again interested parties were invited to comment. This document set out the Commission’s preferred approach as well as summaries of comments received in response to the previous paper as well as an alternative approach set out in that paper. In addition on 24th March the Commission hosted an industry forum to which all parties that responded to the paper were invited.

While the final proposal set out above hasn’t received the full support of the industry the Commission believes it is the only practical option given the current set of circumstances. It already been decided and agreed with the market that SEM go-live will be July 2007 and work programmes to that end are now available.

Having taken into consideration the above facts and 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 again reviewed each of the four Options set out in the initial consultation paper, as well as alternative approaches put forward by market participants, and has decided that the proposal set out above provides the basis for the most suitable approach to the matter. The Commission believes that this approach once implemented presents the market with the most accurate set of tariffs for the relevant period of time and minimises the risk to both market participants and customers for the period of transition to the new market.

The Commission also recognises that insufficient detail on the introduction of a fuel price variation clause has been made available to date and has decided that this arrangement will be subject to a separate consultation at the conclusion of which a final decision regarding its introduction can be made.
Regarding the alignment of tariff years, the Commission believes that it is not necessary to adjust the tariff year any more than is already proposed to do so during 2007. Further changes have the potential to undermine customer perception in the market and may also introduce some degree of regulatory uncertainty regarding the tariff process.

The matter of removing PES tariffs for larger customers while not explicitly dealt with in the decision was also considered during the consultation process and also discussed at the public meeting. While opinions on the proposal are divided it was agreed that the removal of tariff regulation for large customers may be worthwhile in the long run but that any implementation of such change should take place after the period of transition to the SEM.

### 2.2 Consultation Process

Respondents were invited to comment on the proposals set out in the document published on 3rd March.

A total of 11 responses were received from the following:

- Airtricity
- Bord Gáis Energy Supply
- ESB Independent Energy
- ESB Customer Supply
- ESB Power Generation
- IBEC Large Energy Users Working Group
- Synergen
- Viridian Power & Energy
- Energy Options (on behalf of a client)

These comments are published separately.

Section 1 of this paper sets out the background to this consultation, while Section 2 summarises the substantive comments received under a number of headings as well as the Commissions response where necessary.
3 Two Tariffs for 2006

In its paper the Commission proposed that two tariffs be set for 2007, one for the period January to June and a second for the period from July to December.

3.1 Respondents Comments

One respondent noted that two tariff periods in 2007 will lead to suppliers having two sales periods for 2007 and with it inherent overheads. Consumers could interpret this as a price change due to the introduction of SEM. This position is reflected in comments from another party that suggests a discontinuity in tariffs over the year could undermine market confidence in the sector.

A second respondent notes that some of the information required by the Commission for the second tariff may not be available as early as suggested by the paper. Robust modelling and credible price forecasts will take time and may not be available when required.

The same respondent also believes that tariffs should reflect underlying costs and that any misalignment between an annual tariff and seasonal cost may lead to undesirable consequences.

A number of respondents make the point that customers generally prefer an annual tariff and therefore suppliers choose to make such tariffs available. This position was supported by another party who notes that to operate effectively and efficiently a business must be able to budget appropriately for costs over a twelve month period. This may not be possible under the current proposal.

Another party is concerned with our proposal to link tariffs for the second tariff period to PES’ third party contracts, residual purchases from the pool and other market charges. They argue that customer prices must be based on an expectation of pool prices rather than mechanism inferred above. The same respondent also sought clarity on the timetable for the determination of tariffs for the second half of the year.

The same party also expressed concern that the BNE will be used for the setting of prices for contracts that PES will hold. If BNE must be used it should reflect the prevailing gas forward price at the time of its determination.

A supplier commented that it is possible to introduce tariffs in two stages in 2007 with some level of price continuity by adopting a strategy that maximises the use of tariff components not affected by SEM on an annualised basis. This should in the respondent’s view minimise the risk of a step change occurring at the introduction of SEM.

A respondent noted that the modelling work currently underway as part of the SEM project is not based on market costs and that significant work is needed to
allow contracts to be struck in summer of 2006 to allow a PES tariff to be constructed as set out in the Commission paper.

A different respondent noted that we measured each proposal in the original document against robustness to slippage in the SEM work programme. In their view the Commission proposal may not score well and may need to be amended to cope with slippage.

The same respondent, while not favouring the Commission proposal, suggested the following amendments to the mechanism; date to be set in 2007 at which a decision can be made to extend the H1 tariff; replace the fuel price variation clause with a k-factor; and no extension of the tariff into 2008.

Another respondent suggested that the Commission fully consider changes to transmission costs when determining tariffs for H2 of 2007. Likewise calculation of generation costs must use the most accurate available information on directed contract design, pricing and pool price modelling validated by market trialling data. Care must be taken not to make decisions too early.

In relation to modelling of SEM outcomes one respondent commented that such modelling must be robust and transparent in terms of chosen model and data assumptions. Clarity on how this is to be done is required by the respondent.

A supplier suggests that the CER proposal presents undue risk during the transition period from the existing market to SEM. The respondent has concerns regarding how its costs will be recovered under the Commission proposal and notes the importance of K factors adjustments. The respondent requires clarity on the CER position regarding K factors.

The same respondent requires further details on the availability of hedges for the second period. If hedges are not in place the supplier faces increased risk of pool prices not being reflected in the tariff post SEM. This risk may be significant and unsustainable.

A number of respondents have asked for clarity on the timetable for the determination of tariffs for H2 of 2007.

### 3.1.1 Commission’s Position

The Commission recognises that the introduction of a second tariff midway through 2007 will present some inconvenience to the market and customers alike. However, this discomfort is likely to be less than that if other suggested options were adopted. While the proposal is like to have an impact on tariff levels mid year the Commission believes that an early decision on the matter will give customers and suppliers time to consider how this change can be managed.

The Commission also recognises the need to make the necessary information available to allow suppliers operate under the proposed arrangements as early
as possible. In this regard the Commission is currently finalising timetables for the key SEM work streams relevant to this processes and this information will be made available shortly. Matters regarding modelling are being discussed at other fora. Relevant timetables and relevant dates should also be available shortly.

Regarding points relating to the regulation of ESB, PES revenues and K factors are still under consideration and discussions with the business will continue.

3.2 Fuel Price Variation Clause

In its paper the Commission proposed that a fuel price variation clause be introduced in the first half of 2007.

3.2.1 Respondents Comments

One respondent welcomed the introduction of a fuel price variation clause provided it was carefully implemented. This implementation must, in their view, include three aspects: it must be based on market fuel prices; it must be transparent and understood by customers; and must be hedgible.

This view is reflected in the comments of another respondent in that the fuel price variation clause must be formulae based and hedgible.

Another party noted that the introduction of a fuel price variation clause may impose a significant workload and resource requirement on the businesses’ billing and IT functions. Such changes have not been built into the work programme and any further changes may impact on their ability to deliver and implement previously agreed changes.

It was also suggested by another respondent that the introduction of a fuel price variation clause may cause issues with billing electricity consumption estimates and should therefore be avoided.

A generator commented that agreeing on the design of a fuel price variation clause is a considerable task noting that selling it to the market and customers will pose a significant challenge. In addition it may divert resources from other aspects of SEM implementation.

Other parties, including customers, would prefer to see further detail in the mechanism before commenting further.

3.2.2 Commission’s Position

The Commission recognises that any decision regarding the introduction of a fuel price variation clause needs to be considered very carefully. Before commenting fully on the appropriateness of any such mechanism the market requires a great level of detail. Therefore, before making any decision on the matter the Commission will be consulting separately. Following the conclusion of this process a final decision can be made.
3.3 Tariff Year Alignment

In our previous paper the Commission suggested that it may consider extending the second 2007 tariff period beyond 31st December, if necessary, in order to facilitate alignment of the retail tariff years in Ireland and Northern Ireland.

3.3.1 Respondents Comments

One respondent noted that extending the tariff period to April 2008 is difficult to appraise at this point in time and that consideration should also be given to the introduction of a further transitional tariff period from January to April 2008.

Another party suggested that the Commission’s proposal was unacceptable in as costs for 2008 will differ from those of 2007 and tariffs should reflect these costs. Any suggestion to do otherwise exposes generators to a significant risk of under recovery.

One party responded that there is no need to extend the tariff period beyond December 2007. Any change may be considered following the implementation of SEM but also that it may be more appropriate if tariffs in Northern Ireland aligned with the tariff year in this jurisdiction.

3.3.2 Commission’s Position

The Commission accepts that any decision to align retail tariffs in both markets may be premature and should not be considered further until the new market arrangements are in place. Any proposal regarding such alignment will have to be explored on an all island basis.
3.4 **Summary and Next Steps**

The Commission has decided that the proposals as set out in section 1 of this document will be implemented, firstly tariffs for H1 2007 will be developed in line with existing processes and timetables and secondly tariffs for H2 will be developed in line with a timetable consistent with other SEM related schedules and made available to the market as soon as practical.

A consultation paper on the matter of fuel price variation clause will be published over coming months before a final decision on implementation will be made. Finally, all island tariff year alignment and the necessity of PES tariffs for larger customers will be revisited following the implementation of SEM.