VP&E Comments on ESB PES Tariffs and the Transition to SEM

Introduction

For some time we have been concerned that the potential for market distortion, or failure, could result from a mismatch between the wholesale prices which will result from generators bids and a retail price constrained by tariffs. The consultation document raises fundamental questions about how consistent pricing will be established in the SEM, and in that sense prejudices some of the debates that have yet to be had on the mitigation of market power in the new market. We understand that the CER have a tight timeframe with which to determine the tariffs for 2007 but urge that a realistic approach against input costs is used to form 2007 tariffs, anything else risks the integrity of the new market.

This response first sets out what we consider are key principles that should govern decisions on the forthcoming tariffs and then uses these to make our recommendations on the most suitable approach.

Principles

Key principles are:

A. Notwithstanding the significant market power issues that exist in the market, the prices that are manifest in the wholesale and retail markets should approximate what would be expected if there were full competition in the market.

B. The prices in the pool market, including the capacity payment, should align with tariffs.

C. Tariffs are not needed in a fully competitive market. ESB PES has minimal market share in the LEU market in the RoI, and a similar competitive dynamic is manifest in the NI market. There is thus no rationale for applying tariffs to this sector of the retail market. To apply a tariff to the LEU market is to potentially distort competition and potentially impose higher costs on customers than would have been offered by independent suppliers were no tariff existed.

D. In a competitive market prices are set on a marginal cost basis, not on an average cost basis. Marginal cost pricing, where it is not present due to the lack of a competitive dynamic because of market power issues, should be approximated by the regulatory authorities where possible.

E. In a competitive market the full opportunity cost of carbon is passed through in the wholesale and retail prices for electricity.

F. Changing tariffs mid-year is disruptive for both customers and suppliers and should in general be avoided, but could be necessary if the alternative is to forfeit competition.
Application of Principles to Setting of 2007 Tariffs

If the above principles are accepted as valid and appropriate, then applying them results in the following conclusions:

1. There should be no LEU tariff from the start of 2007.

2. The market based approach, option B in the CER paper, provides the closest approximation to a competitive market for customers, and is thus the preferred option. All the information exists to allow the CER to calculate this but it will result in a change in the CER decisions on calculation of ESB PG and PES revenues for the last six months prior to the start of the SEM on 1 July 2007. It will have the following impacts:

   o Provide clear market signals to the independent sector in the run-up to the start of the SEM
   o Will help the regulated sector become familiar with the drivers that will exist under the SEM
   o Give customers an early signal of the prices that will exist in a fully competitive market
   o Should be relatively unaffected by SEM slippage
   o Should not create nugatory work as it will be consistent with the SEM work programme, although the CER assertion that the imbalance market needs to be redesigned needs further consideration as the justification of this assumption has not been set out, and could impact the SEM work programme.
   o Should not create more legal issues than any other option, except if the regulated sector was to challenge the CER decision.

3. If the market based approach, option B, is not adopted then a fundamental problem arises. The average cost methodology used for calculating 2006 tariffs has created major difficulties for the independent sector and damaged retail competition as a result. The 2006 tariffs and associated PSO calculations created a set of tariffs that have not promoted competition. If such an arrangement was to continue into 2007 then independent suppliers will be forced to allow tranches of customers to return to ESB PES.

   If the average cost methodology is applied to half the year, option D in the consultation document, then improved supply competition could return to the market in the second half of the year, after the start of the SEM.

   If the average cost methodology is combined with marginal cost methodology over the full year, option A – the hybrid approach, then competition in supply may be damaged over the full year.
On this basis, if option B – the market based approach, is not going to be adopted by the CER for whatever reason, then our preference is for option D – two tariffs in 2007. While the concept of two tariffs is not one that we embrace from either a supplier administration or a customer interface perspective, the alternative of limiting competition for a full year is an option we strongly oppose.

**PSO calculations**

Whichever option above that the CER decides on, the CER should conduct a separate review of what constitutes a market price for the purposes of setting the PSO. As set out in previous correspondence VPE does not accept that the BNE calculation is an accurate reflection of market prices and urges this process of setting PSO recovery for ESB should be stopped at the earliest juncture. VPE contends that the PSO recovery should be set against prices determined on a marginal basis as would pertain in a fully competitive market.

**ESB PES Economic Purchasing Obligation**

VPE have set out in previous correspondence with the CER that the ESB PES current justifications that they are discharging EPO currently as disingenuous and do not promote competition. VPE would welcome early discussion on how this situation will be improved in advance of the SEM.