CER Consultation on ESB PES Tariffs and the Transition to SEM
CER/06/002
Response by Airtricity

Introduction
Airtricity welcomes this consultation on the basis of PES tariffs for 2007, as this will be an important transition from an administered environment to one where dynamic market forces have a far greater impact. The SEM is purely a change in wholesale market arrangements so it might be thought not to impact on retail prices however, as the Consultation makes clear, there is scope for cost/price dislocation rather than smooth transition to the new Pool as the Commission gives up part of its ability to smooth local and international price pressures over a number of years.

Experience of decimalisation and the more recent conversion to the Euro has shown that customers will generally blame the new arrangements, rather than any underlying cost drivers, for any perceived adverse effect they experience. It is therefore important that the process of change that starts on 1 January 2007 is well conceived and robust. Airtricity believes that an additional criteria should be included for assessment of the four options presented; that of compatibility with the ongoing future retail market interaction with the SEM.

Compatibility with the future market
In 2008 and in subsequent years, Suppliers will base their prices on their expectation of Pool price and will therefore have to forecast the shape and volume of their energy requirements and forecast Pool prices based on both operational experience and their expectations of future fuel price movements and capacity developments. Even with hedge contracts between Suppliers and Generators, the SEM will be a more dynamically priced market than is the case with the current arrangements.

For 2007 therefore, we believe there is an opportunity to begin application of the future processes that the market will require, with current administered arrangements in the first part of the year acting as a stabilising mechanism to smooth out the impact of any volatility in the early stages of SEM operation.

It has long been the Commission's policy for Global Aggregation to be introduced in time for new wholesale arrangements. With Global Aggregation and a single-priced wholesale Pool, PES will continue to be exposed to energy imbalances in each half hour. There will therefore be a clear and economically rational incentive to move towards marginal pricing of tariffs on the basis of the standard settlement profiles of NQH-metered customers. Current tariff structures are somewhat ambiguous in this respect; for example, not all day/night tariffs reflect the higher price of day energy when the day only and 24 hour variants are compared.

The Consultation 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 we would welcome clarification on this important issue.
Options assessment – common factors

**PSO**

It is clear from the Consultation that the legal issues of PSO basis and notification are common to all the options. Whichever of these is chosen therefore, a significant amount of work will be required to address the issues raised. This reinforces the point raised earlier, that the 2007 interim solution must be compatible with requirements for 2008 and subsequent years, to avoid the need to revisit the interim solution.

**k-factors**

Inherent uncertainties in the SEM will make it difficult to ensure that PES is always able to recover its allowed revenue, with the result that k-factor adjustments could result in even greater inter-year price distortions than have been seen until now. We are pleased to note the Commission's appreciation that these adjustments are difficult to apply without distorting the tariff market, however this will be an ongoing issue in the SEM. We have previously argued, in our 2005 submissions on ESB allowed revenues, that the Commission should move from revenue regulation to price regulation - initially for all tariffs, but moving towards fewer, key tariffs, as competition develops and PES loses its price-setting position in different market sectors.

**hedging contracts**

The value of hedging contracts in supporting and developing competition approach should not be underestimated. The Commission has identified this requirement and appears, given the recognition that ESB PGen and the PPB will dominate the shape market, to suggest that ESB PGen could make hedge contract available to the independent sector. We would support this approach if it were implemented in an equitable and cost-reflective manner. We believe this would also be good for ESB PGen, in that it could increase the utilisation of its existing plant, given that ESB PES has reduced its purchases by 40%.

Options assessment – individual comments

**A – hybrid 50:50 administered:forecast**

Of the four options presented, we believe that Option A has the most to commend it, from all perspectives, as it:

- reflects the underlying reality of the trading arrangements at any one time,
- allows an initial, administered regime to temper the impact of any volatility in the early implementation of SEM, and
- is compatible with the processes that will be required from 2008 onwards.

We believe that this is the most appropriate Option on which to base PES tariffs for 2007.

**B – full market-based approach**

This option has a number of advantages in common with Option A, in that 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 PGen or ESB PES.

Time and resources would be required to design an effective method of adjusting the existing topup/spill regime to enable it to map to the market-based approach and this work would have to be undertaken and consulted on, prior to designing and implementing changes to the supporting Settlement systems. All of this additional work would be required to support
approximately six months of market operation and, while this Option would be the least impacted by any slippage in the SEM timetable, we believe that the likely extent of nugatory effort required for its delivery within a highly constrained timescale outweighs any other benefits.

The other identified risks to initial and ongoing tariff disturbance, as a result of outturn diverging from expectations based on modelling, are additional factors that should rule out this Option.

**C – tariff extension**
Of the four options presented, this is the least attractive.

Apart from the workload issues associated with delivering two tariff reviews in a single year, any delay in reflecting real-world energy cost movements into retail tariffs can only result in greater tariff disturbance when the discrepancy is eventually addressed. This problem would be exacerbated by any delay in implementing SEM and, as the Consultation states, would be highly distortionary to competition; in the current world energy price environment, it would be a significant risk to base 2007 prices on a BNE evaluation carried out in the first part of 2005.

As with Option D, there is also a risk that customers would blame the SEM for any adverse tariff disturbance that occurred around the time of go-live.

**D – two tariffs for 2007**
We believe that this Option has been included for completeness, rather than as a serious proposal. This Option also carries the requirement for significant extra work to deliver two tariff reviews for 2007 and also carries the greatest risk of customer dissatisfaction as a result of the mid-year price change, that could lead to the SEM being blamed for any significant discontinuity between administered and market-based regimes – Customers would have seen a price change in January and would conclude that the July price change was the result of a problem with SEM.

**Other issues**
The Consultation sought views on whether or not ESB PES should be required to publish tariffs to apply to all customer categories. Airtricity 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. However, at some future time when the scope of its dominance is significantly decreased, it would be appropriate for this requirement to be relaxed as ESB PES market share falls to a minority level in certain market categories and it is unable to exercise market price-setting power. However we also believe that, as the Supplier of last resort, ESB PES should be required to publish key tariffs. It is also important that domestic and SME customers should always have published prices available, to ensure that they can always be aware of approved prices of which they can avail.

**Summary and conclusions**
Airtricity believes that the approach to setting ESB PES tariffs for 2007 should aim for the maximum compatibility with requirements for future years and, by being as market reflective as possible, avoid the imposition of undue risks on ESB PES and other Suppliers.

We believe that Options C and D carry the greatest risk of distorting competition and leading to adverse public perception of the SEM.

Options A and B are better in that they seek to reflect the future reality of SEM, but both carry the risk of SEM outturn diverging from forecast. As Option B potentially requires a considerable amount of
work required to map its assumptions operationally to existing arrangements for only some six months, we consider that this is unlikely to have a positive cost/benefit.

We therefore believe that, in spite of the risks and challenges it presents, Option A represents the most effective approach to transitioning from current arrangements to SEM, although this conclusion is based on the implied assurance that independent Suppliers will have reasonable access to appropriate hedging contracts from ESB PGen.