ESB PG Response to Consultation Paper CER/06/002 on ESB PES Tariffs and the Transition to the SEM.

ESB PG welcomes the opportunity to comment on the 2007 tariff setting process and the interaction with SEM. The principle underlying the current process is that PG is allowed recovery of approved costs and return. In evaluating any new arrangement ESB PG will need to ensure it can meet two key requirements:

1. Manage the commercial risks and earn a reasonable return.
2. Ensure that ESB is fully compliant with all legal and regulatory provisions.

ESB has evaluated the four options as per the criteria set out in the consultation paper. The results of that evaluation are provided below and an alternative is also proposed.

Option A: Hybrid Approach

Single Tariff
To deal with seasonality it would be difficult for a single tariff to be set at the beginning of the year as it would be formed off 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 sum of monies.

Reliable predictions of SEM costs and revenues
ESB PG needs to ensure that it can manage the commercial risks of the new SEM. The unknown nature of the key System Marginal Price algorithm will need to be addressed before any detailed analysis can begin. The forecasts and contracted positions will need to be at an advanced stage before they can form the basis of a tariff, otherwise the commercial risk is unacceptable. In the absence of a robust timetable to reach this point, it is our opinion that it is imprudent to make any financial commitments in advance.

The Independents would face the same difficulty as ESB PG under this option as robust and credible modelling of the pool price/capacity payments would be required by March 2006 and the time line to reach this point has not yet been established.

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

Single Tariff
To deal with seasonality it would be difficult for a single tariff to be set at the beginning of the year as it would be formed off 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 sum of monies.

Reliable predictions of SEM costs and revenues
As stated above reliable prices for the SEM are not available and in the absence of a robust timetable the prudent option is to avoid making financial commitments to supply a tariff based on unreliable costs. This option is fraught with unacceptable levels of financial risk for all market participants.
**Option C. Tariff Period Extension – extend 2006 tariff decision until SEM commences in July 2007**

Setting new tariff mid year as opposed to January '07.
It is unacceptable to ESB PG that the tariffs set for 2006 should extend into 2007. This is contrary to the agreed methodology of tariff setting prior to SEM. It is also unrealistic to expect that ESB PG’s costs will remain at the same level in 2007 as 2006 thus possibly exposing ESB PG to the risk of significant under recovery.

The costs for 2007 will be different to those in 2006 and, to recover these, the tariffs should reflect the expected costs. The risk of not recovering costs would be unacceptable to ESB PG.

**Reliable predictions of SEM costs and revenues**
The tariff setting for SEM will need to be based on robust forecasts of contract and pool prices and regulation. A robust time line for finalising the form of the contract market or the type of regulation that will underpin it has not been established at this point.

**Option D: Two tariffs in 2007 – one using existing methodology until July 2007 and an SEM based tariff for the rest of 2007.**

To implement this we need to have the following in place:

1. Methodology to apportion costs of partial year.
   This methodology would need to be agreed so that there is 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. However a thorough review of all costs and rules for apportionment will be needed and this will probably extend the regular timetable considerably. This carries a significant risk that the 2007 tariff will not be ready for September/October 2006.

   To set the second tariff for 2007 the contracts, and an agreed model of the non-contracted income, need to be in place. A robust time line for these processes has not been established at this point in time.

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. It is normal for ESB, and indeed many other businesses, to know their 2007 annual budgets before 2007 commences.

**Variant on Option D:**
Alternatively, a variant of Option D could be employed and use the existing methodology for tariff setting until such a time as reliable forecasts of the price projections in the SEM are available. This is not our preferred option as the implementation risks are significant, however it is preferable to options A-D as presented. This will involve setting a new tariff for 1st January 2007. When the costs for the SEM have been determined and forward contracts signed then the process for determining new tariffs for the remainder of the year can commence. It is expected that this phase will take approximately three months. This has the advantage that it could allow the SEM to be implemented in July 2007, if contracts are signed on time, or at a later date in the event of any slippage.
**Option E: An alternative**

*Single tariff change for 2007 based on existing methodology and operate the SEM as a shadow market for 2007.*

**Single Tariff:**
This has the advantage of setting one tariff for the entire year based on the existing agreed methodology. Advantages would include:

- **ESBPG and ESB PES:** The costs would be apportioned and recovered throughout the year as in previous years. This creates certainty.
- **Independents:** Certainty for the entire year for cost and pricing and regulatory policies. ISCOs will be able to offer tariffs from a single flat priced tariff, rather than two periods or based on two regimes which behave very differently.
- **Customers:** Customers would only see one tariff for the entire year, and it is assumed that single annual tariff changes are their preferred options. Customers will also not be subject to any impact from incorrect forecasts of the new market prices because of inexperience, and will be shielded from any impact that slippage or last minute tweaking of the SEM could cause.
- **SEM:** ESB PG is fully committed to ensuring SEM will commence on 1st July 2007. However, for tariff risk mitigation purposes the market should operate in shadow mode for the latter half of 2007. This has the advantage that all systems can be thoroughly checked and implemented prior to setting the next tariff in January 2008 which will be based on market prices and contract positions.
- **Legal Issues:** There are no issues with PSO as it would run for the entire yearly period thus there would be no requirement for legislative changes.
- **Other implications:** Unlike a number of the previous options, this option does not increase the Commission’s work load or that of other stakeholders.

**Conclusion**
Having considered the four options ESB PG believes that it is more prudent to proceed with an option that is not included in the consultation paper i.e. Option E. PG’s considered preference would be for a single tariff to be set for 2007 based on the current methodology and run the SEM in a “shadowing” mode until the end of 2007.

It is expected that there will be a transition to a new market during 2007 and thus the profile of prices is of increased importance so that revenue recovered under the current methodology closely matches the costs incurred throughout 2007. It is not acceptable to ESB PG to have a tariff that does not accurately reflect costs.

Obviously the same solution must be adopted on an All-Island basis. This will require agreement of all parties.