ESB PES Tariffs & Transition to SEM – Draft Decision
Response by Airtricity

Introduction
The draft decision attempts to steer a course between the conflicting desires of customers, for lowest possible prices for as long as possible – and generators/Suppliers, who want to recover real costs and so minimise their financial risk. Any decision on tariffs therefore involves an allocation of risk between electricity market participants and their customers. Under current regulatory arrangements, the risk to ESB business units is reduced, through the "K" factors that perform an inter-year transfer of any surplus/deficit in allowed revenues, but these result in retail market price distortions that impact the cashflow of Independent market participants.

Going forward into the SEM, tariffs will always be set on the basis of a mix of uncertain Pool prices and hedging contracts, so we do not consider that it is possible for Participants’ risk to be eliminated; it is part of the competitive market process that Suppliers will achieve greatest business success when they are able to combine economic purchase of hedging contracts with accurate forecasts of Pool price. One of the stated benefits of the SEM is that the move from an administered price regime to a competitive regime, based on market prices, will result in lower overall costs and therefore benefit customers. Even if this benefit of the SEM is delivered, customers will consider it a failure if wrongly-priced tariffs in H1 2007 result in a step change when market-based prices are introduced in H2 2007.

We therefore consider that an important objective of the overall 2007 PES tariff regime should be that it avoids tariff volatility by delivering basic continuity across the year.

Whilst Airtricity continues to believe that the most appropriate method of minimising tariff disturbance in 2007 would be Option A, we understand that the Commission has now decided to adopt a variant of the two-tariff approach. In this response we have therefore focused on how we believe the decision should be implemented in order to minimise tariff dislocation mid-year in 2007. A measure of success would be that any tariff change for H2 would be purely a result of fuel price movements, offset by efficiency improvements resulting from introduction of the SEM.

Implementation - tariff construction
Retail tariffs comprise generation, transmission, distribution and Supply. Of these, it is unlikely that distribution will be significantly affected by SEM, although the draft decision recognises that there are issues with transmission operational costs in SEM. This leaves generation and supply; for both of these there is an allowed revenue and a pass-through component.

"fixed" components
In implementing the tariff decision, Airtricity believes that tariffs for the two half years should be built using annualised allowed revenues for both PGen and PES, plus distribution charges, to provide a foundation of continuity across the full year. This single-pass approach to the fixed components of PES tariffs would also require a lower level of resource to deliver, compared with a full tariff review mid-year.

variable components
The remaining tariff components in transmission and generation should then be broken down as much as possible, to identify the specific aspects that may/will be impacted by SEM and those that can be known with a degree of certainty similar to that in the current, ex-ante tariff setting process. The more certain components can be treated as described above, to provide additional tariff continuity; the more uncertain items being the subject of detailed review for 2007 H2. A key consideration should be that

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variable tariff components are annualised to avoid H1/H2 seasonal differences contributing to a step change mid year.

We believe that this approach to implementation offers the maximum tariff continuity across 2007, retains maximum consistency in monopoly price control between the pre- and post-SEM environments, focuses on issues directly impacted by SEM and offers customers some reassurance that they will not be impacted by covert adjustments to cost recovery or seasonal misallocation of charges between 2007 H1 and H2. It also offers the greatest level of process transparency to all market participants – including customers.

In terms of the draft decision, this approach to implementation is compatible with the Executive Summary paragraphs a. and b. (two tariffs for 2007, with H1 prices based on existing process).

2007 H2

transmission issues
Transmission impacts as a result of SEM include losses, constraints, ancillary services and other imperfections costs. Although an increased level of understanding new and changed costs in these areas is likely to be obtained by modelling in 2006, we believe that the proposed 3-month market trial in Q2 2007 will be a major test of the modelling results and it would be wrong to ignore valuable input from this activity when determining H2 charges for SEM-impacted aspects of transmission charges.

generation
Similarly for generation costs, we believe this is such an important issue that determination of the generation tariff component should not be finalised until after the end of Q1 2007. The maximum amount of information on directed contract design, pricing, Pool price modelling validated by available market trialling data, must be used in determining H2 tariffs. If a decision is taken too early, there is a risk that the generation estimates will be too high, causing an unnecessary upward price step mid-year; or too low, resulting in an unnecessary increase in 2008.

For the sake of tariff continuity and accuracy, Airtricity believes that the timescale outlined in paragraph d. is unnecessarily restrictive and is likely to result in a greater level of tariff disturbance for customers that if decisions on SEM price impacts are delayed for as long as possible. We consider that publishing price decisions so far in advance of H2 2007 would increase the risk of pricing error.

Other issues

fuel price variation
Whilst a fuel price variation clause is theoretically attractive and could potentially lead to greater alignment between H1 and H2 prices, the draft decision recognises the practical issues of frequent billing price adjustments and customer uncertainty, but other customer impacts would be caused by meter reading and billing cycles and the need to estimate intermediate monthly consumptions. The adjustment could be applied based on the price applicable to the bi-monthly billing date, but perceptions of unfairness (customer billed a few days apart being charged different amounts) and estimated meter readings are likely to lead to an increase in disputed bills.

On balance therefore, we believe that a single mid-year price adjustment is the most practical and equitable approach. If appropriate annualised fuel prices and forward pricing are used to set H1 tariffs, then the impact of H1/H2 seasonal price differences and introduction of Pool prices at the margin, will minimise any mid-year price adjustment.

extension of tariff period
We do not accept that there is any need to extend the tariff period beyond 31 December 2007. Whilst it may be perceived as desirable that the retail tariff years are aligned between NI and RoI, there is no particular reason why this ought to be done. We believe that the workload required to agree allocation of allowed monopoly revenues between years, agreement on indexation allowances and the potential
for tariff dislocation among other issues, means that such a change should only be contemplated once the SEM is properly established and time available to consider the full impact of any change, as part of a controlled programme of regulatory development.

In terms of the number of customers affected, it would be more appropriate to align the NI tariff year with the RoI tariff year if alignment were considered sufficiently important to warrant hurried implementation.

**PSO 2007**
We will respond to the separate PSO consultation in due course, however in developing the PSO we believe that implicit fuel cost used should reflect the forward gas curve in a manner that is predefined and which market participants could replicate (e.g., publish in methodology in May, that defines BNE fuel cost as average of forward gas prices in June to August).

**Summary**
We believe that setting PES tariffs for 2007 in two stages can be delivered with an acceptable level of price continuity by adopting an implementation strategy that maximises use of components unaffected by SEM, on an annualised basis. This approach will maximise the probability that any mid-year price change will be more of an adjustment rather than a significant change. We believe that application of a fuel cost adjustment is not appropriate for a half year and that would be better to apply a greater level of effort to ensure the basic energy price is correct.

In regard to the other issues of tariff period alignment between RoI and NI, and derivation of the PSO, we believe:

- the level of work required for proper impact assessment of the former is inappropriate in the context of delivering SEM successfully and
- that the BNE/PSO methodology should be clear to participants, in advance of the date on which any implied fuel hedging process would have to be started.