ESB Customer Supply Response
CER Draft Decision

ESB PES Tariffs and the Transition to the SEM

(CER/06/022)
1. Introduction:

The CER published its draft decision on March 3rd. This followed the publication of a consultation paper on January 16th and subsequent consultation period which showed, as reported by the Commission, different views from market participants including 2 large consumers on how the setting for our tariffs might be approached in the context of SEM introduction from 1st July 2007.

The Commission identified a number of specified criteria against which options were considered:

- Impact on the regulated sector e.g. ESBPES
- Impact on customers
- Impact on the independent sector and competition
- Robustness to SEM start slippage date
- Impact on the SEM work programme
- Legal issues arising (PSO).

It is clear from the draft decision that the Regulatory Authorities are also considering other issues such as:

- market power mitigation
- how the PES (ESBCS) will be regulated post SEM including scope of tariff regulation
- alternative tariff structures.

These related issues are significant for our business. The issue addressed in this draft decision by the Commission, however, only concerns the approach to tariff setting for the transition to SEM. It is not clear to ESBCS how the preferred option impacts on ESBCS cost recovery for 2007; this issue i.e. the operation of the K factors for the 2007 tariff year is of the utmost importance to ESBCS as it is fundamental to our financial viability. ESB wishes to engage further on this issue with the Commission as soon as possible.

In evaluating the Commission’s preferred option two issues are predominant from a Customer Supply point of view – the availability to CS of hedges for the period July to Dec. ’07 and the impact on our customers during the SEM transition period.

2. Executive Summary

We have considered the Commission’s preferred option against the criteria previously set down by the Commission and are of the view that its implementation as proposed adversely impacts on Customer Supply, our customers, other suppliers and on the wider perception of the impact of the introduction of SEM. In particular we are concerned that undue risk is presented by the CER proposals during this transition period whereas our alternative proposal meets key criteria previously set out by the Commission and is therefore worthy of further consideration.
3. **Commission's Preferred Option**
The Commission’s preferred option is a variant of Option D as originally proposed which did not have the support of any of the respondents to the consultation. This option entails:

- Two ESBCS tariff changes; the first from 1st Jan. '07 set broadly as heretofore and the second from July to December - tariffs for this period will (inter alia) be linked to 3rd party energy contracts, pool purchases and other market charges

- Tariffs for the second period to be determined over quarters 3 & 4 of this year, published in quarter 1 of 2007 and based on an assessment of Pool Prices to the extent that hedges are not in place.

4. **ESBCS comments**

It is not evident what weight the Commission attached to the various criteria used to assess the options considered. Below we set out our comments under each of the criteria listed by the Commission. Our response is mainly focussed on the impact of the Commission's preferred option on our business and our customers.

4.1 **Impact on ESB PES**

We have a number of important concerns here.

Firstly, there is the absence of clarity regarding the extent to which ESBCS will be able to recover its allowed costs including upstream costs under the Commission's preferred option. As previously stated ESBCS operates to an allowed regulated margin of 1.3% of turnover and our tariffs are set for a year as approved by the Commission. Moreover, in excess of 40% of our purchases are as a direct result of 3rd party contracts imposed on PES. In addition, ESBCS is obliged to accept all customers on published tariffs. Due to constraints such as these, ESBCS of all suppliers is least well equipped to cope with risk and should not be exposed to the risk of under-recovery of upstream costs which far out-weigh our own operating costs.

In the absence of normal full commercial freedoms e.g. continual price setting, customer targeting and contract selection, a K factor correction is essential to maintain a sustainable PES. K factors adjust previous forecast of costs for actual costs and in effect correct for market distortions – whether for under or over recovery.

The continuation of regulated revenues and tariffs for 2007 - under both tariff stages - requires the continuation of K factor corrections and we request that the Commission make this clear in the final decision. K factors can be mitigated but subject to the availability of hedges. This emphasises the importance of a forwards market to enable all participants to manage exposure to pool price volatility.

Secondly, ESBCS will need hedge contracts for the period Jul to Dec; if ESBCS is not hedged the likelihood of our tariffs being out of line by reference to wholesale costs increases. It is not clear when hedges may be available and on what basis. In
light of this, the level of uncertainty cannot be mitigated leaving ESB CS exposed to
greater K factor fluctuation. The Commission assumes that these hedges will be
available over Quarter 3 & 4 of this year given the proposed time line for approving
regulated revenues for the second half of 2007. In addition, implicit in the approach
is the view that these hedge contracts will be based on inter alia clarity on CS’s
contractual position and a reliable view of the spot prices which would obtain under
SEM and CS’s exposure to these. Generally the pattern of experience in the
introduction of pool markets has been an initial period of volatility in prices followed
by stabilisation/greater predictability. This volatility could be exacerbated during the
bedding in period due to the participants’ lack of familiarity with the operating rules
and procedures of SEM. It would be reasonable to assume that this uncertainty and
volatility would serve to increase prices. The impact of such increases in prices on
consumers is of major concern to ESBCS and this concern is probably shared by
other industry participants.

Thirdly, two tariff changes in 2007 will place significant additional demands on
Customer Supply to communicate the changes to customers. Under its preferred
option the Commission proposes to publish tariffs for the 2nd tariff period (Jul to Dec)
in quarter 1 of ‘07. This will coincide with our customers receiving their first bill with
the tariff changes introduced from 1st January. This will lead to a lot of confusion and
dissatisfaction for customers. It will result in increased calls to our contact centre,
increased queries, increased complaints and increased costs in resolving these. The
increased costs will not have been factored into agreed costs projections under our 5
year revenue review.

Fourthly, two tariff changes and the possible introduction of a fuel cost variation
charge impose a significant additional workload and resource requirement on our
billing and IT functions to implement the change. It would appear that the concept is
of a charge which changes on a regular basis eg from billing period to billing period
following Commission decisions which reflect underlying fuel price changes. The
administration around the billing processes eg customer queries and bill adjustments
would be significant. These changes and associated costs to implement have not
been anticipated and clearly have not been factored into approved costs projections
which were the basis of our allowed 5 year regulated revenues.

Our IT and Business staff are already dealing with various regulatory driven changes
to business processes and IT systems. Additional changes impact on our ability to
deliver and implement changes successfully; we note that System Operators have
similar concerns in terms of impact on their resources. From our perspective
regulatory driven projects will need to be prioritised by the CER.

The key concern for CS is that if hedges are not in place (eg BPA not extended) we
are exposed to risk of increased pool costs post July not being reflected in tariffs.
This risk could be very significant and unsustainable given our specific exposure to
peak time pool prices. In these circumstances it would be more acceptable to CS to
have a second tariff increase rather than have significant losses even with a K factor
adjustment in 2008 as this might put our tariffs way out of line with the market in 2007
and 2008.

However, a second tariff price adjustment based on pool price projections carried out
in Q3/4 is unlikely to significantly (or sufficiently) mitigate our risks and it is unlikely
that hedge contracts would be in place by Q3/4 this year. Hence, in such
circumstances, the benefits of a second tariff price adjustment may be outweighed by
the difficulties outlined above.

Our proposal previously submitted in response to the consultation has the advantage
of both managing our risk of exposure to potentially volatile pool prices while, at the
same time, not requiring a second tariff price adjustment.
4.2 Impact on our customers

The Commission again notes the preference of customers for a single rather than 2 tariff events in a given year and their expected opposition to the proposed fuel cost variation charge. This coincides with our experience also which indicates that given a choice customers would prefer one annual increase to two (for a similar overall level of increase). This is particularly so for business customers who value the certainty for annual budget setting.

The Commission’s preferred option impacts adversely on the customer on each of these measures and introduces a huge level of uncertainty for customers ie two tariff increases and a possible fuel cost variation charge in bills. Additionally, the introduction of a fuel cost variation charge would be a significant change in the presentation and billing of electricity charges to customers which many would resist particularly if no alternative option was available to them.

The Commission’s preferred option does not give sufficient weight to the importance and value placed by customers, particularly business customers, to certainty in the planning process. The absence of this certainty clearly introduces an additional level of risk for any investment decisions being considered.

Arguably customers would expect that the electricity industry would be able to anticipate and manage the impact and introduction of SEM on the single annual tariff setting process. Notwithstanding the reasonable nature of this customer expectation, as an industry we would in effect be saying to customers that, in the absence of a forwards market, we are not confident we have the capability to manage the transition to SEM without providing for an additional tariff change. Customers are therefore likely to perceive the Commission’s preference for the two-stage approach as a sign of uncertainty over how SEM will impact on end user prices. This could undermine customer confidence in the introduction of SEM.

Furthermore, the prospect of two tariff increases impacts on the capacity of other suppliers to offer annual contracts to customers. To that extent customer choice would be reduced.

On a practical level two tariff increases means double the impact, resources, effort in communicating and explaining the reasons for and detail of tariff increases to customers. This would of course be compounded by fuel cost variation charges. In addition high levels of estimated meter readings coinciding with tariff and or fuel cost variation charge changes will lead to increased customer queries, bill disputes and customer dissatisfaction. Two tariff changes would also add significantly to the complexity and resources required to communicate the impact of the tariff changes clearly to different customer groups.

It is also worth reminding the Commission of its direction to ESBCS to implement transaction charge billing form 1st January 2007. The overall impact on our customers next year could under the Commission’s preferred option comprise 2 tariff increases, a fuel cost variation increase and new transaction charges.

Overall, customers will not want to see a second tariff change. Our alternative facilitates a single tariff increase.

4.3 Impact on other suppliers
It is clear that no supplier expressed a preference for Option D on which the Commission's preferred option is based. Indeed all appear to prefer a single increase in 2007 whether in January or July. As already stated, the prospect of two tariff increases probably impacts adversely on the capacity of other suppliers to offer annual contracts to customers. Perhaps there might be support for the alternative proposed by ESBCS in our initial response – this allows for one tariff increase which would be more reflective of underlying fuel costs than an extension of 2006 tariffs and for the continuation of a full year contract period for the customers of other suppliers.

It is reasonable to assume that the customers of other suppliers would have the same preference as ours, ie would, from the options proposed, prefer the certainty which a single tariff setting process for all of 2007 would offer.

4.4 SEM
The Commission is concerned to avoid slippage in the start date and appears to be of the view that it is essential that market prices under SEM are reflected in tariffs from the go-live date - hence its preferred option. However the tariff setting approach it proposes clearly requires the Commission to take a view on SEM prices in quarter 3 & 4 of this year. Our proposal does not differ that much from the Commission's in that instead of the Commission taking a view later this year on SEM prices post July '07 the Commission would use the regulated BPA between ESB PG and ESBCS as a proxy for its forecast market price. An initial administered regime applies in either case and a single tariff setting process has much to commend it to both customers and industry participants.

4.5 Legal
The Commission acknowledges that SI 217 would have to be amended to facilitate its preferred option. In contrast this issue does not arise under our proposed approach.

5. Commission's view on the alternative
The Commission acknowledges the simplicity of the alternative and assesses it positively under its previously published criteria although pointing out that it undermines SEM start date and the opportunities provided to generators and suppliers in the market. This latter observation however is not aligned with the previously expressed views that the approach should be robust to SEM start date slippage and that the significance of tariffs for other suppliers was that they provided the benchmark for competing offers. Therefore were the Commission to accept our alternative they would reduce the uncertainty but not the opportunities that industry participants could avail of from the introduction of the SEM in July 2007 given the changing structure of the balancing arrangements and ability to secure power when necessary through the pool.

6. Commission's rationale
The Commission sets out four options and finds advantages and disadvantages with all and is dismissive of the alternative. On this basis and for the realities of the tariff
setting timetable, the availability of information and the need for tariffs to be reflective of market conditions the Commission proposed option E.

We have already pointed out that imperfect information will in any event be unavailable in Quarter 3 & 4 and that as in previous years the Commission itself will be taking a view on the underlying market prices that it will have modelled – only at a different point in the process.

Therefore, it appears that the Commission’s preferred option hinges on the reliability or otherwise of the information on which it will forecast pool prices for the period July to December and using these to set ESB CS’s tariffs against which other Suppliers will be pricing their tariffs and calculating their financial exposure. This would mean that tariffs were based on pool prices and not on forward’s market prices. It would also mean that the industry as a whole is exposed to any errors in the CER’s forecast and would require larger K factors.

Again as described above, the pattern of experience following the introduction of pool markets has been an initial period of volatility in prices followed by stabilisation/greater predictability.

7. Conclusion

In our view in considering the issues posed by tariff setting in the transition to SEM and during the first six months of its operation, the key requirements should be to provide a level of certainty or continuity to both customers and market participants by allowing a sufficient period for the new market to bed in and produce real market data which can be used to make commercial and informed decisions. Given the observations made by the Commission in regard to the SEM work programme and the availability of information to forecast market prices for 2007, in our opinion the best option for ESBCS tariff setting in 2007 is a single tariff change for the whole of 2007 based on the existing methodology.

The Commission has acknowledged these advantages but appears to be of the view that more reliable data will be available later but timely enough to facilitate more market reflective tariffs post July ’07.

It is questionable how more reliable this data will be than a view taken some few months earlier.

The balance of advantage to participants and to customers lies with our alternative proposal ie for the existing tariff setting process to operate for the full calendar year and continues to facilitate a market where commercial decisions determine the competition underpinning the wholesale prices and tariffs.