Commission for Energy Regulation

An Coimisiún um Rialáil Fuinnimh

Draft Decision on the ESB PES's Revenue Regulation Framework

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CER – Information Page

Abstract:

This document sets out proposals for the regulatory arrangements that will apply from 1st October 2010. This paper sets out the Commission's proposed decision on the form of price control that will apply to the market, in part or in whole, until such time as the market is deregulated.

Target Audience:

This paper is for the attention of members of the public, the energy industry, customers and all interested parties.

Related Documents:

- Review of the Regulatory Framework for the Retail Electricity Market: Proposals on a Roadmap for Deregulation - CER09189
- Direction to ESB PES on Allowable Costs 2006 – 2010 - CER05164
- Report on a Review of K Factors and Supply Margins - Skyplex Consulting CER09093a
- Final Report on a Review of K Factors and Supply Margins - Skyplex Consulting CER09203b

Responses to this consultation should be returned by email, post or fax and marked for the attention of Fergus O'Toole (fotoole@cer.ie) at the Commission**.**

The Commission intends to publish all submissions received. Respondents who do not wish part of their submission to be published should mark this area clearly and separately or enclose it in an Appendix, stating the rationale for not publishing this part of their comments.

Executive Summary

In December 2009 the Commission set out its intention to deregulate the retail electricity market, removing regulated end user prices in line with developing competition. In that consultation the Commission outlined the criteria for how competition in the retail market should be assessed and a number of proposals for deregulation.

The Commission committed to publishing a decision on the roadmap proposals and the outcome of a competition review in April. The competition review will determine if any retail market (e.g. domestic market, SME's and large business) will be eligible for deregulation from 1st October 2010.

In the roadmap consultation the Commission also noted that there would be changes to the interim regulatory arrangements that would apply until the market was fully deregulated. Recognising the shortcomings of the 2006-2010 price control in the context of falling national demand, increased customer churn and the persistent competition issues raised by the annual k-factor adjustment mechanism, the Commission is reviewing the regulatory formula that will apply until such time as the market is deregulated. In parallel the Commission is, separately, reviewing the internal supply costs that will be allowed to PES as part of the revised formula.

The proposals in this paper draw on the work of the Skyplex report in 2009, which reviewed the application of k-factors and supply margins in retail markets north and south. The Commission is proposing to move to an ex post revenue control which affords the regulated PES greater freedom in tariff setting – both the level of the tariffs and the period over which it applies. This proposal is a step closer to a deregulated environment but maintains the appropriate level of controls to provide the correct incentives to the regulated PES to act in the interests of consumers and not undermine competition.

This new regulatory regime will apply to all categories of PES customer that do not meet the necessary criteria for deregulation as defined by the roadmap. For customer categories subject to price regulation, PES will be given a greater degree of pricing flexibility. PES will be permitted to adjust its tariffs in response to developments in the market, including factors such as fuel price volatility and changes in overall demand.

The objective of the proposals in this paper is to significantly reduce the impact of significant differences between PES's costs and revenues at the end of each year and the impact of this on the electricity prices applying in the following year. The proposed methodology establishes, on an ex post basis, a maximum allowable revenue for each customer category. It is proposed that this MAR will have a revenue formula where hedging costs would be included at a contract cover level equal to 50% of PES' projected demand. Other elements of the overall cost of electricity - including capacity payments, supply costs, network charges, PSO charges and would all be calculated ex post.

The paper proposes a band of +/-3% around the ex-post allowed revenue figure. The Commission is in favour of the following treatment of over and under-recoveries, coupled with applying a supply margin of 1.3%, applied on an *ex post* basis to the aggregate allowable costs;

- Over-recoveries within the 3% band retained by PES. Over recoveries above the band returned to customers via a decrease in the following period's MAR.

- Under-recoveries within band charged to customers via an increase in the following period's maximum allowed revenue. Outside of band, absorbed by PES.

The options presented in this paper all have a common theme. PES will be given substantial pricing flexibility within a given tariff period and will be free to set and adjust prices throughout the year, provided revenue forecasts remain within the 3% band.

The regulatory structure will be such that PES has the incentive to set prices that accurately reflect the market cost of serving load and has neither an incentive to take advantage of customers in market segments which are not yet fully competitive by charging prices that are too high nor an incentive to maintain market share by under pricing and recovering shortfalls through an adjustment in the following tariff period. This is generally accomplished by giving PES the ability to set and adjust the price but in turn have PES absorb any revenue-to-cost shortfalls resulting from the prices it sets and rebating any revenue-to-cost overages relative to the prices its sets. This proposal includes tolerance bands recognising that accuracy in matching costs to revenues is limited.

The Commission will monitor PES's pricing practices and will require PES to produce quarterly reports on its costs and revenues for each category of customer subject to regulation.

Table of Contents

1.0 Introduction

1.1 The Commission for Energy Regulation

The Commission for Energy Regulation ('the Commission') is the independent body responsible for overseeing the regulation of Ireland's electricity and gas sectors. The Commission was initially established and granted regulatory powers over the electricity market under the *Electricity Regulation Act*, *1999*. The enactment of the *Gas (Interim) (Regulation) Act*, *2002* expanded the Commission's jurisdiction to include regulation of the natural gas market, while the *Energy (Miscellaneous Provisions) Act 2006* granted the Commission powers to regulate electrical contractors with respect to safety, to regulate to natural gas undertakings involved in the transmission, distribution, storage, supply and shipping of gas and to regulate natural gas installers with respect to safety. The *Electricity Regulation Amendment (SEM) Act 2007* outlined the Commission's functions in relation to the Single Electricity Market (SEM) for the island of Ireland. This market is regulated by the Commission and the Northern Ireland Authority for Utility Regulation (NIAUR). The Commission is working to ensure that consumers benefit from regulation and the introduction of competition in the energy sector.

S.I. No. 60 of 2005, European Communities (Internal Market in Electricity) Regulations, 2005 outlined the functions of the Commission and the conditions of operation for the Public Electricity Supply Licensee. SI 60 sets out the Commission role with respect to the approval of regulated tariffs.

1.2 Purpose of this paper

The purpose of this paper is to seek the view of the public and the Commission's stakeholders with regard to the regulatory formula to apply to ESB Customer Supply (ESB CS), licensed as the Public Electricity Supplier (PES),for the period commencing 1st October 2010 in its regulated retail markets. In order to make an informed and impartial decision on this topic, the Commission wishes to obtain comments from members of the public, the energy industry, customers and all interested parties. The Commission commits to considering all views equally and affording each respondent the opportunity to clarify any issue raised in this paper.

1.3 Background Information

In December 2009, the Commission published its Review of the Regulatory Framework for the Retail Electricity Market[1] with proposals on a roadmap for deregulation. The roadmap for tariff deregulation set out the Commission's intention to deregulate the retail market when sufficient competition has

[1] Proposals on a Roadmap for Deregulation - CER09189

developed, removing the price controls that are currently imposed on ESB PES. The Commission is due to publish its decision with respect to the roadmap paper in April 2010.

As part of the roadmap consultation the Commission also proposed to conduct a competition review in March 2010 which would determine what defined market categories, would be eligible for deregulation from 1st October 2010. The roadmap paper also set out the Commission's intention to review the interim arrangements for tariff regulation for markets where tariff regulation continues to apply from 1st October 2010 and until such time as those market categories are deregulated. The purpose of this paper is to address the arrangements that will be in place for those market categories still regulated after 1st October 2010.

In 2009 the Commission and NIAUR, the Regulatory Authorities (RAs) which engaged consultants to review the application of k-factors, supply margins and tariff structures[2] in both the Northern and Southern retail markets. This was done in the context of greater harmonisation with respect to the approach taken by both regulatory authorities (RAs) to the regulation of the retail markets. Skyplex consultants were engaged to review the application of k-factors and supply margins. A report[3] to the RA's was produced as part of this project and a number of recommendations were made by the consultants in the report, some of which have incorporated as part of the proposals in this paper and these are discussed in section 2.

In the Commission's 2009/10[4] review of PES allowed revenue, the final year of the 2006 – 2010 price control[5] applicable to 30th September, a number of issues were identified. In its review the Commission noted that it would take into consideration the impact of falling demand and increased competition in the subsequent control formula. One of the primary considerations in the new revenue control model would be to ensure that supply costs more adequately simulate how a competitive market works.

This paper highlights the interactions of both the roadmap and revenue review work streams and details the Commission's draft decision with respect to the interim measures that apply to regulated market sectors for the period 2010 – 2012.

[2] Poyry Final Report on Tariff Structures Review - cer09203
[3] Skyplex Consulting Final Report on a Review of K Factors and Supply Margins - CER09203b
[4] ESB PES Allowable costs for the period 1st October 2009 - 30th September 2010 - CER09152
[5] Direction to ESB PES on Allowable Costs 2006 – 2010 - CER05164

1.4 Structure of this paper

- **Section 1** provides an introduction and some background information.
- **Section 2** of this paper provides the relevant background for the current revenue control and internal PES supply controls.
- **Section 3** Sets out the Commission's goals and proposals.
- **Section 4** Sets out the proposals for the treatment of the various tariff cost elements as well as putting forward the Commissions proposals for the regulatory formula
- **Section 5** of this paper outlines the obligations PES will have under the proposed regulatory arrangements including their EPO, SOLR and USO.
- **Section 6** examines how the regulatory process will work in terms of ex post and ex ante reviews as well as the treatment of excesses and deficits.
- **Section 7** contains an overall summary of the proposals outlined in the paper and the Commission's conclusions. It also outlines the Commission's proposed timetable for this consultation and for the delivery of a decision on the topic of this consultation.

Appendix A contains a summary list of all of the questions which the Commission has asked in this consultation paper. This is designed to be a useful aid to respondents when preparing their submissions and can also serve as a "short-cut" for respondents who may not have the resources to devote to preparing a full submission. If taking the "short-cut" option, respondents should answer questions in the space provided in Appendix A. Appendix A will also be published separately in Word format. Responses which have availed of the short consultation option will be evaluated equally by the Commission, when making its decision.

1.5 Responding to this paper

Interested parties are invited to comment on the issues raised in this paper this consultation paper by close of business on ***Friday 16th April 2010***.

As responses will be published in full on the Commission's website, respondents should include any confidential information in a separate Annex. Submissions on this paper should be forwarded, preferably in electronic format, to:

Fergus O'Toole
Commission for Energy Regulation,
The Exchange, Belgard Square North,
Tallaght,
Dublin 24.
E-mail: fotoole@cer.ie

Participants are encouraged to explain their positions and the rationale for these positions. Responses that provide rationale will be accorded more weight.

2.0 Regulatory Framework 2006 - 2010

2.1 Introduction

There are two key elements that must be considered in implementing changes to the current regulatory framework, which will serve as the interim arrangements until such time as the market is deregulated in full;

(i) Regulatory Formula

(ii) Internal Supply Costs Review.

The form of revenue control determines the nature of control placed on the business (e.g., a cap on revenues recovered from customers or a cap on prices charged to customers). It also sets out an efficient level of revenues (made up of allowed operating costs, depreciation charges on capital expenditure derived from the allowable capex, and an allowable margin) that can be recovered by the business from its customers in a particular operating period (usually a calendar year). The revenue control can also incorporate incentives for the regulated entity to improve both productive efficiency and customer service performance levels.

2.2 PES Supply Price Control 2006 - 2010

In 2005 the Commission determined the allowed revenues for the 2006-2010 price control. The price control formula is in its final year and concludes on the 31st of December 2010[6]. The 2009 decision on PES allowed costs and revenues for the current tariff period[7] concludes on 30th September 2010 and therefore the Commission must determine the appropriate costs for the coming period.

The current model for tariff and revenue regulation is based on *ex-ante* review and analysis of all elements of the price control. The maximum PES revenue formula is set out below;-

Max PES Rev = Base Revenue(1 + CPI Infl Rate - Efficiency Factor) + Margin + Uncertain Costs + Incentive + Kt-1 + Kt-2*

The correction factor, which allows for over and under recovery, was a key element of the price control where;

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[6] Allowed revenue was originally calculated on a calendar year basis and then adjusted when the SEM tariff year was aligned with Northern Ireland from 1st October – 30th September.

[7] ESB PES Allowable costs for the period 1st October 2009 - 30th September 2010 - CER09152.

Kt was the correction factor applying in year t to under or over recovery in year t-1 and was to be determined by the Commission on an annual basis. The then three-month Euribor rate was applied to the correction. The correction factor was applied to both the determinants of the PES's own costs and to any over or under recovery in respect of PES upstream costs. The correction factor also included adjustments for under or over recovery in respect of the components of INCENTt. Kt was determined based on estimated or actual values for each component of Rt and the PES upstream revenue available at the time determined by the Commission for PES providing such information in year t in respect of year t-1.

Kt-1 was the correction factor applying in year t-1 to under or over recovery in year t-2 this amount to be determined by the Commission on an annual basis. The then three-month Euribor rate was applied to the correction. The correction factor applied to both the determinants of the PES's own costs and to over or under recovery in respect of PES upstream costs. The correction factor also included adjustments for any under or over recovery in respect of the components of INCENTt. Kt-1 was determined based on estimated or actual values for each component of Rt-1 and the PES upstream revenue available at the time determined by the Commission for PES providing such information in year t-1 in respect of year t-2.

2.3 PES Allowed Revenue Annual Review 2009/10

The 2009/10 annual review highlighted a number of issues with the form of the 2006-2010 price control model. The general downturn in the economy combined with the development of competition at all levels of the retail market lead to the accumulation of a large K-factor. During the review the Commission examined the appropriateness of using the current regulatory formula given the fall in overall market demand and the impact of reduced PES customer numbers resulting from the introduction of competition in the domestic market. The issues with the structure of the price control resulted in the Commission deciding not to allow any of the K-factor under-recovery to be recouped in the 2009/10 PES tariffs. The issue of the outstanding k-factor will be addressed in a separate consultation which will examine ESB PES's allowed supply costs for 2011/12.

The Commission highlighted a number of issues to be considered in the development of any future review. These included:

- The fact that one of the key assumptions made when the revenue model was designed was that national demand growth and new connections would continue to rise, which was not the case over the twelve months of the 2008/9 tariff year. This contributed to the accumulation of K-factors indicated that any future price control would need to have the flexibility to deal with demand uncertainty.

- The importance of providing a stable and predictable regulatory environment is a primary concern. The inclusion of a k-factor to cater for under/over recovery against the PES allowed revenue has the potential to create an undesirable level of uncertainty for independent suppliers and impact on competition in the market. The Commission's objective is to ensure that consumers benefit from regulation and the introduction of competition in the energy sector. In particular, the Commission was anxious to avoid any unintended consequences such as higher unit costs per customer.

2.4 Review of k-factors and Supply Margins

In 2009 the RA's initiated a joint work programme consisting of a number of projects to promote greater harmonisation between the retail markets to develop competition in order to deliver a net benefit to all electricity customers. As part of this work, the RA's engaged Skyplex consultants to do a review of the application of K-factors and supply margins and Poyry to review the retail tariff structures.

Skyplex undertook a full review of practices in the retail markets in both jurisdictions and elsewhere. Further to this review and as part of a full consultation process Skyplex set out three proposals for changes to how k-factors are applied, with a view to promoting the development of supply competition. The three proposals were as follows;

- Proposal 1: Minimal change

  k-factors are retained, in the hope that hitherto developments in retail competition will continue to progress, but a number of changes to the existing arrangements are made in order to address the detrimental effect that k-factors have on competitor suppliers.

- Proposal 2: Asymmetric k-factors

  Any over-recovery must be repaid with a premium or any under-recovery may not be subsequently fully recovered.

- Proposal 3: No k-factor with maximum allowable revenue determined by ex-post pool prices and customer demand.

  Use of k-factors is discontinued completely and allowable revenues for NIE Energy (NIEE) and ESB Customer Supply (ECBCS) (together the "regulated suppliers") are set ex-post based on the pool purchase costs of the electricity actually used by their customers, not including hedging costs.

In their final report to the RA's Skyplex took into consideration the different levels of competition in each of the respective markets and recommended different options for each of the two retail markets north and south.

In Northern Ireland, given that retail competition has not yet developed in the domestic section of the market and the known constraints on the switching system which will limit the amount of actual switching should competition emerge, Skyplex proposed that NIAUR should examine implementing Proposal 1 in the Northern Irish retail market. As retail competition is more developed in Ireland including competition in the domestic sector. Skyplex's recommendation was that the Commission should implement Proposal 3, a Maximum Allowed Revenue (MAR) to be calculated on an ex post basis.

2.4.1 Maximum Allowed Revenue (MAR)

The Skyplex proposal for a MAR was described at a relatively high level. It proposed that there should be no compensation in year t for under or over recovery in year t-1 (or t-2). The MAR would be determined after the end of the tariff period in accordance with the revenue restriction formula in the licence or direction, as the case may be. The MAR would be determined to be the cost of energy purchases, priced at actual pool prices and known demands, plus a margin and an allowance (as now) for internal supply business costs. The proposal for a MAR is described in the formula below.

*MAR = (Energy Purchases (at outturn SMP) * Outturn Demand) + Margin + Supply Costs (determined by price control)*

Skyplex proposed that no allowance would be made for Contracts for Differences (CfDs), although the supplier is free to enter into Contracts for Difference if it believes these are favourably priced or should it consider that it is worth sacrificing margin for some reason. The time at which MAR would be determined was not viewed to be critical. Skyplex proposed that it should be late enough such that the required information is known to an acceptable degree of accuracy, but not so late that there remains uncertainty for the supplier as to whether it is deemed to have complied with its obligations.

Any under-recovery against MAR through pricing too low would be lost to the supplier. An over-recovery would be considered a breach of the MAR, and hence breach of licence or Commission direction. However this may be avoided by an ex-post discount to the suppliers' customers in their final bills for the relevant year. The PES would be given freedom to set its tariffs without recourse to regulatory approval. Finally, an adjustment would be made to the allowed margin so that the supplier would continue to be expected to recover its allowable revenues over the long term, notwithstanding the fact that it is not permitted to collect under-recoveries through k-factor adjustments.

The Commission has reviewed the details of the MAR recommended by Skyplex. The proposal was described at a relatively high level, and so this paper proposes how it would apply in detail.

3.0 Form of Price Control

3.1 Introduction

The Commission has stated its goal is to have in place fully competitive and deregulated markets in all segments of the electricity retail market. This is supported by policy coming from the EU, which purports that effective competition is likely to be superior to regulation and thus where markets are effectively competitive the replacement of end user retail tariff regulation is a desirable outcome. The Commission considers that a fully competitive retail market can bring real benefits to consumers in terms of the choice and quality of the offers available from suppliers, improved value-add services and potentially lower prices. However the Commission intends to keep regulation in place for market segments that do not meet the criteria for deregulation currently being consulted upon as part of the Commissions roadmap for the deregulation of the market.

The Commission proposes to retain regulatory control over those markets that are not deemed to be competitive for the following three reasons:

1. Consumer Protection
   To prevent a dominant undertaking (or collectively dominant undertakings) from extracting economic (monopoly) rents through excessive pricing.

2. Encouraging efficiency
   In the absence of meaningful competition, regulation can provide the right incentives for rewarding success and penalising failure. Thereby encouraging regulated entities to act efficiently and in the best interest of final customers.

3. Promotion of Competition
   Proper regulation prevents exclusionary prices that discourage efficient entry by setting retail prices too low in the short term. Through regulation the right market dynamics and price indicators can be put in place in order to encourage new, efficient market entrants.

The final decision on the criteria for deregulation coming out of the roadmap consultation and the subsequent competition review may result in all segments of the market deregulated either this October or in the not too distant future. However, where market segments are not deemed to be fully competitive the Commission must maintain some form of regulation in order to ensure that consumer protection, efficiency and the promotion of competition. In addressing how this should be done the Commission has considered a number of options as to the form of price control to adopt, taking into account the shortcomings of the previous price control, changing market dynamics and the recommendations coming from the 2009 review of K-factors and supply margins. This Section sets out the Commission's proposals.

3.2 Options

The Commission has considered a number of options. One option that has been considered is to maintain the *status quo*. This would involve maintaining the existing regulatory formula, and reflecting falling demand and diminishing customer numbers in the Kt-1 and Kt-2 k-factor adjustments. The shortcomings of the existing regulatory formula have previously been highlighted in this paper and therefore the Commission rejects the *status quo* because it does not sufficiently advance the price control process to take account of changing market conditions.

The proposal to set a maximum allowable revenue on an ex-post basis is a measure that promotes competition and brings the system of regulation closer to that of a deregulated market, minimising the impact of the k-factor. The following sections set out a proposal, with number of options, for how the regulatory formula for an ex-post MAR could be implemented for the period commencing October 1st 2010, for markets that continue to be regulated.

3.3 Customer Categories

The Commission proposes that the Regulatory Formula define a Maximum Allowed Revenue for each customer category. A customer category is a grouping of individual tariff classes. The current definition of customer categories for PES is illustrated in the table below:[8] Section 4 will set out each of the tariff elements in detail.

[8] See ESB Customer Supply Tariff Methodology Statement for Tariff Period 1st Oct 2009 – 30th Sept 2010.

ESB Customer Supply - Customer Tariff Categories

Customer Category	Main Tariff Category	Tariffs
DOMESTIC	Domestic Rural Domestic Urban	Domestic Urban 24Hr Domestic Urban N/S Domestic Rural 24Hr Domestic Rural N/S
SMALL BUSINESS	Residential Business Premises General Purpose	Res Bus Prem 24Hr Res Bus Prem N/S GP 24Hr NQH GP N/S NQH GP 24h QH GP N/S QH
MEDIUM ENTERPRISES	Low Voltage Max Demand Low Load Factor	LVMD (NQH & QH) LLF (NQH & QH)
PUBLIC LIGHTING & Miscellaneous Supplies	Unmetered Public Lighting Unmetered Single Point	Public Lighting - Unmetered PL - 24 Hour Public Lighting - Unmetered PL - Dusk to Midnight Public Lighting - Unmetered PL - Dusk to Dawn Unmetered Single Point
LARGE ENERGY USERS (LEUs)	10kV/20kV (MV) 38kV Looped 38kV Tailed 110kV	Pool Price Pass Through (PPPT) Individual & Group variants

4.0 Tariff Cost Elements

4.1 Introduction

Section 2 illustrated the current regulatory formula and while this paper proposes amending that formula, the key elements to the regulatory formula remain the same. Below is a list of the key elements and this section addresses how the Commission proposes treating each of these elements.

Elements of the Regulatory Formula

1. Wholesale Generation Costs
   - Energy Costs
   - Capacity Costs
   - Market Operators Costs

2. Network Charges

3. Supply Costs & Allowed Margin

4. Public Service Obligation Levy

$$MAR_{BY\ CUSTOMER\ CATEGORY} = \textit{Wholesale Generation Costs} + \textit{Network Charges} + \textit{Supply Costs} + \textit{Allowed Margin} + \textit{PSO Costs}$$

4.2 Wholesale Energy Costs

4.2.1 Allowed Cost of Energy

The portion of the price control formula addressing the allowed cost of energy is designed to remunerate PES for the costs of meeting the generation needs of PES customers. It is anticipated that PES will meet these needs in a number of ways ranging from purchases in the SEM spot market, to purchases of Directed- and Non-Directed Contracts and possibly through other financial instruments (e.g. fuel and foreign exchange hedges).

The Commission has two proposals for the treatment of the costs of energy in the control formula and is seeking comments from stakeholders on the appropriateness of each option.

4.2.1.1 Option 1 – No Allowance for Contracts for Difference

Under Option 1, no Contracts for Difference (CfD) costs would be included in the allowed revenue formula. The calculation of allowed revenue in this formula would be done purely by taking account of purchased power at a level equal to the outturn demand in each half hour during the tariff period multiplied by the outturn System Marginal Price (SMP). The calculation of the MAR would be done for each customer category that is still regulated. In other words all domestic customers would be grouped together, all GP customers, etc. The revenue control formula, as it would look under Option 1, is shown in the box below;

Energy $_{\text{BY CUSTOMER CATEGORY}}$ = (Outturn demand times outturn SMP) + Capacity + SEM Charges

If Option 1 were to be adopted there are potential consequences that could occur. If the Commission does not allow CfD costs to be included in PES tariffs, PES may be incentivised not to contract forward for their projected demand. Under Option 1 PES's least-risk supply strategy would be to purchase all customer needs at the SMP price. Whilst the policy would permit hedging on its own account, such hedging would effectively be speculation for PES. Therefore, we expect that the consequences of not providing an allowance in the price control mechanism for contracted quantities would include:

1. The introduction of greater spot price volatility to end-user tariffs

   PES would be allowed recover the SMP value of electricity purchased. Therefore their cost inputs would fluctuate in line with changes in the average SMP and in order for PES to keep their tariffs cost reflective they would need to adjust their retail tariffs on a more regular basis. – The more volatile the wholesale markets, the more often retail tariffs would need to change.

2. The removal of a large buyer from the forward contracting market

   The Commission sees two potential outcomes for the impact of reduced PES participation in the forward contracting market. Firstly the absence of PES as the main purchaser of forward contracts could mean that other suppliers would have greater opportunities to purchase forward contracts, particularly if the volatility of a SMP-driven PES tariff were to cause customers to migrate from the PES tariff to other suppliers' retail offerings. In this case, there could be a positive effect on market liquidity for other electricity suppliers.[9] However,

[9] Note that the liquidity in the Irish forward CfD market is currently driven by hedgers. There is little or no activity by speculators to add liquidity to the market. The analysis here therefore focuses on the activities of hedgers.

customer inertia, at least in the small customer market segments could limit migration away from the ESB PES tariff. If a large amount of load remains on the ESB PES tariff and ESB PES is not incentivised to hedge and thus not covered by forward contracts, the overall activity in the forward market could be reduced. Since a robust market for hedge contracts facilitates the efficient functioning of the competitive supply market, the Commission seeks to avoid regulatory structures that limit liquidity in that market.

4.2.1.2 Option 2 – 50% Allowance for CfDs

Under Option 2, CfD costs would be included in the allowed revenue formula at a contract cover level equal to 50% of PES' projected demand. PES would be free to design a portfolio of fixed-price, fixed-quantity baseload, mid-merit and peak contracts that fulfil the potential to cover 50% of its projected demand on an energy (GWh) or peak demand (MVA) basis. The Commission anticipates that PES will perform its own analyses of the price risk associated with the regulated customers' loads. Based on those analyses, PES will be expected to optimise the hedge portfolio in accordance with its regulated load obligations and its assessment of price risk in the SEM. The Commission will grant considerable deference to the portfolio choices made by PES so long as the PES is able to demonstrate consistency with the target objective of hedging up to 50% of regulated loads and meeting its Economic Purchase Obligation.

For example, if the hedge portfolio identified by PES for regulated customers is below the 50% target on an energy basis, but greater than 50% of the projected peak demand, PES may justify the portfolio as compliant with a hedge target of up to 50% on an energy basis. PES may wish to use a peak demand target for certain seasons of the year, and an energy target for other seasons. This would also be permitted.

Recognising that load forecasts can change frequently, the question arises as to the timing of the forecast used for determination of the 50% target contract cover. The Commission proposes that the forecast demand be calculated at the time of the CfD auctions (Non Directed Contract Auctions), so that the contract level is in line with load expectations at the time the contracts are entered into. The Commission proposes that PES submit its forecast demand for the regulated tariffs in advance of the first DC/NDC auctions at which time the Commission will undertake its own forecast to check the reasonableness of the PES submission (and checking its consistency with other forecasts used in setting prices such as the demand forecasts underlying the transmission and distribution use of system charges). Stakeholders are invited to give their opinion on this proposal.

The allowed revenue formula would recognise the full cost of this contracted power, and would price the residual PES' demand at outturn SMP. This allows the price control to track directly the purchased power costs of PES:

Energy $_{BY\ CUSTOMER\ CATEGORY}$ = (Purchases (contract at 50% of projected demand plus residual demand at outturn SMP) + Capacity + SEM Charges

Directed Contracts (DC) are offered to suppliers each year and the quantity of hedges offered to each supplier is based on their customers' MIC on 1st April. This is calculated by the RAs using the accumulated demand total of each customer category (defined by Distribution Group) in each quarter. In the 2010 DC allocations PES will be offered a certain amount of DC hedges based on the MIC of all their customers – regulated or not. The Commission is proposing to allow PES the flexibility of determining which DC contracts PES enters into will be attributed to regulated customer categories for the purposes of the regulated revenue control. Immediately following the DC auctions, PES will be required to provide to the Commission a list of those contracts that were entered into on behalf of regulated customers. When the MAR is set for regulated customer categories, only those DCs that were identified by PES at the time of the auctions will be considered in the allowed revenue formula.

To the extent that PES wishes to rely on other types of financial hedge contracts (fuel, foreign exchange), it will be required to give the Commission notice prior to hedge execution of the type of hedge contracts it intends to rely upon. Further, in order to have the hedge contract costs included in the allowed revenue formula, it must demonstrate to the Commission within one week of contract execution that the contracts selected and entered into do indeed further the objective of hedging 50% of ESB PES forecast regulated load obligations. A foreign exchange hedge would need to be associated with another hedge (*e.g.*, power or fuel) that is denominated in a currency other than the Euro. All hedges would need to be tied back to PES' load forecast, either to meet energy requirements (GWh) or peak demand requirements (MVA).

Any hedges that PES enters into that the Commission is not informed of within one week will not be considered when the MAR is calculated, even if that means that the volume of hedges included in the MAR is below the 50% level. PES would be free to hedge above the 50% level, but should they do so, for the purpose of calculating the MAR, the Commission will take into consideration the hedges in date order. Should PES purchase a hedge that takes them above the 50% then the MAR will take into consideration the portion of that hedge up to the threshold. For example, if PES have informed the Commission of hedges accounting for 48% of forecast GWh demand and subsequently enter into a single hedge contract for a further 4% then only 2% would be considered in the MAR calculation.

Hedges need only be specified by PES for the *aggregate* regulated load, as projected by PES on an *ex ante* basis. Hedge contract costs or benefits will not be attributed to individual customer classes and categories until the Commission undertakes its *ex post* allowed revenue control. Where hedges are entered into on behalf of a customer class that is regulated at the time of the CfD auctions but becomes deregulated prior to the *ex post* allowed revenue control, all hedge contract costs or benefits will accrue to those customer classes which remain regulated at the time the *ex post* allowed revenue control. Hence, there will be an implicit reallocation of hedge contract costs or benefits from the recently deregulated customer category to the remaining regulated customer categories. This is appropriate, as the ownership of gains or losses related to hedges entered into by PES, in its role as a regulated provider of electricity, should remain with regulated customers.

PES will be required to demonstrate that hedges identified for regulated customers comply with its Economic Purchase Obligation.

Determining the Contract Price and Cost Allocation

While the formula above sets out the basis for the calculation it does not address how the allowed contract value would be calculated at the individual tariff level. We propose that the contract costs be pro-rated based on loads for each customer class in each half hour. In other words, if the contract quantity were 500 MW for that half hour, and one class has 10% of the total PES load in that half hour, that class would be assigned 50 MW of contract supply in that half hour. Outturn demand would be used to assign contract costs to different customer classes. This is illustrated in the table below for a hypothetical contract and three hypothetical customer classes.

Once the contract costs have been determined for each individual customer class, they will be aggregated for the purpose of defining the MAR at the customer category level. That is, the allowed contract costs for a customer category will be the sum of the allowed contract costs for the individual customer classes within that customer category.

Baseload Contract Struck at €50/MWh 100 MW						
Half-Hour Ending	Customer Class 1 Outturn Demand	Customer Class 2 Outturn Demand	Customer Class 3 Outturn Demand	Customer Class 1 Allocation	Customer Class 2 Allocation	Customer Class 3 Allocation
00:30	50	100	50	25 MW @ €50/MWh (25 MWh) residual at SMP	50 MW @ €50/MWh (50 MWh) residual at SMP	25 MW @ €50/MWh (25 MWh) residual at SMP
01:00	60	100	40	30 MW @ €50/MWh (30 MWh) residual at SMP	50 MW @ €50/MWh (50 MWh) residual at SMP	20 MW @ €50/MWh (20 MWh) residual at SMP

It is ESB PES' current practice to shape contract costs in each half-hourly period to reflect the shape of the SEM half-hourly price curves prior to attributing contract costs to customer tariffs[10]. The Commission seeks input from interested parties as to whether the allocation of contract costs to customer tariffs would benefit from shaping the flat prices for baseload, mid-merit and peak CfDs. The Commission expects that the approval of either method will permit PES to rely on its existing tariff systems and models to attribute contract costs to the various customer classes.

The Commission, in conjunction with NIAUR, will continue to publish details of both PES's purchases in updates on the annual contract rounds. These updates will provide information on contracted levels for regulated tariffs only.

Q1. The Commission's proposed decision allows for pass through of hedge contract settlements at a 50% hedge target. Are you in favour of allowing CfD prices to be reflected in PES tariffs?

[10] See ESB Customer Supply Tariff Methodology Statement for Tariff Period 1st Oct 2009 – 30th Sept 2010 – CER09168.

Q2. Is a hedge target of 50% of forecast PES load a reasonable amount of contract cover? If not, what level do you think is appropriate?

Q3. The Commission's proposed decision allows PES to define a set of contracts to meet the hedge target of 50% of forecast PES load on an energy and/or capacity basis for regulated customers. Are you in favour of the Commission's proposal to allow PES the flexibility of combining base load, mid-merit and peak contracts to create a portfolio that meets the 50% target for regulated customers?

Q4. It is ESB PES' current practice to shape contract costs in each half-hourly period to reflect the shape of the SEM half-hourly price curves prior to attributing contract costs to customer tariffs. Are you in favour of this practice?

4.2.2 Capacity Payments

The capacity payment mechanism is in place in the SEM in order to provide a degree of financial certainty to generators and to incentivise investment in sufficient generation plant to meet current and future electricity demand. The mechanism allocates an amount of money (the Annual Capacity Payment Sum) determined prior to the start of each year into monthly amounts and is paid to generators based on their availability in each half-hour[11].

These capacity payments are recovered via capacity charges levied on each supplier according to their demand. Currently capacity charges are allocated to all ESB PES customers, regardless of tariff category, on the same €/MWh basis (at the trading point) in each trading period. The overall capacity charge for each customer will depend on the overall demand profile for that customer i.e. the level of demand and the coincidence between the customer's demand and the system demand. As with the SMP costs, the actual cost of capacity in each trading period (in €/MWh) is not finalised until ex-post, and PES forecasts the cost curve for input to tariff-setting.

Under the ex-post review, PES will estimate its capacity payments for the tariff period according to the overall pot and its forecast demand. The allowed revenue formula will recognise the full cost of capacity payments needed to serve the load of PES' customers. The regulatory formula will calculate the allowed capacity payment on an *ex post* basis in accordance with the SEM Capacity Payment Mechanism and ESB PES outturn demand.

[11] www.allislandproject.org

4.2.3 SEM Charges

SEM charges consist of Market Operator (the costs of operating the pool market) and Imperfection charges (which include transmission congestion charges and currency charges) which are calculated on an all-island level. These costs apply to all suppliers in the market are fixed on an annual basis and allocated to customers on a demand (i.e. per MWh) basis.

Under the new price control any SEM charges or fees that are imposed on PES will be recoverable through the price control.

4.2.4 Error Supplier Unit

ESB PES is currently designated as the Error Supply Unit (ESU) and it picks up the jurisdictional balancing volumes caused by errors in the systems based on profiling, theft etc. The energy and capacity obligations assigned to the PES in the SEM are calculated as a residual. The SEM begins with total aggregate metered demand for the RoI and subtracts the loads of independent suppliers to arrive at the load attributable to PES. Hence, the loads attributed to PES differ from the loads that would be computed pursuant to approved profiles and aggregated half-hour meters.

This difference, termed "unaccounted for energy", will be recognised in the price control, and PES will recover (or rebate) the costs (or benefits) of unaccounted for energy. The difference will be calculated as follows. SEM load obligations for PES will be calculated for each half hour using meter data, published customer profiles and published loss factors. This imputed PES load obligation in each half hour will be compared to the load obligation imposed on PES by the SEM. The kWh difference in load obligations in each half hour will be multiplied by the outturn SMP for the corresponding half hour. These values will be aggregated over the tariff period, to get an aggregate MAR adjustment for all customer categories.

The total MAR adjustment will be allocated to the MAR for individual customer categories on a pro rata basis, using outturn kWh demand for each customer category during the tariff period. For the sake of clarity, if PES makes sales to a customer category that has been declared competitive and to which a MAR does not apply, there will be no allocation of the residual load to PES customers in such categories. The Commission is considering this matter further to determine is there is a fairer mechanism that can be applied for the recovery of these amounts.

4.3 Network Charges

The network charges are the energy transportation costs associated with transporting energy from the point of purchase (trading point) to point of sale (customer point). Costs arising from the use of the transmission and distribution networks follow from the regulatory approved tariffs i.e. the Transmission Use of System Charges (TUoS) and the Distribution Use of System Charges (DUoS) which are published annually in advance of tariff setting.

PES will be allowed to recover the network charges applicable to PES customers based on the rates published in the DUoS and TUoS decision papers. For most customer categories, these include both TUoS and DUoS charges.

A key factor in determining DUoS and TUoS charges for each customer class has been the estimation of how much of the class usage occurs during the day and how much occurs at night. In this regard, PES has previously relied on the day-night usage split from its historical settlement data for each customer class to forecast network charges. Under the new structure the allowable TUoS and DUoS charges will be determined on an *ex post* basis in accordance with outturn demand.

4.4 Supply Costs & Allowed Margin

4.4.1 Internal Supply costs

Early in 2005, the Commission undertook to develop a revenue control to apply to the supply businesses for the next 5-year period, from 2006 to 2010. This involved a thorough analysis of PES's costs of supplying electricity to customers over this period. Given the recent changes in market conditions and pending outcome of the roadmap process the Commission is proposing to put in place a two year price control.

A review of PES's allowed supply costs for the 2011-2012 period is presently underway, with a Consultation paper anticipated in May and final Decision in July. This review will set out allowable costs and the methodology for allocating these costs to the different customer segments. PES will be permitted to recover an efficient level of internal supply costs. These will include the OPEX and CAPEX costs associated with the PES business. As in prior price controls, PES will submit these costs to the Commission for approval in advance of the tariff period.

Currently, PES relies on a cost-of-service model to attribute allowed internal supply costs to different customer tariffs and customer category. The Commission proposes to continue this practice, and does not anticipate that ESB

PES will be required to make any material changes to its current modelling approach and cost allocation practices. When apportioning costs to the regulated and deregulated customer categories for the purposes of the allowed revenue formula, however, ESB PES will be required to use outturn demand as an input to the Cost-of-Service model.

Note that it is possible one customer category may become deregulated during the tariff period. If the deregulation of a customer category occurs and PES loses customers in that customer category, the amount of PES supply costs that will be borne by customers in that category will be reduced due to the lost load – it is, after all, outturn demand that drives the allocation of supply costs across customer categories. In this case, the remaining regulated customers will bear a greater portion of PES' supply costs than they would have had PES maintained customers in the newly deregulated customer category.

The Commission believes that such an outcome is reasonable and appropriate in light of the public service obligations placed upon PES, and its unique position in the market. PES should and will be granted an opportunity to recover an efficient level of supply costs from its customer base, however big or small. Further, if migration away from the PES tariff is sufficiently great, this will push up costs (and hence tariffs) for remaining regulated customers to a level that is likely to trigger entry by other retail suppliers. This in turn would likely lead to a deregulation of all customer categories.

4.4.2 Allowed Margin

PES was allowed a margin on PES sales of 1.3% in the context of the 2006-2010 price control. This margin was designed to reflect the risks faced by PES in its role as PES during that time period. The two-period k-factor regime in place during that price control period limited to a large degree the load and price risks faced by PES.

Studies carried out by NERA that benchmark profit margins for regulated supply entities against unregulated firms with similar business models showed that the latter will typically achieve sales margins that are in the region of 5%. Under the Commission's proposed price control, however, PES will be subject to more risk and less k-factor protection. One option to address this is to increase the allowed margin on sales. This could be set to 2%, the same level of margin currently allowed for the Large Energy User Pool Price Pass Through Tariff (PPPT). Section 6.5 discusses the level of allowed margin further and outlines the margin proposed under each of the two options for treatment of over or under-recoveries.

Under the 2006-2010 price control the 1.3% margin is calculated based on external turnover. Under the current proposal the allowed margin will be applied to outturn costs on an *ex post* basis. Outturn costs are calculated from outturn demand, outturn SMPs, capacity costs, network and SEM charges, and PSO costs.[12] The exception is supply costs, where allowed supply costs are included in the calculation of "outturn" costs, in order to keep PES's incentive to achieve efficiency and control its supply cost.

4.5 Public Service Obligation (PSO)

The PSO levy is charged to all electricity customers and is designed to recoup the additional costs incurred by ESB and other suppliers in meeting their obligations to purchase electricity from sustainable, renewable, and indigenous sources pursuant to the relevant support schemes. The Commission calculates the PSO annually and notifies all relevant parties of the level PSO levy each year in accordance with section 39 of the Electricity Regulation Act 1999 (the Act), (Public Service Obligations) Order 2002 (SI 217 of 2002) as amended.

- For domestic customers, the PSO levy is a fixed charge per customer basis
- For small commercial customers with an MIC < 30kVA, the PSO Levy is charged on a fixed cost per customer basis.
- For medium and large customers with an MIC > 30kVA, the PSO Levy is charged per kVA.

The proposed price control formula will permit the pass through of PSO costs. The PSO applied as a separate line item on customer bills and therefore will not be a feature of the tariff recalculation.

[12] Included in energy and capacity costs are costs associated with SOLR and unaccounted for energy.

5.0 PES Obligations

5.1 Introduction

SI 60 set out obligations on PES and these are implemented through the PES licence. SI60 requires that the Commission reviews and approves tariffs and the change to an ex-post regime proposed in this paper will require the SI 60 to be amended and therefore is subject to Ministerial approval.

ESBCS will continue to have specific obligations with respect to its position as the PES. These include the obligation to purchase economically in order to obtain value for customers, to act as the Supplier of Last Resort in the event of another supplier leaving the market and also as the default supplier with a Universal Service Obligation. The continued requirements with respect to these obligations are discussed below.

5.2 Economic Purchase Obligation

Under condition 9 of its licence, ESB PES is subject to an economic purchase obligation (EPO). The purpose of the EPO has been to ensure that PES, in the absence of effective competition which would sufficiently constrain any possible monopolist behaviour, purchase their energy requirements and enter into associated financial hedging in a manner which should;

(a) Obtain the best value for customers
(b) Provide stability and price certainty for final customers
(c) Procure electricity in a fair, open and transparent manner

The EPO currently applies to CfDs and any other hedging arrangement considered by PES. As part of its licence condition PES publishes a general Hedging Policy Statement annually. In addition, the Commission approves a detailed Hedging Methodology Statement and Bidding Strategy.

From 1st October 2010, the Commission proposes that where an allowance is made in the regulated revenue for the purchase of CfDs and other hedges, the EPO will continue to apply. If Option 1, 0% allowance for CfDs, is selected, then the nature of the EPO will change.

If Option 2, as set out in the previous section, is introduced for the calculation of allowable energy costs, 50% allowance for CfDs, is selected, then the Commission would need to approve the set of CfDs that PES selects to meet the target 50% contract cover. PES will be required to demonstrate that these identified hedges comply with the EPO. Therefore the EPO would still apply, but would be amended. PES would still be required to obtain the best value for customers and procure electricity in a fair, open and transparent manner, but the requirement to provide stability and price certainty for final customers would be reviewed as this may be inconsistent with the increase in the degree of pricing flexibility PES is allowed.

5.3 Supplier of Last Resort ("SOLR") Costs

Recognising that PES is the Supplier of Last Resort, the formula proposed by the Commission allows for the full recovery of the costs of serving Supplier of Last Resort load. Should another supplier exit the market and that supplier's load fall on the PES, PES will be granted full recovery of the costs of serving that load. This includes energy at outturn SMP, capacity, TUoS and DUoS, margin, internal supply costs, and PSO in accordance with outturn SOLR loads.

The role of SOLR has traditionally been fulfilled by the PES, however this role has been offered to others suppliers in the past and the Commission will also seek expressions of interest in the future.

5.4 Universal Supply Obligation

PES has a Universal Service Obligation (USO) as set out in Section 18 of SI 60 of 2005 which states that "the public electricity supplier shall meet all reasonable requests to supply electricity" and that "the Commission may specify the terms and conditions under which a request to supply electricity may, as respects a customer or a group or class of customers, be considered to be unreasonable". Condition 8 of the ESB PES licence further confirms this obligation.

In practice this obligation means that PES has a duty to meet all requests for supply on the tariffs and standard terms and conditions approved by the Commission under licence. The USO continues to apply and as such the costs arising from meeting this are recoverable through the tariffs or an alternative mechanism to be agreed with the Commission.

6.0 Regulatory Processes

6.1 Introduction

The change in the regulatory formula and move to an ex-post review constitutes a major shift in the current regulatory processes, enabling the PES to change its tariffs in line with changing markets conditions, in order to stay cost reflective. As part of this proposed approach, the Commission envisages that the regulatory process for setting and monitoring tariffs will have the following four elements. Although it does represent a major shift in the regulatory processes, the Commission does not anticipate that it will require PES to go out and acquire new accounting systems or new tariff models. It is expected that PES will be able to rely on its existing systems and models to implement the new regulatory arrangements.

6.2 Ex Ante Approvals

Although the Commission will not perform a formal detailed *ex ante* review of PES' tariffs, PES will be required to demonstrate that they are setting tariffs, for each customer category, in line with the revenue formula based on projections for demand, SMP, contract cover at the time tariffs are set. As discussed, the Commission recognises that this will require an amendment to Section 3 of S.I. 60 of 2005[13] and will liaise with the Department of Communications, Energy and Natural Resources to examine this.

In relation to the cost of energy, if option 1 is introduced, all allowable costs are assessed ex-post. If Option 2 is pursued, PES would also be given an opportunity to specify a set of hedge contracts that meet the objective of covering 50% of its projected demand on an energy and/or capacity basis. As discussed, PES would be free to design a portfolio of fixed-price, fixed-quantity baseload, mid-merit and peak contracts that fulfil the potential to cover 50% of its projected demand. (Or as set out in Section 4, the Commission will consider other types of financial hedge contracts, providing PES give notice prior to hedge execution of the type of hedge contracts it intends to rely upon). These contracts would be subject to the EPO and along with the projected demand for each customer category would be vetted by the Commission. Once vetted, the contracts would be considered as part of the MAR. Following each CfD auction, PES will declare those contracts that were entered into to meet the 50% hedge target for regulated customer segments.

PES will be required to demonstrate to the Commission, prior to changing any tariffs that they are reasonable and cost reflective. The ex ante review will be

[13] S.I. No. 60 of 2005

conducted by the Commission, stakeholders will however have an opportunity to comment on tariffs in a consultation held with regards to the ex post tariff review. The Commission would like to emphasise that Condition 7 of the PES supply licence[14] pertaining to the prohibition of discrimination of supply will still apply to PES tariffs when they are being set ex ante.

6.3 Within-period Data Provision

PES must set tariffs to recoup revenues in line with the forecast MAR. Section 6.5 outlines that a there will be +/-3% band around the forecast MAR within which PES forecast revenues must stay. If revenue forecasts fall outside that 3% band then PES must alert the Commission and adjust tariffs to bring revenues back in line. Outside of this requirement to keep revenues cost reflective, PES will have the freedom to change tariffs as they see fit during the period, but an alternative to this could be to impose a limit of four tariff changes per year. That said, whenever PES elects to change the PES tariffs within the period, it will be required to provide the Commission with *prima facie* evidence to support the change. While the Commission will monitor tariffs throughout the year, the PES is required to make necessary changes to the tariffs to ensure that tariffs are cost-reflective.

Under current arrangements, notification to customers of changes to regulated tariffs must be given four weeks in advance of the changes coming into place. The Commission intends to maintain the four week notification period. Therefore PES must notify the Commission of its intention to change tariffs in sufficient time to allow the Commission to review the necessary supporting documents. The Commission will not formally approve in year tariff changes, nor will there be a consultation process. Instead the Commission will conduct an informal review to sense check the proposed tariffs reasonableness.

In the review of the tariffs, the Commission will give considerable deference to the judgment of PES with respect to the market outlook. The tariff could be adjusted to reflect deviations that occurred in past months between the allowed MAR and actual costs, expectations of future market conditions and change in expected loads. It would be expected that the Commission would intervene only if there were indications that the PES was setting the tariff to game the regulatory arrangement, for example, by deliberately under-pricing for the initial part of the year and then sharply increasing prices in the last month or two when it would not be feasible for customers to switch en masse to competing suppliers. This behaviour will be easy to detect and the Commission would retain the authority to revise PES tariffs if this occurs.

14 Interim Public Electricity Supply Licence Granted to Electricity Supply Board - cer06073

Q5. The Commission is proposing that ESB PES have flexibility to set tariffs at the levels it deems appropriate. The CER would only intervene if it observed abusive pricing practices by ESB PES. Are you in favour of the Commission's proposal?

Q6. The Commission is also proposing to require ESB PES to adjust tariffs if outturn costs and revenues or forecast costs and revenues diverge by fixed threshold. Are you in favour of this approach, which would require ESB PES to change tariffs when they are no longer cost-reflective?

Q7. The Commission's proposed decision provides for asymmetric k-factor recovery outside of a tolerance band, while providing PES an opportunity to minimize any k-factors through pricing flexibility. Are you in favour of asymmetric recovery?

Q8. The Commission's proposed decision fixes the tolerance band at +/-3%. Do you believe that this is a reasonable range for the band? If not, what level do you think is reasonable?

6.3.1 Quarterly Reports

PES will be required to submit quarterly reports to the Commission stating its accrued over-recoveries or under-recoveries. These will show the over or under-recoveries by customer category and by month. In addition PES will be required to include in the quarterly reports their forecast revenue and cost position by customer category and month for to the end of the MAR. The Commission expects that such reports could be produced within one or two weeks following the end of the quarter.

6.4 Ex Post Review

At the conclusion of the 12 month MAR review period, the Commission will perform a detailed *ex post* review of PES' tariff revenues and the MAR formula.

For the purpose of carrying out this review, PES will be required to provide to the Commission with the below list as well as any additional data the Commission deems necessary.

- Actual revenues by tariff class by month;
- Contract details for DC, NDC and any other hedge portfolio (profile, quantity, price, delivery period);
- Loss factors;
- Outturn demand by half-hour and by tariff class;

- MIC data for any relevant tariffs;
- SEM Capacity charges by tariff;
- Outturn SOLR demand by half-hour and by tariff class;
- PSO by tariff class.
- Any SEM fees or other costs applied to PES;
- Unaccounted for energy attributed to the PES.

PES will be required to provide all the above data within two months of the end of the tariff period. The Commission will use this data to carry out a full review in order to determine the *ex post* Maximum Allowable Revenue for each tariff category. A full review will take place to ensure that the MAR is calculated in a clear and transparent manner and to gain stakeholder feedback on the process. It is the Commission's intention to have completed the review and issue a final decision within four months of the end of the MAR review period. This decision will set out the MAR for the tariff period and the treatment of revenues collected in above or below the MAR is discussed below.

Q9. The oversight process proposed by the Commission anticipates a limited ex ante review of PES tariffs, quarterly reports from PES to the Commission, a review by the Commission of any changes made to the tariff, and a detailed ex post review. Are you in favour of the Commission's proposal? If not, what alternatives would you propose?

Q10. Are the data sets that the Commission proposes to review in detail in its *ex post* review appropriate? If not, what alternatives would you propose?

6.5 Treatment of Excess / Deficit

There will inevitably be a difference between the revenues collected from customers in accordance with PES' *ex ante* pricing and the *ex post* revenues permitted by the revenue control formula. The following section sets out the Commission's proposals for how these differences will be treated. This is a crucial part of the Commission's overall proposal for interim regulatory arrangements and as such stakeholder's comments are sought regarding how excesses and deficits should be treated for regulatory purposes.

One of the Skyplex proposals was to apply k-factors asymmetrically. In other words, over-recoveries would flow back to customers whilst under-recoveries would be borne by PES. Although this approach has advantages, we must be sensitive to the incentives faced by PES. Faced with asymmetric cost recovery, PES would have an incentive to set its price at a relatively high level so as to maximise the likelihood it would over-recover and minimise the likelihood that it would under-recover. However, the Commission also notes that the incentive to assure over-recovery through high prices is tempered by competitive forces in the supply market. Should PES believe that pricing at a higher-than-forecast level will risk migration of its customers away from the PES tariff and to alternative suppliers, it would not price at that level.

The Commission also notes that for customer categories still under this proposed regulatory regime it is assumed that the competition review would have been carried out and found that sufficient levels of competition did not exist to warrant deregulation. Therefore the incentives created by competition to assure over-recovery through high prices is tempered may not be sufficiently developed. That said, if PES' prices were set high enough, entry would become attractive for other suppliers and the degree of competition in the market could change.

A symmetric cost recovery regime provides PES an incentive to forecast accurately and to price at its expected costs. The Commission therefore proposing a small tolerance band, and putting forward two options as to how excess/deficits within and outside the band are treated. These two options are set out in this section. Furthermore, it is worth noting that within-the-period pricing flexibility for PES should assure that large excesses and deficits do not accrue.

While the Commission prefers an approach that eliminates k-factors, the retention of a tolerance band in concert with an asymmetric k-factor for over- or under-recoveries outside the band makes sense as a transitional tool, particularly when PES has pricing flexibility and incentives to keep prices at the cost-reflective level.

The band proposed is +/-3% around the ex-post allowed revenue figure. The band was calculated in consideration of expected volatility of PES costs over the course of the year, assuming that PES would be free to update rates on a regular basis when the tariff revenues become poorly aligned with PES' costs. We note that the main driver of cost volatility is volatility in spot market purchases. If one considered spot purchases alone, 3% would potentially result in overly frequent occurrences of outturn costs outside the tolerance band. However, total cost volatility is reduced by the following factors, which collectively make 3% a reasonable choice:

> a) the CER is proposing to include 50% CfD contract cover in the allowed revenue formula - this effectively reduces spot price exposure by half[15];
>
> b) energy purchases themselves are about 60-70% of total costs, with network charges and supply costs representing the other 30-40%. Network charges and supply costs are far more stable than energy purchases; in practice, short-term total cost variability is therefore nearly 30-40% less than short-term energy volatility;
>
> c) we anticipate that PES would be able to re-set tariffs as required over the course of the year if forward-looking costs expectations continued to deviate from each re-set tariff level. While the difference between outturn costs and revenues may be positive in one tariff sub-period, it may be negative in subsequent sub-periods. Because only the net outturn over the full tariff period determines if PES is inside or outside of the tolerance band, the independence of deviations over multiple tariff re-sets further reduces the volatility of the expected over- or under-recoveries.

While the Commission believes +/-3% is a reasonable band in light of the volatility of PES' underlying costs, we seek input from stakeholders as to whether they believe is set at the right level. Note the tolerance band is set as a percentage above and below the maximum allowable target revenue for a given customer category, as determined by the CER in an *ex post* review. There is one tolerance band based on the total maximum allowable revenue; there are not separate tolerance bands for the separate cost components. This means that, for example, an over-recovery of energy revenue could be cancelled by an under-recovery of network charges.

As mentioned out above, the Commission is putting forward two options for the treatment of over or under recoveries within and outside the band. In these options the Commission has considered the potential factors that might encourage PES to over or under recover in a period. Due to the fact that customer categories not deregulated under the roadmap will have been deemed not to be fully competitive, the incentives created by competition to assure over-recovery through high prices is tempered may not be sufficiently developed. However the Commission is of the view that the possibility of the large scale

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[15] In practice this may be somewhat less than half, as the CfDs do not hedge against load variations, and the price-load correlation is quite strong.

migration of customers away from PES should tariffs be over-priced will act as a deterrent from over-recovery. The Commission has also considered the potential incentive for PES to under- recover in order to attract customers and deter competition. Therefore bearing these factors in mind the Commission is proposing the following two options for the treatment of excess / deficits calculated in the ex post MAR and is seeking input from stakeholders as to which of the two (or combination of) they believe is the most appropriate.

Option 1

Under option one there are the following four scenarios for the treatment of over or under-recoveries within and outside the 3% band;

Scenario 1- If PES over-recover, but the collected revenues are within the 3% band then the excess of collected revenues over the MAR are applied as a reduction to the following years MAR.

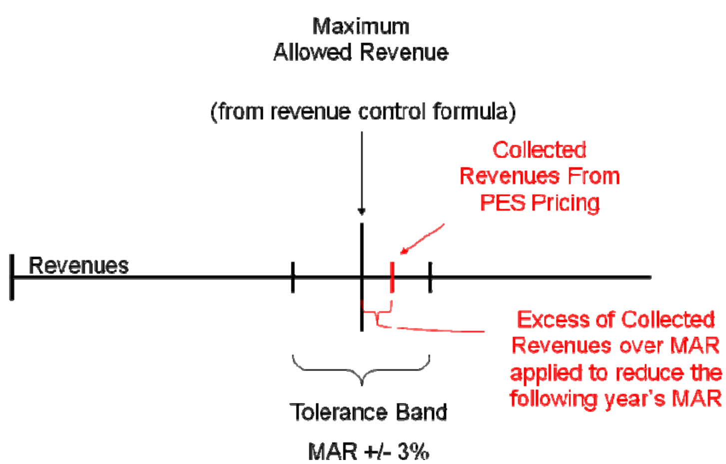

Figure 6.1 Option 1, Scenario 1

Scenario 2- If PES under-recover, but the collected revenues are within the 3% band then the shortfall of collected revenues under the MAR are applied as an increase to the following years MAR.

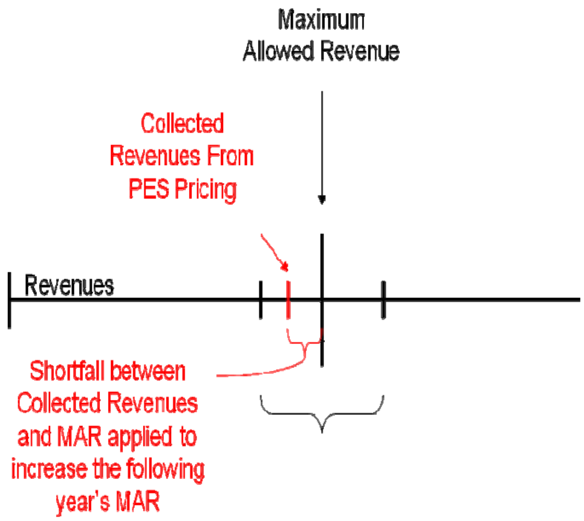

Figure 6.2 Option 1, Scenario 2

Scenario 3- If PES over-recover and the collected revenues are above the 3% band then the excess of collected revenues over the MAR are applied as a reduction to the following years MAR.

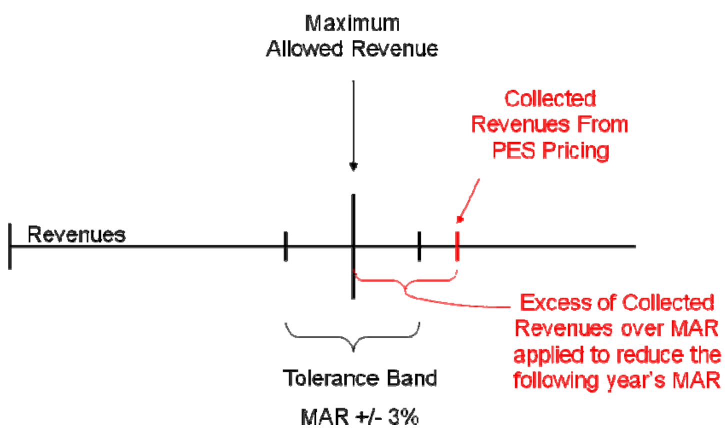

Figure 6.3.Option 1, Scenario 3

Scenario 4- If PES under-recover, but the collected revenues are below the 3% band then the first 3% of the shortfall of collected revenues under the MAR are applied as an increase to the following years MAR, but any shortfalls beyond 3% are lost to the PES.

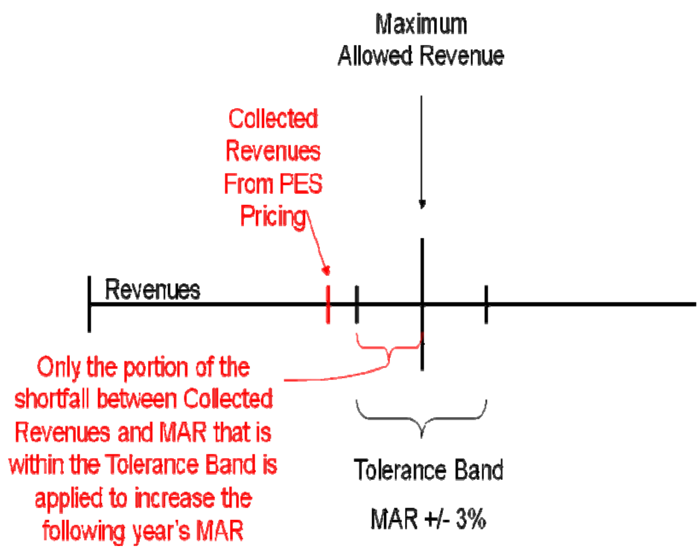

Figure 6.4 Option 1, Scenario 4

Under option one PES would be allowed a 2% margin in line with the additional risk outlined in Section 4.4.2.

Option 2

Under option two there are the following four scenarios for the treatment of over or under-recoveries within and outside the 3% band;

Scenario 1- If PES over-recover, but the collected revenues are within the 3% band then the excess of collected revenues over the MAR are retained by PES.

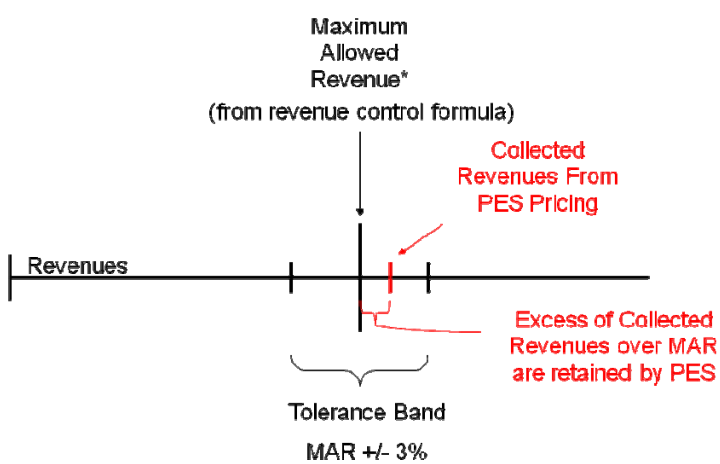

Figure 6.5 Option 2, Scenario 1

Scenario 2- If PES under-recover, but the collected revenues are within the 3% band then the shortfall of collected revenues under the MAR are applied as an increase to the following years MAR.

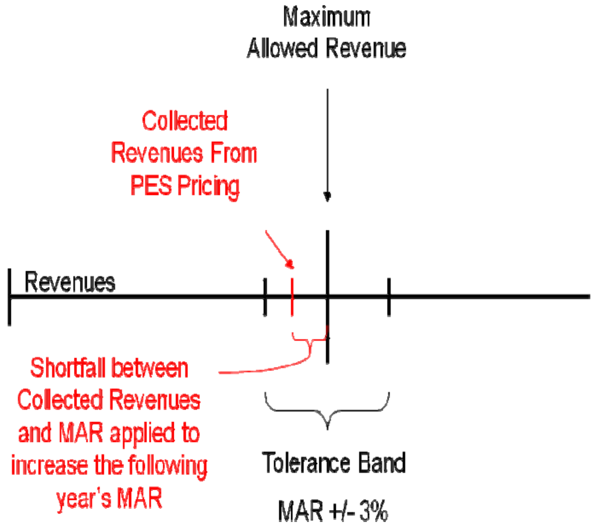

Figure 6.6 Option 2, Scenario 2

Scenario 3- If PES over-recover and the collected revenues are above the 3% band then the first 3% of the excess of collected revenues above the MAR are retained by PES, but any excess beyond 3% are applied as a reduction to the following years MAR.

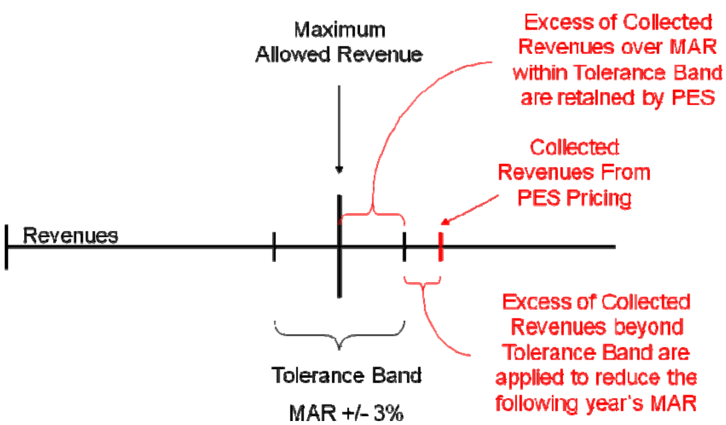

Figure 6.7 Option 2, Scenario 3

Scenario 4- If PES under-recover, but the collected revenues are below the 3% band then the first 3% of the shortfall of collected revenues under the MAR are applied as an increase to the following years MAR, but any shortfalls beyond 3% are lost to the PES.

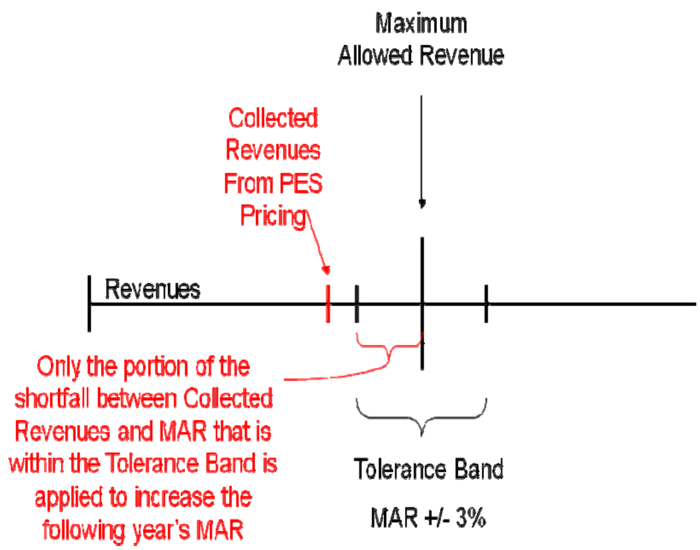

Figure 6.8 Option 2, Scenario 4

The Commission anticipates that it will take several months following the end of the tariff period to complete the *ex post* review based on final settlements in the SEM. The adjustment to future period MAR would therefore be made public as of January following the end-September close of the MAR review period.

The Commission is proposing that Option 2 is adopted, where, if PES over-recover and the collected revenues are above the 3% band then the first 3% of the excess of collected revenues above the MAR are retained by PES, but any excess beyond 3% are applied as a reduction to the following years MAR. Given that this approach strongly incentivizes PES to set tariffs to recover a revenue within 3% above the MAR the Commission's proposal is to keep the margin at its current 1.3% level.

Q11. The Commission's proposed decision provides that differences between *ex post* allowed revenues and revenues collected from customers be applied to future period MARs. This means that the tariffs for future periods will carry over a small amount of prior period k-factors. Are you in favour of the Commission's proposal to apply differences to future period MARs? Would you favour a one-time charge or credit? Would a one-time charge or credit be administratively feasible?

Q12. The Commission proposed a tolerance band of +/-3% as a measure for the treatment of over- or under-recoveries. This is proposed as a transitional tool, giving PES pricing flexibility and incentives to keep prices at the cost-reflective level. Do you think the 3% is appropriate? If not, why not?

Q13. Would you be in favour of an alternative treatment of over-recoveries that allows PES to retain revenues in excess of MAR within the 3% tolerance band? If so, why or why not?

7.0 Conclusions and Next Steps

7.1 Introduction

The Commission has set out proposals with a number of detailed options for the price control that will apply to regulated markets from 1st October 2010. The Commission's preferred approach is summarised in the next section.

7.2 Summary of Commission Proposed Decision

The Commission preferred choice is to adopt Option 2, in relation to the purchase of wholesale energy. The formula below sets out the maximum revenue that the PES can earn in a given year.

$$MAR_{BY\ CUSTOMER\ CATEGORY} = \text{Wholesale Generation Costs} + \text{Network Charges} + \text{Supply Costs} + \text{Allowed Margin} + \text{PSO Costs}$$

If the above MAR formula is adopted the Commission is requiring that PES would have the following obligations.

<u>Reporting</u>

- PES will be required to demonstrate that they are setting tariffs, for each customer category, in line with the revenue formula based on projections for demand, SMP, contract cover at the time tariffs are set.
- During the year the PES is free to change its tariffs.
- PES will be required to monitor actual costs and revenues and changes in demand, revenue and cost forecasts to assess its position with respect to a 3% tolerance band about the forecast of the ex-post allowed revenue figure.
- PES will be required to submit quarterly reports to the Commission stating its forecast revenue position with respect to the forecast of the ex-post allowed revenue figure.
- Where the PES triggers a tariff change, it will be required to report to the Commission, justifying the change based on changes actual and/or forecast demand and SMP.

<u>Within Year Correction</u>

- Where demand / SMP deviates from forecasts and PES moves outside of the +/-3% tolerance band it must take corrective action by implementing a change in tariffs.

- Where the PES determines that it will under recover at year end it should increase tariffs to bring forecasts revenues back in line with the ex-post allowed revenue based on forecasts at that time. If it does not, it risks facing a large loss.

- Changes can happen as often as is required during the year i.e. a further fall in overall demand, customer losses through increased competition or fuel price volatility will result in more frequent changes. Although the Commission notes that the time to allow for submission to the Commission and customer notification will limit the number of changes that can happen in practice.

<u>Over/under Recovery</u>

- This should result in the PES being suitably incentivised to keep tariffs cost reflective.

- PES will forfeit any under recovery outside the band at year end.

- If PES over-recover and the collected revenues are above the 3% band then the first 3% of the excess of collected revenues above the MAR are retained by PES, but any excess beyond 3% are applied as a reduction to the following years MAR.

- PES maintains the current 1.3% margin.

The terms of the proposed MAR formula are summarised in the table below, together with the proposed treatment of any over-recovery or under-recovery relative to the maximum allowable revenue.

Cost Component	**Determination of Allowed Revenue**	**Treatment of Over-recoveries**	**Treatment of Under-recoveries**
Allowed Cost of Energy	*Option 2: CfDs at 50% contract cover, residual at ex post SMP*	Option 2 Tolerance band. . Over-recoveries within the 3% band retained by PES. Over recoveries above the band returned to customers via a decrease in the following periods MAR.	Option 2 Tolerance band. Under-recoveries within band charged to customers via an increase in the following period's maximum allowed revenue. Outside of band, absorbed by PES.
Capacity Payment	*Ex post* cost		
Margin	1.3 percent. Applied on an *ex post* basis to the aggregate allowable costs (i.e., SMPs, DUoS and TUoS costs, etc.		
Internal Supply Costs	Fixed euro value approved by CER. Expressed as per kWh charge based on *ex post* outturn demand.		
Network Charges	*Ex post* cost		
Supplier of Last Resort Energy and Capacity	Energy at *ex post* SMP Capacity at actual cost	All over-recoveries returned to customers via a decrease in the following period's maximum allowed revenue.	All under-recoveries charged to customers via an increase in the following period's maximum allowed revenue.
Public Service Obligation	*Ex post* cost	None. Separate line item on bill.	None. Separate line item on bill.

Through the consultation paper on the roadmap for deregulation the Commission is undertaking a full review on the circumstances under which price controls should be removed from PES. A key component of this process is to consider the approach under which elements of the PES business that do not meet the necessary criteria for deregulation will continue to be regulated.

This consultation paper is part one of the Commissions two part approach to the review of how PES is regulated over the coming two year period. The Commission expects to have concluded the consultation process and published a final decision paper by end April in order for all market participants to have full knowledge of how PES will be regulated from 1st October 2010.

The second consultation paper will set out the allowed revenue for the PES business from 1st October 2010. The Commission has engaged independent consultants to assist in the assessment of PES's OPEX and CAPEX for the period. A consultation paper will be published in May with a final decision paper to follow in July.

7.3 Next Steps

7.3.1 Timetable of Implementation

Publication	**Date**
Draft Decision on the ESB PES's Revenue Regulation Framework	19th March 2010
Decision on the ESB PES's Revenue Regulation Framework	30th April 2010
Consultation Paper ESB PES Supply Costs 2011/12	May 2010
Decision ESB PES Supply Price Costs	July 2010

Appendix A – List of Substantive Questions

Question/ Proposal	Yes	No	Comments
1. The Commission's proposed decision allows for pass through of hedge contract settlements at a 50% hedge target. Are you in favour of allowing CfD prices to be reflected in PES tariffs?			
2. Is a hedge target of 50% of forecast PES load a reasonable amount of contract cover? If not, what level do you think is appropriate?			
3. The Commission's proposed decision allows PES to define a set of contracts to meet the hedge target of 50% of forecast PES load on an energy and/or capacity basis for regulated customers. Are you in favour of the Commission's proposal to allow PES the flexibility of combining base load, mid-merit and peak contracts to create a portfolio that meets the 50% target for regulated customers?			
4. It is ESB PES' current practice to shape contract costs in each half-hourly period to reflect the shape of the SEM half-hourly price curves prior to attributing contract costs to customer tariffs. Are you in favour of this practice?			
5. The Commission is proposing that ESB PES have full flexibility to set tariffs at the levels it deems appropriate. The CER would only intervene if it observed abusive pricing practices by ESB PES. Are you in favour of the Commission's proposal?			
6. The Commission is also proposing to require ESB PES to adjust tariffs if outturn costs and revenues or forecast costs and revenues diverge by fixed threshold. Are you in favour of this approach, which would require ESB PES to change tariffs when they are no longer cost-reflective?			
7. The Commission's proposed decision provides for asymmetric k-factor recovery outside of a tolerance band, while providing PES an opportunity to minimize any k-factors through full pricing flexibility. Are you in favour of asymmetric recovery?			
8. The Commission's proposed decision fixes the tolerance band at +/-3%. Do you believe that this is a reasonable range for the band? If not, what level do you think is reasonable?			
9. The oversight process proposed by the Commission anticipates a limited ex ante review of PES tariffs, quarterly reports from PES to the Commission, a review by the Commission of any changes made to the tariff, and a detailed ex post review. Are you in favour of the Commission's			

proposal? If not, what alternatives would you propose?			
10. Are the data sets that the Commission proposes to review in detail in its ex post review appropriate? If not, what alternatives would you propose?			
11. The Commission's proposed decision provides that differences between *ex post* allowed revenues and revenues collected from customers be applied to future period MARs. This means that the tariffs for future periods will carry over a small amount of prior period k-factors. Are you in favour of the Commission's proposal to apply differences to future period MARs? Would you favour a one-time charge or credit? Would a one-time charge or credit be administratively feasible?			
12. The Commission proposed a tolerance band of +/-3% as a measure for the treatment of over- or under-recoveries. This is proposed as a transitional tool, giving PES pricing flexibility and incentives to keep prices at the cost-reflective level. Do you think the 3% is appropriate? If not, why not?			
13. Would you be in favour of an alternative treatment of over-recoveries that allows PES to retain revenues in excess of MAR within the 3% tolerance band? If so, why or why not?			