



Draft Decision on the ESB PES's Revenue Regulation Framework

CER 10/042

Endesa Ireland welcomes the opportunity to respond to the Draft Decision on the ESB PES'S Revenue Regulation Framework, in which CER proposes moving towards an ex-post revenue control which would allow ESB PES greater freedom in tariff setting provided its Maximum Allowable Revenue (MAR) remains within a $\pm 3\%$ revenue band.

Endesa Ireland agrees with the Commission's view that k-factors in the current model for tariff and revenue regulation, which cater for under/over-recovery of costs from previous years, lead to tariffs to end-customers that are both uncompetitive and are not cost-reflective. Endesa Ireland supports a move from the current tariff regime to one without k-factors, consequently allowing for more cost-reflective tariffs to the end customer.

Endesa Ireland considers allowing the development of competition to be the most appropriate way of ensuring end-customers are offered reasonable and cost-reflective prices. In order to ensure competition can grow and be sustained in Ireland, CER must ensure that PES' tariff structures do not pose a barrier to entry for new market entrants, so that they will be able to compete effectively with ESB PES. In order to facilitate such competition, Endesa Ireland considers it essential to strictly regulate the minimum price of tariffs that are offered by PES to ensure that independent market participants are not undercut. Endesa Ireland considers this to be of greater importance than controlling MAR, as higher prices will simply encourage customers to move to independent suppliers, helping to enhance competition.

The Commission has presented two options for implementation of a Maximum Allowable Revenue (MAR) tariff. Under Option 1 the MAR would be determined to be the cost of energy purchases, priced at actual pool prices and known demand, plus a margin and an allowance (as now) for internal supply business costs. Option 1 is described by the equation below and does not allow for recovery costs of CfDs.

$$\text{Energy}_{\text{BY CUSTOMER CATEGORY}} = (\text{Energy Purchases (at outturn SMP)} * \text{Outturn Demand}) + \text{Capacity} + \text{SEM Charges}$$

Option 2 is of a similar form but allows for the recovery of CfD costs equal to 50% of PES's projected demand on energy (GWh) or peak demand (MVA) basis.

Within the current proposal CER suggests allowing one tolerance band based on total MAR, meaning that over-recovery of one cost/revenue component can be offset by under-recovery of another¹. Endesa Ireland considers that CER needs to be more conservative in the flexibility it affords PES, as this proposal would enable PES to under-recover certain costs, which would allow them to undercut other market participants and cross-subsidise this through over-recovering for another one.

¹ Page 36, CER 10/042, Draft Decision on the ESB PES's Revenue Regulation Framework



Although CER states that this will be difficult as there will be constant monitoring of PES, Endesa Ireland considers that the time lag between discovery of the problem, analysis and the implementation of a solution could result in an independent supplier incurring such losses that it would be forced to go out of business.

Endesa Ireland considers that the new proposals do little to reduce the regulatory intervention in relation to PES' tariffs as CER will now need to monitor the tariffs on an ongoing basis, analysing the impacts any changes in one tariff will have on the entire market.

Endesa Ireland does not support CER's proposals. However, if CER is determined to implement one of these two proposals, Endesa Ireland would prefer a cost control formula which allows for recovery of CfD costs as these are a fundamental ingredient to both a liquid and competitive market, while also ensuring stable prices to end-customers.

Endesa Ireland considers that in order for this strategy to be employed with no negative impacts on competition, CER would need to establish a retail market monitor. The market monitor would help to ensure that any change in PES' tariffs was not an exertion of market power. In the absence of a retail market monitor, Endesa Ireland would request that PES' tariffs continue to be published for consultation, including any within-year changes to these tariffs, such that market participants would have the opportunity to highlight any anti-competitive pricing in advance of implementation of the new tariffs. Endesa Ireland would ask CER to reconsider their approach and look into the benefits of setting a minimum tariff, with no MAR.

Below are Endesa Ireland's responses to the specific questions posed in the consultation paper:

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?

Endesa Ireland supports the proposed decision that allows for pass through of hedge contract settlements. Given that ESB PES is likely to continue to supply a large fraction of the load and is at present the largest purchaser of CfDs, removal of incentive to participate in competitive hedges, could significantly reduce movement in the CfD market impacting liquidity.

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?

Endesa Ireland considers that the hedge target percentage should be set based on negotiations with PES, who should present a detailed proposal which would outline and justify their requirements for hedging and how this may impact market liquidity.

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?

Endesa Ireland considers it essential for all suppliers to have fair and equal access to enter hedge agreements. Provided there are sufficient contracts available to competing suppliers, there should be no restrictions on PES.

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?

Endesa Ireland is in favour of shaping contract costs in each half-hourly period to reflect the shape of the SEM half-hourly price curves.

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?

Endesa Ireland is not in favour of this proposal and considers that CER should impose a minimum tariff level for all customer categories to ensure that new market entrants are not undercut.

Allowing an overall MAR allows for under-recovering of costs in one area (possibly to undercut other participants) and cancelling this through over-recovery in another area. Given that a loss can be recoverable through an increase in the following year's MAR, it may even be in PES's interests to make an overall loss through charging low prices that undercut other market participants and subsequently recover these losses the following year with an increased market share.

Endesa Ireland considers the CER's proposal to intervene only if it observed abusive pricing practices is not sufficient to safeguard competition. It is possible that the time lapse between the introduction of new tariffs, the identification of abusive pricing and the implementation of a remedy by CER would be too long to prevent independent suppliers from facing substantial losses that could result in insolvency. Endesa Ireland considers that if such an approach is implemented, a retail market monitor should be established and/or PES tariffs should continue to be published for consultation.

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?

Endesa Ireland considers that if customers are charged prices that are not cost-reflective they are free to seek other suppliers. Endesa Ireland does not consider that PES should be obliged to increase their MAR in one year due to under-recovery in prior years – this is a continuation of the k-



factor policy that should be abolished. Endesa Ireland considers that PES should be able to set their tariff at any level, provided they are above a regulated minimum tariff.

In the event that PES tariffs are too low and acting as a barrier to entry, hindering the development of competition, Endesa Ireland considers it appropriate for CER to intervene. This intervention should be immediate, rather than at year-end. Endesa Ireland suggests that if this approach is implemented, ESB should be required to submit quarterly reports analysing their income.

Endesa Ireland considers that ESB should be free to set their tariffs as often as they like, provided they do not hinder competition.

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?

With asymmetric k-factor recovery, over-recoveries would flow back to customers whilst under-recoveries would be borne by PES. While, Endesa Ireland welcomes the merits that exist in such proposal, we believe k-factors should be eliminated.

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?

Endesa Ireland considers that the chosen tolerance band of $\pm 3\%$ may be reasonable but the tolerance band should be set for each tariff category, rather than for PES' overall income. In addition, Endesa Ireland considers that the tolerance band should be reviewed annually.

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?

As stated previously, Endesa Ireland has significant concerns that this proposal will allow PES too much freedom to exercise market power. While CER is prepared to review any changes made to the tariff and will conduct an ex-post review, Endesa Ireland considers that this will result in an increase in the regulatory intervention of PES, rather than a decrease. Endesa Ireland is in favour of measures that will provide certainty that fair competition has the opportunity to emerge in the market. The establishment of a retail market monitor would help to provide confidence in CER's ability to monitor PES' activities.



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?

The data sets include, actual revenues by tariff class and month, all contract details for DC, NDC and other hedges, 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 other SEM fees and unaccounted energy attributed to PES.

Endesa Ireland would also consider it highly important, to review how PES's tariffs impact the development of competition in the market.

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?

Endesa Ireland is not fully supportive of either of the two options put forward. With Option 1 in the case that PES over-recovers in excess of the 3% band, all of the excess revenues are applied as a reduction to the next year's MAR. If this scenario occurs under option 2, the first 3% of excess revenues is retained by PES with the excess applied as a reduction in the following years MAR. This could result in tariffs that are not cost-reflective, as the tariffs would be set to recover the MAR, which may be reduced below cost due to over-recoveries in the prior year.

With both options, if PES under-recovers and the collected revenues are within the 3% band, then the shortfall of collected revenues under the MAR are applied as an increase in the following MAR but any shortfalls beyond the 3% band are borne by PES.

Endesa Ireland considers that if such a policy is implemented, PES should be able to recover any losses through MAR, but this recovery should be equally apportioned to all tariff categories – PES should not be free to increase the tariffs for less-attractive customer categories and decrease them for others. In addition, Endesa Ireland would have concerns that PES may intentionally incur losses to undercut other market participants, allowing PES increase its own market share in categories that CER have determined are fully competitive, while having the flexibility to recover any losses in the next period or to recover those losses in other customer categories.

CER has indicated a preference for option 2. Endesa Ireland also considers this the more appropriate of the two options presented.



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?

Endesa Ireland considers that the 3% tolerance band should be applied to each tariff category, such that ESB is not able to undercut independent suppliers in particular tariff categories. An overall tolerance band will give ESB a greater potential to exercise market power.

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?

Endesa Ireland considers that treatment of over-recoveries must allow for development of sustainable competition. It is our view that over-recoveries should be rebated to customers in full at the close of the financial year and should not be included as a separate credit in monthly/bi-monthly customer bills.

This will ensure that the rebates are not viewed as a reduction in tariffs, helping to ensure fair competition.