PES RETAIL TARIFF PERIOD ALIGNMENT

IN BOTH REGULATORY JURISDICTIONS

CONSULTATION PAPER

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1 Executive Summary

This paper presents the key considerations in respect of aligning PES retail tariff periods in both regulatory jurisdictions of Northern Ireland ('NI') and Ireland ('IRL') in the context of the introduction of the SEM. Currently tariff periods in both jurisdictions coincide with underlying cost periods. As a consequence of the introduction of the SEM in November 2007 key underlying costs drivers will not coincide with the current retail tariff period in either jurisdiction. This paper examines the merits for aligning the two retail tariff periods to more fully correspond with the SEM wholesale cost period. The paper sets out the implications of <u>not</u> aligning the retail tariff period with underlying cost components and also examines the merits of aligning tariff periods for the development of retail competition in both jurisdictions (as well as facilitating the operation of directed contracts in the wholesale market). Also illustrated is the situation for both jurisdictions <u>at the start of the SEM</u> (1st Nov 2007) in respect of misaligned tariff cost component periods.

Two different alignment 'periods' have been considered by the Regulatory Authorities:

Option 1: **1st Apr. – 31st Mar.**

Option 2: **1st Oct. – 30th Sept.**

The advantages and disadvantages of each 'period' are identified for both jurisdictions as well as the associated implications in respect of both the All Island Project ('AIP') work stream deliverables and non-AIP deliverables.

To conclude, this paper puts forward a favoured tariff alignment period of **1st Oct. – 30th Sept.** in both jurisdictions period. In Ireland, this option involves setting an 11-month PES retail tariff (1st Nov. 07 to 30th Sept. 08) and 12-month tariff thereafter to align with a 1st Oct. – 30th Sept. tariff period. In Northern Ireland, there are a number of options available to OFREG, for example, initially set a 7-month tariff (1st Apr. 07 – 31st Oct. 07), an 11-month tariff (1st Nov. 07 – 30th Sept. 08) and a 12-month tariff thereafter.

2 Introduction

Central to the consideration of aligning tariff periods in both regulatory jurisdictions is tariff cost reflectivity. It is desirable that retail tariff periods reflect as much as possible the underlying cost periods which will be altered as a result of the SEM for a significant proportion of cost components.

Misalignment of Tariff Cost Components Periods at start of SEM

With the introduction of the SEM on 1st November 2007, a large tariff cost component, that is, the wholesale market-related costs (directed, market, PSO contracts etc) in both jurisdictions will be out of line with other tariff cost component time periods (e.g. network costs, SMO and SSS costs, capacity costs, supply overhead costs etc).

To better illustrate these cost misalignments, the following table sets out the 'periods' of tariff cost components in both jurisdictions as at start of SEM:

Supply Tariff Cost Components	**Underlying Cost Component Period** (as at SEM start date)	
	IRL	**NI**
TUoS	1st Jan 07 – 31st Dec 07	1st April – 31st Mar.ch
DUoS	1st Jan 07 – 31st Dec 07	1st April – 31st Mar.ch
Directed Contracts & Market Contracts	Implication: 1st Nov 07 – 31st Oct. 08	Implication: 1st Nov 07 – 31st Oct. 08
Capacity Charges	Implication: 1st Nov 07 – 31st Oct. 08	Implication: 1st Nov 07 – 31st Oct. 08
SMO & SSS charges	Implication: 1st Nov 07 – 31st Oct. 08	Implication: 1st Nov 07 – 31st Oct. 08
PSO contracts	Implication: 1st Nov 07 – 31st Oct. 08	Implication: 1st Nov 07 – 31st Oct. 08
Supply overheads	1st Jan 07 – 31st Dec 07	1st April – 31st March
	IRL	**NI**
Current PES retail tariff period	1st Jan 07 – start of SEM	1st Apr. 06 – 31st Mar. 07

This fundamental 'cost misalignment' issue is the driver of tariff year alignment considerations. Section 3 of this paper sets out the merits of aligning tariff periods in both jurisdictions and presents two separate alignment periods for consideration. The advantages and disadvantages of each are identified for each regulatory jurisdiction as well as the implications for AIP and non-AIP deliverables. Section 4 sets out the Regulatory Authorities' favoured alignment period and section 5 invites comment from interested parties.

Implications of <u>not</u> aligning Tariff period with underlying cost components

Without aligning tariff periods, and by implication, underlying cost periods, the development of retail competition in both jurisdictions will be hindered. Setting a retail tariff that is misaligned with its constituent cost components (TUoS, DUoS, Capacity Charges, SMO Tariff charges, SSS charges, supply overheads, wholesale contracts) requires making assumptions about the price changes of certain cost components *within* the retail tariff period. This has the undesirable effect of significantly increasing the risk of tariff revenues not recovering costs, a situation which lends itself to the need for k-factors.

The application of k-factors negatively impacts on retail market competition by potentially distorting retail prices from period to period causing customers to frequently switch back and forth between the PES and independent suppliers. Competing against a volatile PES tariff makes it difficult for independent suppliers to compete for customers.

3 Tariff alignment periods considered

Firstly the merits of aligning tariff periods in both jurisdictions itself must be considered. While it is possible for different retail tariff years to apply in each jurisdiction setting retail tariffs that line-up with the wholesale energy market cost periods (a cost component which constitutes a large portion of each jurisdiction's PES tariff) is likely to lead to tariff period alignment in both jurisdictions. Aligning tariffs with underlying costs is essential to further develop retail competition in both jurisdictions. In addition, aligning tariff periods will also have the real benefit of facilitating the operation of directed contracts in the wholesale market.

Align to what tariff period?

If it is accepted that retail tariff alignment in both jurisdictions is a natural development, consideration by each regulatory authority must be given to which tariff period is most appropriate, firstly, for the period immediately following commencement of SEM (1st Nov. 07), and secondly for the longer term. However, proposals on the tariff period to apply in the period following the commencement of SEM can only be made in the context of the decision on the longer term.

While any number of tariff periods may be proposed the following two tariff periods were considered as viable by the Regulatory Authorities for the longer term following consideration of the various factors underlying the construction of the retail price:

Option 1: **1st Apr. – 31st Mar.**

Option 2: **1st Oct. – 30th Sept.**

Note that a January to December tariff was not considered in detail as it required tariff adjustment during one winter period. This was considered to be unsatisfactory as it retained the potential for large price increases during the winter period of peak demand. Below, the advantages and disadvantages of the two options to each regulatory jurisdiction as well as the possible implications for the AIP and non-AIP work stream deliverables are identified.

3.1 ‘1st Apr. – 31st Mar.’ period

Below both the advantages and disadvantages of aligning the PES tariff period to a ‘1st April – 31st March’ period commencing in April 2008 are identified for each jurisdiction.

ADVANTAGES: **NI Jurisdiction**

- Retain alignment of current retail tariff period. No disruption to NI customer in respect of the time period at which price changes are introduced. A decision will be required on how retail tariffs will transition the SEM implementation period.
- In line with current NI TUoS and DUoS revenue control/tariff period therefore no adjustment will be required.
- Retain alignment with NI company financial year. Some customers prefer if their costs align with the financial and budget year.

ADVANTAGES: **IRL Jurisdiction**

- April implementation date improves billing impact (in respect of price increases) to domestic (heat & lighting) customers relative to current IRL January implementation date

DISADVANTAGES: **NI Jurisdiction**

- Out of line with gas year. Some suppliers may prefer to fix retail prices in line with gas purchase arrangements or hedges around such arrangements.

DISADVANTAGES: **IRL Jurisdiction**

- Out of line with TUoS revenue control/tariff period.
- Out of line with DUoS revenue control/tariff period. - Distribution tariffs in Ireland can be reset annually from 1 April date. This raises the issue as to whether alignment of the network price control periods is also appropriate
- Out of line with current PES revenue control period – However, allowable costs for the PES supply business could be reset annually from 1 April
- Out of line with gas year
- Out of line with IRL company financial year, some customers prefer if their costs align with their financial and budget year.

Implications for All-Island Project and non-AIP Deliverables of 1st Apr. – 31st Mar. period

The following list identifies a number of implications for both AIP and non-AIP deliverables in respect of aligning the PES tariff period to a ‘1st April – 31st Mar.ch’ period commencing in April 2008:

- ***Directed Contracts.*** The initial Directed Contracts to run for a period of either 5 or 17 months. Neither is desirable. Firstly, setting a 5-month transitional tariff (1^{st} Nov 2007 to 31^{st} Mar. 2008) that covers a winter period, where generation costs are most expensive, and not balanced by a less-costly summer period is likely to result a very high tariff level for the 5 month period. This also could have the effect of introducing a significant swing in the tariff level from one period to the next. On the other hand, setting a 17-month tariff involves predicting SMP prices over a long period which introduces significant difficulties in accurately forecasting prices.
- ***PSO tariffs.*** PSO tariffs would have to be recast against a 17 month prediction of SMP or an interim period of 5 months and then set annually. As above, these period durations are not desirable.
- ***IRL Transmission tariffs.*** Transmission tariffs to be formulated on the basis of an interim 5 month period and then an annual tariff based on an April start date
- ***IRL Distribution tariffs.*** Distribution tariffs in IRL to be reset annually from 1 April. This raises the issue as to whether alignment of the price control periods was also appropriate
- ***SMO & SSS tariffs.*** The SMO and SSS tariffs to be set for an interim 5 month period and then annually.

3.2 '1st Oct. – 30th Sept.' period

Below both the advantages and disadvantages of aligning the PES tariff period to a '1^{st} October – 30^{th} September' period from October 2008 are identified for each jurisdiction.

ADVANTAGES: **NI Jurisdiction**

- In line with gas year
- Accurately forecasting SMP or wholesale costs enhanced (relative to 1^{st} Apr. – 31^{st} Mar. tariff period) due to increased proximity of tariff period start date to winter period.

ADVANTAGES: **IRL Jurisdiction**

- In line with gas year
- Accurately forecasting SMP or wholesale costs enhanced (relative to 1^{st} Apr. – 31^{st} Mar. tariff period) due to increased proximity of tariff period start date to winter period.
- October implementation date slightly improves billing impact (in respect of price increases) on domestic (heat & lighting) customers relative to current IRL January implementation date

DISADVANTAGES: **NI Jurisdiction**

- Out of line with current retail tariff period. OFREG is currently considering the length of the tariff period immediately preceding the SEM start date.
- Out of line NI TUoS and DUoS revenue control/tariff period
- Out of line with NI company financial year

DISADVANTAGES: **IRL Jurisdiction**

- Out of line with current retail tariff period. Disruption to IRL customer in respect of the time period at which price changes are introduced. Tariffs will have to run from November 07 to October 08, an eleven month period.
- Out of line IRL DUoS and TUoS revenue control and tariff period
- Out of line with IRL company financial year

Implications for All-Island Project and non-AIP Deliverables of 1st Oct. – 30th Sept. period

The following list identifies a number of implications for both AIP and non-AIP deliverables in respect of aligning the PES tariff period to a '1st October – 30th September' period commencing in October 2008:

- **Directed Contracts.** The initial Directed Contracts will have to run for a period of 11 months.
- **PSO tariffs.** PSO tariffs to be recast against an 11 month recovery period.
- **IRL Transmission tariffs.** Transmission tariffs to be formulated on the basis of an interim 11 month period and then an annual tariff based on an October start date
- **IRL Distribution tariffs.** Distribution tariffs in the Ireland to be reset annually from 1 Oct. This would raise the issue as to whether alignment of the price control periods was also appropriate
- **NI Transmission and Distribution tariffs.** NI UoS tariffs will need to be formulated on the basis of an initial 7 month period until the start of the SEM, then an 11 month period followed by 12 month periods.
- **SMO and SSS tariffs.** The SMO and SSS tariffs to be set for an interim 11 month period and then annually

4 Favoured Approach

On balance the Regulatory Authorities favour aligning all tariff periods in both jurisdictions to a '1st October – 30th September' period.

Option 1: 1st Apr. – 31st Mar.

There are obvious advantages to NI in respect of retaining alignment to the current retail tariff period and underlying components as well as the NI company year. In addition, there is no disruption to NI customer in respect of timing of price changes. However, this option requires that wholesale contracts and associated AIP project deliverables, to be set for either a 5 month or a 17 month period. Neither is desirable, especially the difficulty in accurately forecasting SMP prices over a 17 month period.

Option 2: 1st Oct. – 30th Sept.

This option presents fewer challenges for the development of transitional tariff period(s) and aligns both jurisdictions' retail tariff period with the gas year. This is likely to be advantageous to suppliers as it allows them to fix retail prices in line with gas purchase arrangements or hedges around such arrangements. Further, accurately forecasting SMP or wholesale costs is enhanced due to increased proximity of tariff period start date (1st October) to winter period when prices are most uncertain. This has the important advantage of minimising the need for, or the magnitude of, k-factors thereby aiding the development of retail competition in both jurisdictions. It may require the NI to set a 7-month PES retail tariff (1st Apr. 07 – 31st Oct. 07), an 11-month tariff (1st Nov 07 – 30th Sept. 08) and a 12-month tariff thereafter. IRL would have to set an 11-month tariff (1st Nov 07 to 30th Sept. 08) and 12 month thereafter.

5 Request for Comments

The Regulatory Authorities invite comment from interested parties on the proposals set out in this paper. The Regulatory Authorities intend to publish all comments received; those respondents wishing for certain sections of their submission to remain confidential should submit the relevant sections in an appendix marked confidential. Comments on this paper should be forwarded to both Caroline Johnston and Lisa Mullan, preferably in electronic form, by 5.00pm on the 12th February 2007 at:

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