Northern Ireland Electricity plc

PES Retail Tariff Period Alignment in both Regulatory Jurisdictions Consultation Paper 22 January 2007 AIP/SEM/07/04

NIE's Response

12 February 2007.

PES RETAIL TARIFF PERIOD ALIGNMENT

Introduction

The consultation paper AIP/SEM/07/04 proposes that ESBCS and NIE Supply align their tariff years to run from October 1st to September 30th and that the relevant wholesale tariffs UoS, SSS, PSO, SMO, etc. should be similarly aligned.

Tariff period

NIE agrees that, with the introduction of the all-island wholesale market, it is sensible to align the retail and wholesale tariff periods in both jurisdictions. Having discounted the option of a common tariff period that runs from January to December, the RAs seek views on two alternative periods:

Option 1: 1 April – 31 March and
Option 2: 1 October – 30 September.

Directed contracts

The RAs appear to regard the length of the initial transitional period and the consequent term of the initial directed contracts as the main consideration in deciding between April and October start dates. Their preferred October start date gives an initial 11 month period for directed contracts whereas an April start gives an initial 5 month transitional period. The shortness of this led the RAs also to consider lengthening the transitional period to include the first full year which would result in a 17 month period for the initial directed contracts.

As the RAs point out there is difficulty in accurately forecasting SEM prices and so in setting administered contract prices. This is particularly the case for the initial directed contracts, which will be set before there has been any experience of the SEM.

The England and Wales pool provides one experience of CfDs being priced in advance of market start-up. In 1990 one and three year CfDs were put in place on the basis of forecasts made before the wholesale market started operation, but (unlike in the SEM) this was before full market opening and suppliers only took the contracts to the extent that they had a monopoly franchise that extended at least as far as the contract term. The out-turn pool prices differed from the assumptions on which the CfDs had been priced and there were differences between the prices charged in the monopoly and competitive markets.

There is therefore an advantage in having a relatively short initial directed contract term. A 17 month initial term is unattractive because of the likelihood of error. By the same token, an April tariff start date and a 5 month initial contract period extending only over the 2007/08 winter is preferable to the 11 month interim period that results from the October tariff option.

The disadvantage of the short interim period is the inconvenience for generators, suppliers and customers of having to reset contracts and tariffs after a shorter period. However, this is less serious than the probability of error associated with the longer period. Indeed, the resetting is likely only to cause minor disruption and transaction costs if the SEM outcome does not differ markedly from the forecast. If it does differ and the revision is more significant, its being early would have been all the more beneficial.

The RAs' concern that the 5-month period would result in high transitional tariffs because it would cover the high cost winter months is misplaced. NIE's proposed 2007-08 tariffs, which would run from April to October, are predicated on a full year's generation costs averaging the cheaper summer and more expensive winter periods. The five-month transitional DC period would only result in higher tariffs to the extent that the directed (and other) contract costs for that period were higher than the generation costs already assumed for the period. Because of this averaging the pre-SEM and interim periods cannot be accounted separately in setting PES tariffs. An April start would make the averaging comparatively simple for NIE. Either proposal requires some averaging and k-factor adjustment for ESBCS. The October start, implying 10, 11 and 12 month RoI periods, is not likely to make this any easier than an April start with 10, 5 and 12 month periods.

We therefore consider that the fact that an April tariff year is associated with a relatively short initial directed contract term is not a strong argument against it. Indeed, on balance, it is an argument for it.

Gas year

The consideration relating to directed contracts is a transitional issue rather than an enduring one. Whilst an October start date aligns with the start of the gas transportation tariff year we regard this as a relatively minor advantage since we estimate that gas transportation charges account for only 4% (c£30m) of the overall NI electricity bill. There is no specific "gas year" for wholesale gas trading.

However, the key issue is not the overall magnitude but rather the volatility of the costs. In N Ireland, the postalised gas transportation charges are published for each new gas year along with a forecast for the 4 subsequent years and they are relatively predictable. The annual variance in the forecast published along with the tariff for the 2006 gas year shows a change of c£1m for 2007. This is only a forecast but it clearly indicates that the volatility is largely insignificant and is likely to be outweighed by other variances within SEM.

Customer billing

It has been the practice in NI to apply new tariffs from the meter reading following their introduction and not to estimate the amount of electricity used between the notional tariff change and the meter reading. This system has historically been the norm for domestic and SME customers throughout the UK. However, more recently, many GB suppliers have applied new tariffs to bills immediately after the "effective from" date, and have estimated consumptions at the old and new rates using estimation algorithms. Our understanding is that this is how ESB CS also applies domestic and other bi-monthly billed customers.

When suppliers changed their tariff application regime in GB the related estimation process proved extremely unpopular with many customers, as by definition, estimated consumption can always be subject to dispute. Our own experience is that there is a clear correlation between estimated bills and customer complaints. For that reason NIE has focused over the past few years on minimising the numbers of bills based on estimates. Indeed today only c23% of NIE Supply's bills are issued using an estimated consumption. Any change in the method of applying new tariffs could compromise these billing service levels and lead to significant customer confusion and annoyance. NIE therefore wishes to retain its current arrangements and we believe that customers and their representatives would support this.

This means that in NI, a notional October start date would actually result in later tariff changes and produce a situation similar to the calendar year tariff cycle that the RAs have rejected. Customers in NI, particularly those in the fuel poor category would not welcome a change in the start of the retail tariff year to October. In effect, an October start date would mean that all NIE Supply quarterly billed customers (c600k) would have the new tariff applied to bills issued from 1 January. In light of winter consumption and seasonal expenditure commitments which are typically much higher than the customer's yearly average, this would clearly be a difficult time for increases in retail tariffs to be working their way through to customers.

Conclusions on tariff period

- Option 2 (October – September) would bring alignment with the gas transportation year, but we consider this is an insignificant benefit.
- It needs to be weighed against what is likely to be an adverse reaction from quarterly billed customers in NI who would feel the first impact of annual tariff increases in their January bills.
- Changing the way in which NIE applies tariff changes within the quarterly billing regime is not a solution.
- Option 1 (April – March) avoids the problem.
- Option 1 means that the initial directed contracts would be set for 5 months. Given the potential for inaccuracy in setting the price of directed contracts (in the absence of any pool price history and participants' actual bidding behaviour) and in the absence of any

published plans to benchmark the Plexos modelling against the market clearing engine), there could be merit in having the ability to reset the price of directed contracts after a relatively short period. Whilst the subscription window for the second set of directed contracts would begin in November 2007, in making their choices, Suppliers would have the benefit of (i) the period of shadow running pre November and (ii) up to 20 business days of experience of "real-life" market prices (under the 5% daily allocation rule).

- For these reasons, NIE prefers Option 1 (April – March).

Other comments

The RAs' discussion of the tariff period alignment makes brief references to important features of supply price control, such as tariff approval and correction factors. We assume that the RAs will consult separately if they wish to change any of these features

It is not reasonable to assume, as the RAs appear to do, that costs can be known sufficiently well in advance for tariffs to be set irrevocably, even given the operation of correction factors. In NIE's view, correction factors are necessary for the operation of price controls in their present form and at anything like present supply profit margins.

NIE is at present free to alter its tariffs when it considers this to be appropriate, provided that it abides by its price control and other licence obligations, and it does not consider it reasonable that this freedom should be removed. The ability to change tariffs mid-year may be important in keeping correction factor adjustments low.