Regulatory Framework for the PES Businesses in NI and ROI

Proposal regarding EPO, Revenue Correction Mechanism and Tariff Methodology

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1. Introduction

The consultation process 'A Strategy for the Regulation of ESB and NIE in the Single Electricity Market' commenced on the 26th February, 2007 and since then there has been engagement between the Regulatory Authorities in Northern Ireland and the Republic of Ireland and the two PES[1] businesses on the key components of the Regulatory Framework.

This document sets out proposals from ESB Customer Supply (ESBCS) and NIE Supply (NIES) regarding the PES activities and how they intend to conduct their wholesale contracting activities to ensure that hedge contracts are procured in the most cost effective and efficient manner in order to deliver competitive and stable prices for customers. In addition, this document sets out details of how the PES businesses propose to satisfy their Economic Purchasing Obligation (EPO) and recover their costs through tariffs.

2. Regulatory Approval of Key Principles

In relation to the Regulatory Framework for the two PES businesses, each business shall be able to recover all prudently and reasonably incurred costs by way of intra-year tariff adjustment or in the tariff setting process in the following year. The Regulatory Authorities can be satisfied that costs have been prudently and reasonably incurred and allocated through the Hedging Policy Statement, the Procurement Guidelines and the Tariff Methodology Statement.

The key principles to be incorporated into the Regulatory Framework for ESBCS and NIES for approval by the Regulatory Authorities are as follows:-

1. ESBCS and NIES will use all reasonable endeavours to be hedged as much as possible in respect of customer demand associated with fixed price tariffs, subject to hedges being available, suitable and economic. ESBCS and NIES hedge contracts will be procured via various channels in the market including Directed Contracts (DC), Non-directed Contracts (NDC) and subsequent bilateral negotiations. Procurement activities and decisions taken shall be auditable to provide assurance regarding compliance with economic purchasing.
2. ESBCS and NIES will procure hedges from generators through bilateral negotiations with counterparties. However, without the prior approval of the relevant RA and with the exception of purchases through the DC and NDC processes, the PESs will not procure bilateral contracts from affiliates.
3. Both ESBCS and NIES will pass through pool price exposure to larger non-domestic customers (ie Customers supplied at medium voltage and above in RoI and monthly billed customers in NI) via pool price linked tariffs.
4. In light of the DC allocation, both PES businesses will start from the same position before the NDC process with regard to the proportion of their demand that is hedged.
5. Consistent EPO arrangements will apply in NI and the ROI. Hedges procured in line with the Hedging Policy Statement will be deemed to be EPO compliant.

[1] In the Republic of Ireland (RoI), ESBCS is designated the Public Electricity Supplier (PES). In Northern Ireland (NI) the concept of a PES will be phased out but NIE Supply will be subject to similar obligations to ESBCS, and therefore is referred to as the PES in this paper.

6. All forecast pool price exposure shall be incorporated into tariffs at the time of tariff setting with an ex-post correction for volume and price variances.
7. With regard to the overall revenue correction mechanism, tariffs shall be reviewed annually. Within year tariff adjustments may occur where the prevailing market circumstances would otherwise result in year end variances between the actual costs and revenues included in the tariffs would be in excess of a specified threshold range.
8. Both ESBCS and NIES shall submit a Tariff Methodology Statement to the relevant RA.
9. The timelines for the tariff setting process will be determined to accommodate the timeframes for the NDC process.
10. The same form of price control (including revenue correction mechanism) that is currently in place[2] will continue. There shall be consistent treatment of PSO contracts in both jurisdictions including provision for auctioning PSO contract hedges and PSO benchmark.

3. Regulatory Context

With the commencement of the SEM, both ESBCS and NIES will be purchasing energy from the pool to meet the energy demand of their customers. The price that is paid for this energy demand in the pool is subject to change over every half-hour period. As tariffs are predominantly set with fixed prices for time intervals of a year in most cases, there is a potential exposure for the PES businesses where pool prices deviate from the wholesale energy price incorporated into the tariff. Due to this potential exposure, it is intended that the PES businesses will secure hedging contracts with fixed prices for as much of their customer demand that is linked to fixed priced tariffs as is economic and feasible in advance of setting tariffs in order to reduce the potential financial exposure of the business.

4. Proposed Approach to CfD Procurement

4.1 Hedging Policy

It is proposed that both PES businesses will put in place a Hedging Policy Statement. The objectives of the Hedging Policy are to:-

- seek to hedge wholesale exposure prudently and economically in order to obtain the best value risk management on behalf of customers; seek to manage the potential volatility of energy costs and provide price stability for customers;
- balance the proportion of long, medium and short term contracts within the portfolio and strike a balance between providing price stability to customers and reflecting prevailing market costs;
- not discriminate between market participants.

In practice, “prudent and economic” hedging will mean seeking to procure as many hedges as possible through all the available channels as long as the price is judged to be economic. The reality is that it will not be possible for the PES businesses to be

[2] Adjusted where necessary to take account of reasonable additional costs and risks in SEM

fully hedged, both because of uncertainty in the volume of hedges available in the market and because the hedge contracts will be “blocky” with fixed volumes and will not match the actual demand profile. Even if there was an unlimited supply of standard base load, mid merit and peaking hedge contracts with different volumes on a monthly (rather than quarterly) basis, there would still be exposure to the pool for the PES businesses.

The uncertainty in the level of hedging that is likely to be available is compounded by being the first year of the new market and having no experience of what volume of hedges will actually be provided by generators or how much competition there will be for the hedge contracts that are offered.

4.2 ‘Best Practice’ Process for Determining Hedging Requirements

It is intended that the PES businesses will use a best practice approach in determining the optimum mix of hedges and prices for hedge contracts. This approach will include:-

- Demand forecasting on a half hourly basis
- Pool price forecasting using complementary modeling techniques
- Contract Portfolio Optimisation modeling to calculate the optimum mix of base load, mid-merit and peak hedge contracts.

This analysis will be used to assist in decision making in relation to the hedge product requirements and bidding strategies to be adopted in the generator auctions via the FAXboard.

4.3. Securing Hedge Contracts

The main channels for procuring hedge contracts for the PES businesses are as follows:-

- DCs and any supplementary DCs
- Generator auctions via FAXboard or otherwise
- PSO contract auctions[3] through the FAXboard.
- Bilateral negotiations with counterparties provided that there will be no bilaterals with affiliates without the prior approval of the relevant RA
- Moyle interconnector capacity related hedges.
- Ongoing refinement of hedge contract portfolio through available channels

It is envisaged that independent generators will have access to the ESBCS and NIES energy demand by posting a FAX with volumes and prices on the same days as ESBPG and PPB. It is proposed that this will take place during July and August.

4.4 EPO Compliance

As part of the overall EPO process the PES businesses will provide a Hedging Policy Statement and Procurement Guidelines to the relevant Regulatory Authority.

The Regulatory Authorities want to ensure that the PES businesses strive to achieve as much hedge cover as is economically possible to ensure that customers are not exposed to tariff disturbance arising from pool price volatility. It is intended that each

[3] PSO contracts made available as hedges through the FAXboard auction process in NI and ROI.

PES business will aim to have as much of its energy demand covered though hedge contracts to a level that is feasible (hedges are available) and economic (the hedges available are at a price that is deemed to be economic). In participating in processes to secure hedge contracts, the PES businesses will evaluate price offers (in bilateral processses) and/or determine bid prices (in auction processes) based on criteria that are aimed at securing the best value for customers whilst managing the risk of the business. The criteria to be used in this evaluation will include key commercial considerations e.g. best price, suitability of products, counterparty credit assessment and alignment with respective Hedging Policies.

In its Procurement Guidelines Statement, each PES business will set out its views on the level of hedging that it expects to achieve and the assumptions underpinning this view. Hedge contracts will be deemed to be EPO compliant provided that 'all reasonable endeavours' are made to procure hedge contracts in accordance with the above and all related costs including both the cost of hedge contracts (including any DC currency exposure) and residual pool costs are allowed to be recovered through the tariffs. The PES businesses will report to the relevant Regulatory Authority on hedge procurement activity on a quarterly basis.

4.5 Timetable for Wholesale Contracting

It is planned that the DC process will take place in June with supplementary DC contracts available to market participants in July. If the FAXboard is to be the main medium for the NDC process this year and it can only commence operation in mid-July with hedge contracts being procured during the last two weeks in July and first two weeks in August, then the tariff setting timescales will need to be reviewed accordingly.

5. Revenue Correction Mechanism

The revenue correction mechanism for the PES businesses needs to be appropriate to the commercial conditions pertaining to these businesses. Given the responsibility of delivering the obligations of the Public Electricity Supplier in each jurisdiction and also the complexity in forecasting customer demand due to having a predominantly domestic customer base with peaky and varying demand levels and the PES demand being derived under the differencing methodology, it makes it more difficult to accurately predict the hedge cover that is required. While every effort will be made to reduce this exposure during the year, there is likely to be variances between the actual wholesale costs and those that are included in the tariffs. Therefore there needs to be an ex-post revenue correction mechanism for the PES businesses that ensures that all reasonably incurred costs are recoverable through the tariffs.

In order to address this situation the Ex-post Revenue Correction Mechanism proposed is:-

- For customers other than larger customers supplied by the PES's(i.e. customers supplied at medium voltage and above in RoI and monthly billed customers in NI), if forecast variances between costs included in the tariffs and revised forecast costs during the year exceed a threshold the tariffs will be reviewed. To reduce the frequency of potential adjustments from a customer's perspective tariffs may only be adjusted if the forecast variance exceeds a specific threshold e.g. X% (+or-) during the year. The tariff rates will be revised to reflect this change in costs for the remainder of the year. The procedure for implementing an adjustment will need to be simple to administer to ensure that adjusting the tariffs within year is not a lengthy and complicated process

- Over and above this, cost variances below the threshold would be catered for in a year end adjustment and consequently, incorporated into the tariffs for the following year.

- For larger customers (as qualified above) a pricing contract based on actual pool prices would apply.

Prudently managing wholesale costs throughout the year, as described above, coupled with the mechanism to adjust tariffs within year, should help to minimise the amount of a year end adjustment that remains to be accommodated in the tariffs for the following year. This proposal will ensure that changes in costs arising from changes in market conditions are reflected in tariffs during the year and will help to minimise the possibility of large variances applying at year end.

6. Tariff Setting Methodology

The tariff setting process will commence following the NDC process. At this stage it is expected that the wholesale contract costs (the amount of the demand that is hedged for the tariff period) will be known and forecast pool prices will be used to predict the expected wholesale generation costs associated with the residual forecast demand. In addition, other forecast costs[4] and supply overhead costs (as per the relevant Price Control mechanism) will be incorporated.

A Tariff Methodology Statement will be prepared by each PES business that sets out the following:-

- Statutory and Licence requirements in relation to Tariff Setting
- Clear objectives to be met and high level principles to be followed in setting tariffs e.g. non-discrimination, transparency, cost reflectivity.
- Forecast of expected customer demand and risk characteristics for the tariff period.
- Tariff cost elements and method of cost allocation to individual tariff groups.
- A detailed breakdown of cost and margin components contained within specified tariffs[5].
- Revenue correction mechanism and risk abatement procedures.
- Policy objectives in relation to Universal Service Obligation, energy efficiency etc..

It is proposed that the Tariff Methodology Statement would be submitted by the PES businesses to the relevant Regulatory Authority in advance of the tariff period.

7. Minimising Market Start-up Risks

There are significant risks in the run up to actual SEM go-live, and an overly concentrated and materially significant market hedging process could add an unnecessary layer of complexity and risk during this market start-up stage. The

[4] TUoS , DUoS , MO and PSO Charges etc.
[5] [Domestic in NI, Business and Domestic in RoI

PES's in particular would potentially have to secure a very large volume of hedges over a very short period of time. The Non-directed Contracts process can be de-risked significantly by having a transitional contracting arrangement that includes a baseload regulated contract allocation in both jurisdictions[6]. This arrangement would be reviewed in light of experience with the bulletin board and in time for the next annual contracting round.

8. Conclusion

There is a need for regulatory approval for the key components of the Regulatory Framework for the PES businesses in NI and the ROI to enable the businesses to prepare to participate in the SEM. In particular, there is a need for the key principles as set out in Section 2 of this document to be approved in order to allow the PES businesses to commence the wholesale contracting, EPO implementation and the tariff setting process for the trading period commencing from November 2007.

[6] In NIE Supply's case a baseload contract with PPB, and in ESB CS's case a baseload contract derived from the Capacity 05 and Peat contracts.