



**Regulation of ESB and NIE in SEM: A Decision
Paper**

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1. Background and Summary

For the past number of months the Regulatory Authorities (the RAs) have been considering approaches for the regulation of the retail electricity market in the Single Electricity Market.

This process commenced with the publication of a paper, in February 2007, on a Strategy for the Regulation of ESB and NIE in the Single Electricity Market¹. The paper considered the following; (a) supply licence framework, (b) generation regulatory framework, (c) Public Service Obligation backed contracts, (d) PES regulatory framework and (e) setting supply tariffs. Subsequent to this publication, a number of other related consultation papers were published:

- (a) IRL Proposed Changes to Supply Licences (AIP/SEM/07/156, 16th May)
- (b) NI Supply Licence Consultation Papers (AIP/SEM/07/153, 15th May and AIP/SEM/07/56 27th Mar)
- (c) ESB Power Generation (ESB PG) and NIE Power Procurement Business (NIE PPB) approach to Non Directed Contracts (AIP/SEM/07/213, 23rd May)
- (d) Calculation of the Market price(s) used to Determine PSO Amounts (AIP/SEM/07/240, 1st June).
- (e) A Joint Proposal from ESB Customer Supply (ESB CS) and NIE Supply (NIE) on the Nature of Supply Regulation (AIP/SEM/07/217, 23rd May)

This paper sets out the RAs decisions in relation to a number of matters set out in the February paper. These decisions are summarised below. Decisions in relation to the PSO Benchmark Price and Supply Licensing will be set out elsewhere following conclusion of their current consultation process.

It should be noted that the following decisions are transitional in nature and will be implemented for the first year of SEM. Further work in relation to more enduring arrangements will be considered in greater detail by the RAs over the coming year.

¹ AIP/SEM/07/16 – “ A strategy for the Regulation of the ESB and NIE in the Single Electricity Market: a Consultation paper”

1.1 Contracting Framework

ESB PG and NIE PPB will offer non directed contracts (NDC) through a joint periodic auction that will take place over July and August 2007.

ESB CS and NIE Supply can purchase contracts through a number of channels including the ESB PG/NIE PPB auction and the directed contracts process. ESB CS and NIES will be obliged to set out how they intend to comply with the economic purchase obligation to their respective Regulatory Authority in their approved Hedging Policy Statements. The RAs will publish details of these statements during July.

1.2 Tariffs

NIES and ESB CS will submit Tariff Methodology Statements to their relevant Authority. This document will set out the principles and methods by which wholesale costs will be allocated to individual groups of customers, and be in accordance with the Hedging Policy. Again the RAs will be publishing details of these statements in July.

NIES and ESB CS will be allowed a revenue correction mechanism (K-factor) for the first year of SEM. The RAs recognise that both businesses currently deliver the obligations of the Public Electricity Supplier in each jurisdiction and face considerable uncertainty in forecasting customer demand due mainly to having a large domestic customer base; much of this may be unhedged to the extent that such hedges may be unavailable in an immature market. However both businesses will have to demonstrate to the RAs that they have made every effort to comply with both their Economic Purchase Obligation and hedging policies. In addition both businesses will adjust their tariffs within year should unanticipated changes to the external environment indicate an unacceptably large k-factor adjustment in the subsequent year.

This is a transitional step and the scope and use of the K-factor will be subject to further review. ESB CS and NIES will also introduce pool price pass-through prices for larger customers in place of existing published tariffs. Details of these arrangements will be included in the Tariff methodology Statements.

1.3 Supplier of Last Resort and Universal Service Provider

The RAs have decided that ESB CS will act as the Supplier of Last Resort and Universal Service provider in the Republic of Ireland. NIES will fulfil a similar function in Northern Ireland. This decision is set out in the relevant licensing decision papers and will be reviewed as the market matures.

1.4 Consultation Process

The RAs received 9 responses to the SEM Regulation consultation paper, from each of;

- BGÉ
- AES
- Airtricity
- ESB Regulatory Affairs
- ESB Power Generation
- ESB Customer Supply
- ESB Independent Energy
- Synergen
- NIE

The RAs received three comments from interested parties on the 25th May joint ESB CS /NIES proposals on the nature of supply regulation:

1. ESB Customer Supply
2. Energia
3. Airtricity

1.5 Paper Structure

Section 2 of this paper sets out in further detail the decisions of the Regulatory Authorities in relation to the generation regulatory framework, PSO backed contracts, the supply regulatory framework and tariffs.

2. Regulatory Authority Decisions

2.1 *Non Directed Contracts*

In the February paper, the RAs suggested that ESB PG and NIE PPB should deal with market participants in the contracts market at arms length basis and on fair commercial terms. The RAs also sought views on the treatment of NIE PPB and ESB PG contracts in the SEM and how they might be allocated to market participants.

2.2 *Summary of responses to paper*

Most respondents agreed that ESB PG and NIE PPB should offer their output to the market via non direct contracts and stated the importance of a liquid contracts market. Some parties also suggested that the level of directed contracts should be increased. In addition, all respondents supported proposals that hedges linked to PSO backed contracts should be offered to the market.

Taking account of these responses, the RAs met with the incumbent generators to develop a possible approach for offering non directed contracts to the market. The outcome of these discussions was the publication by ESB PG and NIE PPB jointly of an outline of their suggested approach on 23rd May (AIP/SEM/07/213, 23rd). The purpose of this paper is to set out how ESB PG and NIE PPB will trade their contracts in SEM. They propose a joint approach to contracting whereby ESB PG and NIE PPB will send out contract offers to all suppliers on prescribed days in July and August. Interested parties will then submit bids for these contracts. ESB PG and NIE PPB will evaluate these bids and allocate the contracts to the successful parties. The benefit of this approach is that all parties have equal access to hedge contracts.

The RAs received a number of comments in response to the ESB PG/NIE PPB information paper. In general, respondents agreed that it was an appropriate manner to proceed stating the importance of ensuring that all suppliers have equal access to hedge contracts. One party suggested that the auction should be based on a clearing price

basis rather than a pay as bid auction. All requested additional information. The RAs have passed these comments onto to ESBPG and NIE PPB for consideration and final proposals will be published shortly.

2.3 Regulatory Authority Decision

ESB PG and NIE PPB are continuing to develop an approach to non-directed contracts as outlined in their recent information notice. Given the tight timescales in which any arrangements needs to be finalised, the RAs have decided to allow the market access to these hedges through an auction approach with the price based on a market clearing price mechanism. Given the form of contract that is likely to be available (i.e. fixed price/fixed output baseload, mid merit or peaking hedges) the RAs have decided to concentrate on hedges associated with plant that have reasonably predictable levels of output.

In the case of ESB PSO backed contracts the availability of such contracts will be limited to those whose output is reasonably firm.

2.4 Regulatory Framework for the PES Businesses

In the February paper, the RAs made a number of proposals in relation to fulfillment of an economic purchase obligation, tariffs, tariff formulation and revenue correction factors (k-factors). The RAs proposed:

1. Development by each PES of a hedging policy statement including procurement principles and routine reporting of compliance with these statements.
2. Pool price pass through tariffs for the largest customers (medium voltage or greater) and tariffs for other customers based on an agreed methodology.
3. The development of a tariff methodology statement setting out the principles and methods by which wholesale costs would be allocated to individual customer groups, and be in accordance with the hedging policy.
4. ESB CS and NIES will retain some form of correction factor (k-factor) but limited to their uncontrollable costs.

5. NIES and ESB CS supply margin could be increased to take account of increased risk.

In consideration of comments received to the consultation paper, the RAs engaged with ESB CS and NIES to further develop some of the proposals set out in the February paper.

Subsequently, NIES and ESB CS issued a joint consultation paper. The purpose of this paper was to set out a regulatory framework that could be applied to these businesses taking into account the new contracting proposals set out by ESB PG and NIE PPB. Amongst the proposals set out in the paper were:

- ESBCS and NIES will use all reasonable endeavors to be hedged to the extent 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, Non-Directed Contracts and subsequent bilateral negotiations. Procurement activities and decisions taken shall be auditable to provide assurance regarding compliance with economic purchasing.
- Any bilateral deals with affiliates will require advance RA approval
- 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.
- Both ESBCS and NIES shall submit a Tariff Methodology Statement (TMS) in line with RA proposals to the relevant RA.
- Consistent treatment of PSO contracts in both jurisdictions.
- ESB CS and NIES should be allowed a 'regulated' contract with ESBPG and PPB respectively.

2.5 Summary of Responses to Papers

February consultation – RA Proposals

Most respondents agreed with the proposals set out by the RAs in the February paper. A variety of views were expressed in relation to the continuation of k-factors. A number of parties agreed with the need for k-factors, some argued for a full k-factor combined with within year tariff reviews and others were concerned with the need to limit k-factors. Another respondent argued that there should be prices caps rather than revenue caps in operation. In addition, there was some support for ESB CS and NIES receiving a higher net margin. One respondent was concerned that the regulatory approach was too interventionist. There was also some concern about the timescales required for introducing these arrangements.

May Consultation – NIES and ESB CS proposals

The RA's received three comments in relation to this paper. In relation to contracting, respondents generally agreed that this process should move forward but that the businesses should not be allowed any form of 'regulated' contract. In general the comments acknowledge that there needed to be clarity on what would be deemed an "economic" hedge. Some respondents supported the proviso for regulatory approval before bilateral deals with affiliates are agreed. Some respondents also stated that the details of such deals (including price) should be published prior to completion to provide transparency to the market.

The general comment from respondents in relation to tariffs was that while placing more emphasis on the role of ESB and NIE on setting their own tariffs was a good approach, the proposals to maintain the k-factor would adversely affect retail competition and impact on independent suppliers. Respondent were generally positive in relation to the revenue correction mechanism but argued that it should be clearly set out the threshold of where a tariff adjustment would take place. Respondents stated that adjustment thresholds for customer tariffs need to be clearly defined to eliminate uncertainty. One respondent stated that the decision to retain the revenue correction mechanism should be reviewed after the first year of SEM.

2.6 RA's decision Economic Purchase Obligation

The RAs have decided to place a series of controls on ESB and NIE in order to facilitate competition in generation and supply, to protect the interests of final customers and to

provide a clear, transparent and non-discriminatory mechanism for the determination of PES tariffs. In setting out these controls, the RAs are conscious of the need to operate a light handed approach to regulation. At the same time the RAs are aware that this needs to be balanced with a desire to provide customers with the full benefit of the SEM through the promotion of retail competition.

A key regulatory control relates to the Economic Purchase Obligation (EPO). As part of the hedging framework, the RAs have decided that ESB CS and NIES can participate in the non directed contract auctions run by ESB PG and NIE PPB. The EPO criteria require ESB and NIE to purchase contracts in a manner that is fair, transparent and non discriminatory while at the same time not overpaying for their contracts. To the extent that these suppliers pay too much for their contracts, their customers will pay too much for their electricity. The RAs have decided that both suppliers will be required to produce a Hedging Policy Statement including procurement principles. By approving these statements the RAs aim to ensure that ESB CS and NIES operate to a clear set of guidelines when deciding whether or not a particular hedge is viewed as being compliant with the EPO. Once approved, the RAs will publish details of these documents in July. The RAs are currently working with NIES and ESB CS on the format and content of the documents.

ESB CS and NIES suggested that they should be allowed some form of regulated contract for a proportion of their output. The RAs have decided that this is not an appropriate approach as it would result in a lower volume of hedges being offered to other suppliers at a time where there is a scarcity of hedges in the market. The RAs have been advised that the total volume of hedges sought by all suppliers will be less than the volume offered by generators.

2.7 Tariffs

The RAs have decided that ESB CS and NIES will submit, for approval, their Tariff Methodology Statements. The RAs are currently in discussions with the businesses on the form and content of these documents. The RAs will publish details of these documents during July.

The RAs have also decided to require ESB CS and NIES offer pool pass through based tariffs to their existing large customers (medium voltage or above). In relation to those large customers who may wish to revert to ESB CS a previous CER decision paper (Ref.: CER/06/206, 10th Oct. 2006) set out that ESB PES will no longer offer tariffs to non-ESB PES customers at MVMD, 38kV and 110kV or to new enterprises that would up to now contract with ESB PES. The CER proposes to continue this arrangement and will be consulting on the matter shortly.

All other tariffs to be based on the agreed methodology set out in the tariff methodology statement. ESB CS and NIES have agreed to submit relevant proposals to the RAs as part of their Tariff Methodology Statement.

The RAs have decided to allow NIES and ESB CS operate a correction factor relating to the tariff period November 2007 to September 2008. The RAs have also decided, for the time being, not to change the supply margins currently operated by ESB CS and NIES as the existence of the k-factor significantly removes the level of risk faced by both suppliers.

