



TRADING AND SETTLEMENT CODE

Terms of Reference for the Market Audit

DECISION PAPER

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AIP/SEM/07/502

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1 Introduction

1.1 Background

The Trading and Settlement Code (“TSC” or “the Code”) for the Single Electricity Market (SEM) was designated on 3rd July 2007. The TSC provides, inter alia, that a Market Audit will be conducted annually. Paragraph 2.136 of the TSC provides that the Regulatory Authorities (together the Commission for Energy Regulation (CER) and Northern Ireland Authority for Utility Regulation (NIAUR)) shall consult with Parties on the terms of reference for such Market Audit at least 10 weeks in advance of the commencement of the audit period. The first audit period for the SEM will commence on the Market Start Date, which is scheduled for 1st November 2007. The first audit period will cover the period from the market start date to 31st December 2008. The Regulatory Authorities have engaged an independent firm of Auditors to advise them on the scope of the terms of reference for the first audit period.

On 31st August 2007, the Regulatory Authorities published a paper¹ (“the Consultation Paper”) proposing terms of reference for the first Market Audit. The Consultation Paper sought comments by 21st September 2007. Comments were received from eight parties: Airtricity, ESB Customer Supply (ESBCS), ESB International² (ESBI), ESB Power Generation (ESBPG), Northern Ireland Electricity plc (NIE), the Market Operator (the MO), Synergen and Viridian Power and Energy (VPE).

Paragraph 2.136 of the TSC sets out that the Regulatory Authorities shall specify the precise terms of reference for the audit 4 weeks in advance of the commencement of each year (or audit period). This paper considers the comments received on the Consultation Paper, sets out the Regulatory Authorities’ response (in Section 2) and lays out the Regulatory Authorities’ decision on the terms of reference for the first Market Audit (in Section 3).

1.2 Requirement for Market Audit

The requirement for a Market Audit is set out in section 2 of the Trading & Settlement Code in paragraphs 2.131 to 2.143. Specifically,

- The Market Auditor is appointed by the Regulatory Authorities;
- The Market Auditor shall conduct an audit of the Code, its operation and implementation and the operations, trading arrangements, procedures and processes under the Code at least once a Year; and
- The Regulatory Authorities shall consult with Parties on the terms of reference for the audit, and specify and publish annually the precise terms of reference for the Market Audit.

¹ See AIP/SEM/07/457

² On behalf of Coolkeeragh ESB Ltd, Hibernian Wind Power Ltd, ESB Independent Energy Rol Supply and ESB Independent Energy NI Supply.

1.3 Next Steps

The Regulatory Authorities will now conduct a procurement exercise, as per paragraph 2.131 of the TSC, using the terms of reference set out in Section 3 to engage the Market Auditor. In accordance with paragraph 2.136 of the TSC, the Regulatory Authorities shall review these precise terms of reference of the market audit in their entirety in advance of the commencement of each audit period. It is expected that the terms of reference will be next consulted on and specified in advance of the 2009 audit.

1.4 Document Structure

This document is structured as follows:

- Section 1 sets out the requirement for a Market Audit as defined in the TSC and the consultation process regarding the terms of reference for the Market Audit;
- Section 2 summarises the key comments received from respondents and sets out the Regulatory Authorities' response; and
- Section 3 sets out the Regulatory Authorities' decision on the terms of reference for the first Market Audit.

2 Summary of Key Comments and Regulatory Authorities' response

This section sets out an overview of the comments received during the consultation process and the Regulatory Authorities' response.

2.1 Contractual and Governance Arrangements

2.1.1 Respondents' Comments

Three respondents expressed a desire for a governance panel, audit committee or more active role for the Modifications Panel to oversee the Market Audit, influence or determine the terms of reference and receive the Market Audit report. It was also suggested that an audit committee's remit should extend to receipt of MO monthly reports, and that an audit committee should comprise representatives from participants, Regulatory Authorities and the MO.

A desire was expressed for best practice governance and independent oversight, and comparisons were made to the GB position under NETA and BETTA. There were differing views as to whether the role of the Modifications Panel should be extended to provide the necessary independent governance, or whether this would over stretch the Modifications Panel, especially during the initial periods of market operation.

2.1.2 Response by the Regulatory Authorities

The Regulatory Authorities have decided that, for the initial period of operation, it is more practical for them to appoint the Market Auditor, determine the terms of reference and receive the Market Audit report. In doing so the RAs are effectively undertaking the role of an independent audit committee as they do not have an operational role in the running of the market or executive management responsibility for the MO.

The Regulatory Authorities have no objection in principle to the creation of a governance panel or similar body at a suitable time in the future. However, they would draw attention to the scale of the changes which would be required to be made to the Code to effect this and do not believe this represents a priority at this stage. The Regulatory Authorities would encourage discussion among participants on the nature of such a panel and to develop a consensus view on future direction.

2.2 Period of First Audit Report

2.2.1 Respondents' Comments and Response by the Regulatory Authorities

The Regulatory Authorities recognise the widespread support for interim audit procedures to be undertaken but note the concern expressed by the MO regarding the pressure this would place on MO resources during the first audit period. Accordingly, the RAs have decided that the interim audit procedures,

representing approximately 50% of the annual audit work, should be performed on the first seven months of the audit period, and that the scope should not be limited unnecessarily.

2.3 Materiality

2.3.1 Respondents' Comments

Three respondents suggested that a lower materiality threshold of 0.1% of market volume be adopted instead of 0.25% which they considered to be too high, pointing out that it may translate into a monetary amount of €7.5 million. However, one respondent stated that 0.25% was an appropriate level, representing approximately one day's market volume. A respondent further suggested that materiality be based on participant margin rather than turnover and another suggested that the significant issues threshold be aligned with a TSC threshold of €50,000 for High Materiality disputes. Another respondent requested clarification over circumstances which may give rise to qualification.

2.3.2 Response by the Regulatory Authorities

The determination of materiality is a matter of judgement and reflects cost benefit considerations as well as an assessment of risk and susceptibility to error. The Regulatory Authorities are advised that a materiality threshold of 0.25% represents a reasonable level for the first audit period noting that the materiality threshold represents the level of issue which would lead the Auditor to qualify its opinion in contrast to the transparency afforded through the reporting of significant issues using a threshold of 10% of materiality (i.e. at 0.025%). The level of materiality will be subject to review for future audits.

Basing materiality on participant margin would not be practical. The Market Auditor would not be party to commercially sensitive information on participant margins, and it would be impractical and costly to conduct an audit with different materiality levels for each participant.

Although the TSC defines High Materiality being above €50,000 for the purposes of the Settlement Queries and Disputes processes, it is principally used to determine the timing of the corrective settlement run and such a level would be inappropriate for the setting of the significant issues threshold for the Market Audit.

As alluded to in section 4.3.4 of the consultation document, matters which would fall to be corrected in the normal course of settlement would ordinarily not be included in the quantification of errors for the purposes of the audit opinion.

2.4 Nature of Market Audit Report

2.4.1 Respondents' Comments

Only a few comments were received on the proposed nature of the Market Audit report. One respondent expressed a preference for a compliance opinion, while

another preferred an ISAE3000 or SAS70 type report, along with benchmarking of market rules and operation. It was further suggested that clearance on the wording of the report be obtained from the Accounting Standards Board (ASB) or professional Institute.

2.4.2 Response by the Regulatory Authorities

The Regulatory Authorities are advised that a compliance opinion is appropriate for the initial audit period, as it would provide assurance on the MO's compliance with the Code and Agree Procedures (APs) in the period following the implementation of the new market and could be delivered in an acceptable timeframe for a reasonable cost. A "true and fair" type opinion would not be practical as the main data providers (MDPs and TSOs) are excluded from the proposed scope and such an opinion would be required to be heavily caveated.

An ISAE3000 or SAS70 engagement would place a significant burden on the MO for the preparation of the required controls documentation. An ISRS4400 engagement would not lead to an audit opinion but instead to a report of factual findings which would need to be interpreted by each recipient. Benchmarking of market rules and operation against similar international markets does not form part of a market assurance role and would not be practical.

Specimen opinions were provided in the consultation document to assist the understanding of the various options; the specific wording will be a matter for the appointed Market Auditor in consultation with the Regulatory Authorities. There is no precedent or necessity for advance clearance with a professional Institute. Furthermore, it should be noted that the ASB is concerned with financial reporting and accounting standards, and is not the relevant body for Auditing Standards.

2.5 Reporting

2.5.1 Respondents' Comments

Comments were received on the reporting of significant issues and reporting timescales; with several respondents requesting that all significant issues be reported and others commenting that clear, unambiguous reporting timelines need to be established. In addition, the MO expressed concern that there was no provision for it to see the draft report in its entirety prior to finalisation despite the fact that it would be the only entity subject to audit, and it would be unable to comment and respond on the overall conclusions of the Market Audit report. One respondent highlighted the likely requirement for letters of representation, and expressed a desire for a Market Audit Seminar.

2.5.2 Response by the Regulatory Authorities

Under Auditing Standards, the Market Auditor designs the audit procedures to deliver a high confidence of reporting material errors. In addition, it is proposed that there is also reporting of any issues identified during the course of the audit which are above the significant issues threshold. To provide a high confidence of identifying all significant issues would require materiality to be reduced to the

significant issues threshold, and this would result in a very substantial increase in the level of audit testing and resultant cost. For the avoidance of doubt, all significant issues identified during audit testing will be reported.

Market Audit finalisation and reporting timescales will be agreed between the Regulatory Authorities and the appointed Market Auditor. The Regulatory Authorities share the desire for timely reporting but would wish to ensure timescales are achievable and realistic.

It is for the Regulatory Authorities to decide which entities should have sight of draft reports and at what stage. As part of the drafting process, individual issues will be discussed with the audited party in order to confirm factual accuracy and context, and to elicit resolution actions, before the full draft report is delivered by the Market Auditor to the Regulatory Authorities. However, as the Market Audit will concentrate on the activities of the MO in the first audit period, the Regulatory Authorities believe it would be just and reasonable for it to provide the MO with sight of the draft report in its entirety prior to finalisation to allow the MO to consider the whole report and comment and respond appropriately.

The need for letters of representation from the Regulatory Authorities and/or MO will be a matter for the appointed Market Auditor, in consultation with the Regulatory Authorities. As noted in section 7.1 of the consultation document, the MO will enter into a side agreement with the Market Auditor acknowledging the terms of engagement of the Market Auditor and respective responsibilities.

The Regulatory Authorities are keen for participants to have visibility over the Market Audit report and any issues identified therein. An appropriate communication forum will be considered by the Regulatory Authorities, for example, inviting participants to attend as observers at the Modifications Panel meeting at which the Market Audit report is presented.

2.6 Boundary of Audit

2.6.1 Respondents' Comments

Three respondents stated that the MSP Pricing Engine should be included without the exclusions proposed in the consultation document, with one stating that it represented a critical commercial element of the market. Other respondents commented that the components of the MSP Pricing Engine are the most important part of the market price determination.

One respondent supported the exclusion for the audit of the internal workings of MSP given the testing already performed by the MO and participants. Three respondents were of the view that the scope of the audit should be extended beyond the MO to include the Meter Data Providers (MDPs) and the Transmission System Operators (TSOs), in view of the criticality of the completeness, accuracy and timeliness of source data on settlement allocations.

Two respondents requested that the audit include Market Participant User Documentation as well as the Code and Agreed Procedures. Other comments related to focusing on manual workarounds, change control, contingency plans,

communication processes, disputes and detailed aspects of audit testing. One respondent expressed concern about the potential duplication between the Market Audit, Market Monitor and MO Monthly Reporting.

2.6.2 Response by the Regulatory Authorities

The Regulatory Authorities recognise the concerns expressed by respondents regarding the exclusion of certain components of the MSP Pricing Engine and omission of MDPs and TSOs in the first period of audit. However, the proposal to focus on the activities of the MO represents a sensible and practical scope for the first period. The Regulatory Authorities believe that focusing on a new organisation operating new systems under a new Code will provide value to participants at a reasonable cost and without undermining the ongoing operation of the Market.

The Regulatory Authorities also point out that individual participants will be able to perform their own validation and reasonableness checks on their data and, if they have concerns or consider there may be errors, they may raise queries and disputes under the Code. Based on experience during the initial period of operation, the Regulatory Authorities will revisit the scope boundaries in determining the terms of reference for future years.

The Market Audit will review compliance by the MO with the Code and Agreed Procedures and will cover the MO activities set out at section 7.6 of the consultation document. Reviewing compliance with the Market Participant User Documentation is not considered relevant or appropriate. The specific design of audit tests will be a matter for the appointed Market Auditor. The Market Auditor, Market Monitor and MO Monthly Reporting have clear and distinct purposes, and the Regulatory Authorities believe there is minimal if any duplication or overlap between them.

3 Terms of Reference

This section sets out the Regulatory Authorities' decision on the terms of reference for the first Market Audit, based on the matters discussed in section 2 above.

3.1 Contractual and Governance Arrangements

In accordance with paragraph 2.136 of the SEM Trading and Settlement Code (TSC), the Regulatory Authorities hereby specify the terms of reference for the first market audit for the period from the Market Start Date to 31st December 2008 as set out below. The Regulatory Authorities will undertake a procurement exercise and appoint a Market Auditor in accordance with paragraph 2.131 of the TSC.

Based on the terms of reference, the chosen Market Auditor will prepare an Audit Plan setting out the detailed audit approach which will be presented to and agreed with the Regulatory Authorities. In preparing the Market Audit Plan, the Market Auditor may consult with the Regulatory Authorities, Market Operator and other participants as required.

The Market Operator and Market Auditor will enter into a side agreement acknowledging the terms of engagement of the Market Auditor and respective responsibilities. It is likely that the chosen Market Auditor will enter into some form of agreement with Parties to the TSC who receive a copy of its report.

3.2 Period of First Audit Report

Given the length of the period of the first audit, it is intended that the chosen Market Auditor should perform interim audit procedures during this period to cover the first seven months of the audit period. This would involve approximately 50% of the audit work that would be required for a full year, and lead to the production of an Interim Review Report and Report of Significant Issues. The purpose of the Interim Review Report would be to report to the Regulatory Authorities and Parties whether any issues had been identified which may lead to qualification of the Audit Opinion for the full audit period.

3.3 Materiality

The materiality for the audit shall be set at 0.25% of estimated annual market value.

A lower threshold, 10% of materiality, will be adopted for the reporting of significant issues identified during the course of the Market Audit, although it is recognised there may be qualitative aspects in determining the significance of any issue. That is, the Market Auditor shall report on issues which come to its attention which exceed this significant issues threshold or which it believes to be significant for other reasons.

3.4 Nature of Market Audit Report

The Market Audit Report shall take the form of a compliance audit report and shall also include a Report on Significant Issues, identifying significant issues that have come to light during the course of the audit which did not affect the overall audit opinion.

3.5 Reporting

In the preparation of the Market Audit Report, the Market Auditor will discuss individual draft issues with the Market Operator and other Parties insofar as they relate to them in order to confirm factual accuracy of the issues and their estimated quantification, and that all pertinent information and clarifications have reasonably been included.

The Market Auditor will subsequently discuss a full draft of the Market Audit Report with the Regulatory Authorities who may, at their discretion, invite or include named participants in the discussion of the draft report. The Regulatory Authorities believe that it may be necessary for them to discuss with the Market Operator and the Market Auditor any relevant Significant Issues included in the draft report.

The final version of the Market Audit Report will be addressed to the Regulatory Authorities. The final version of the Market Audit Report will be provided to Parties to the TSC, in line with the provisions of the TSC, and subject to any confidentiality provisions required by the Market Auditor.

3.6 Boundary of Audit

The Trading and Settlement Code Section 2.133 sets out that “the Market Auditor shall conduct an audit of the Code, its operation and implementation and the operations, trading arrangements, procedures and processes under the Code”. The remit of this proposed scope for the first market audit period has been set on the basis of this, and the Regulatory Authorities consider that the systems, activities and processes under the aegis of the Market Operator (and other parties where stipulated) fulfil the requirements of the Market Audit provisions in the Code. The Terms of Reference are set on an annual basis by the Regulatory Authorities and it is intended that the boundaries of the Audit will evolve over time, as the market develops.

The scope of the Market Audit for the initial period of operation of the market will focus on the activities of the Market Operator under the TSC and Agreed Procedures and cover the systems and processes within the control of the Market Operator.

This contained scope excludes activities undertaken by the TSOs, Meter Data Providers and other participants as set out in the TSC and Agreed Procedures. However, in view of the transfer of the calculation of Modified Interconnector Unit Nominations from the Interconnector Administrator to the Market Operator twelve

months after the Market Start Date, this activity will be included within the scope of the initial Market Audit.

The relevant Market Operator activities, to the extent covered by specific requirements in the TSC, Rules and Agreed Procedures, will include:

- Accession and Registration
- Settlement production, including operation of the MSP Software (subject to the limitation set out in the paragraph below), Instruction Profiling, calculation of Energy Payments and Charges, and calculation of Capacity Payments and Charges, etc.
- Market Operator, Currency, Balancing and other Charges
- Invoicing and Payment
- Credit Cover management, including Settlement Reallocation
- Disputes
- Design Authority / Code development

For the first Market Audit period it is intended to exclude the operation of certain components of the MSP Pricing Engine from the scope of the Market Audit. The excluded components are the operation of Unit Commitment, Economic Dispatch and calculation of Shadow Prices. The reduced scope for the MSP Pricing Engine would therefore include:

- Performing testing over change control, IS operations and access security to verify that only thoroughly tested and properly authorised changes are made to the MSP Pricing Engine; and
- Performing a set of test procedures limited to the application of Uplift to Shadow Prices to determine System Marginal Prices and areas of manual intervention and controls exercised by the Market Operator over the operation of the MSP software, including controls over receipt and upload of data inputs, including system static data, Generator Unit standing data and Offer Data; controls over the modification of data provided to the Market Operator, e.g. conflicting input data, replacement of zero single ramp up/down rates; and adherence to timetables for gate closure and settlement runs.