Response of Bord Gáis Energy Supply

to

The Directed Contract Implementation Report

SEM-08-02

Bord Gáis Energy Supply (BGES) is appreciative of the opportunity to provide comment on the 'Directed Contract Implementation Report' issued by the Single Electricity Market (SEM) Committee on 5th February 2008. The following are our thoughts on the proposals/elements contained within that paper; as follows:

The structure of the Single Electricity Market (SEM) wholesale market means that hedge contracts are an instrumental and vital tool in the enablement of a competitive retail market. The overall elements of availability, design and structure of Contract for Differences (CfDs) must interlink effectively in order for them to provide adequate hedges for Independent Suppliers in operating a stable and effective retail market that delivers real and efficient benefits for customers. Therefore, while it is important to have a feasible plan in delivering Directed Contracts (DCs) to the market, it is imperative that this is delivered complimentary to and in tandem with an overall effective hedge contracts or CfDs marketplace.

While Directed Contracts are only an element of the overall hedge contract market, they have to date formed the basis and template of it. While it is hoped that a liquid and effective non-DC market will develop over time; for now the operation of the DC market must be recognised as being the integral element. It is vital therefore that appropriate volumes and forms of products are put in place which will enable both the development of a non-regulated marketplace and a successful retail market. While theory and measures are required to determine product design and volumes, the particular environment that they are being applied to sometimes requires a change in perspective. In the developing All-Island market there is a need to identify the real requirements to deliver a sustainable, secure and reliable marketplace. In this regard, we believe that there is a clear requirement for a high level of Directed Contracts to be made available to the market and were somewhat disappointed that the Regulatory Authorities (RAs) did not set a HHI target of 1,150 in determining the volume of contracts that are made available under the DCs market stream. At this early stage of market development and in the context of the current environment, we do not believe that there is adequate justification to increase this setting at this time.

A high-level view of the current market environment might point to an availability of Independent Generation and hence CfDs for Baseload contracts; in context these are only available for contract with certain Independent Suppliers hence the potential to foreclose the market, in this early stage, exists. Related to this is the availability of products which are useful to the retail market in fulfilling their objective which is to supply a competitively priced product for retail to customers who should benefit from their ability to do so. Hence, while standard products are of course easier to deliver and administer, they may impede on the ability of an Independent Supplier to deliver on its objectives; the requirement for innovation and differentiation should not be overlooked.

To attempt to provide some sort of solution to this issue; while a certain level of baseload, mid merit and peak contracts are required in the current marketplace, a suitable alternative would be the provision of a larger number and mix of additional standard products over a more differentiated time period than currently proposed. For example products provided on a monthly, rather than quarterly basis, allow Suppliers to differentiate their portfolio providing an ability to differentiate their product offerings to customers, providing customers with the ability to choose a differentiated service. Following on from this theme, a variance on standard products, whilst recognising the need for efficient administration, could be as follows:

- A 10 hour Mid Merit product (6am – 4pm) (7 days)
- A 10 hour Off Peak product (8pm – 6pm) (7 days)
- 1/2 Mid Merit products (as currently available with proposed change to commence time of 7am)
- An 8 hour Working Hour product (9am – 5pm, weekdays)
- A 4 hour Peak product (4pm – 8pm) (5pm – 9pm)
- A 2 hour Peak product (5pm – 7pm)

Originally it was intended that products would be offered to the market with a choice of One-way or Two-way pricing however this was overturned later on the basis that One-way options were difficult to price. With the benefit of SEM operation, the ability to offer One-Way pricing should be improved. Could this be introduced for a particular product e.g. the 2 hour Peak?

Returning to the issue of the overall hedge/CfD marketplace, it is imperative that a coordinated set of auctions are put in place providing adequate time for both Suppliers and Generators to partake in the auctions efficiently. Due to the nature of the different pricing mechanisms, we believe that a longer duration for the DC Subscription window is warranted even at the expense of the NDC and PSO auction timeframes. The current proposed windows allow only 4 weeks in total for the DC auctions. We understand that market participants have previously requested a longer NDC window even if this was at the expense of the DC timeframe, however we believe this may have been a result of the 2007 experience, which for a variety of understandable reasons, did not deliver an overall efficient process for the operation of the hedge/CfD marketplace. We therefore request that the RAs reconsider the current proposals, without changing the overall time allocated to the auction processes, so that there is a 4 week plus one (supplemental) timeframe for DCs auctions followed by 3 weeks for NDCs and 1.5 weeks for the PSO auctions. The auctions for annual Moyle capacity should take place in tandem with the NDC/PSO auctions.

On the same issue of an overall hedge/CfD marketplace, the provision of full and timely information will go a long way towards achieving a coherent and stable contracts market which will enable the natural setting up of an efficiently competitive retail market. The operation, efficiency and value of the overall auction processes would be significantly enhanced by an initial publication of the important elements of all CfD auctions (and the Moyle capacity one) prior to the commencement of the first auction. Ideally full or indicative information on timing, volumes, products and pricing basis would add a lot of clarity and transparency for all market participants would be provided in early April.

While the provision of a standard DC is a welcome element, inflexible terms contained in same should be avoided. The industry should encourage and reward efficiency and innovation however the current standard contracts imposes constant terms and conditions on all purchasers of DCs. This can be highlighted by the approach to credit cover. All parties should be allowed to contract with other parties whom they view to be credit-worthy or indeed meet necessary requirements to forego same. In standard CfD contracts, it is unusual for one party to waive the right of another to assess if the former is deemed creditworthy under the latter's normal criteria for same. Indeed, it could foreclose the ability of a market participant to contract. In a competitive market, this simply means that the purchaser would have to go elsewhere to conclude same; however the very fact that directed contracts have been regulated and taking the context of the current environment into account, options can be limited. More unusual, is for that same party to not have the ability to determine if it is satisfied that all, some or none of the interested counterparties are considered creditworthy by its own standard set of criteria. The fact that a similar approach to credit cover exists in the wholesale market is a separate debate. There is little justification for the repetition of rules (particularly excessive ones) from one market to another. Appropriate wording of a term or clause in a contract can be inserted into standard contracts, to cover an ad-hoc approach with clear parameters in place, to demonstrate that a transparent, clear and fair approach is in place for different treatment of different parties in standard auction processes.

We note in the paper that the RAs intend on publishing a new Master Contract for Differences in due course. We would like to request that as the RAs are involved in the provision of NDC and PSO auctions that draft contracts are issued to participants as soon as possible as the process for organisations in obtaining legal review of same can be time-consuming and can detract participants attention from the auction processes themselves. Ideally final contracts for all hedge/CfD auctions (and the Moyle capacity auction) should be made available to market participants a number of weeks (3 – 4) prior to the commencement of the first auction.

Finally, in order to aid the development of a non-regulated hedge/CfD marketplace, restrictions, or potential restrictions on parties discussing non-standard hedge/CfD contracts, should be removed if at all possible. This should not extend to the current restriction on ESB and NIE PES organisations from engaging in or concluding bilateral contracts with their affiliates without advance RA approval. We would appreciate it if the RAs would confirm if these restrictions are only in relation to ESB PG and NIE PPB respectively i.e. is ESB PES free to negotiate hedge/CfD contracts with ESB Independent Generations and also if such approval is given by the RAs that this approval is published and made known to the market. While incidental to this particular consultation paper, this is important to clarify for understanding regulated tariff charges to which the DC process contributes.

To conclude, we would like to take this opportunity to thank the RAs for taking a proactive approach in enabling a more stable hedge contracts process/market in 2008 and we look forward to being able to participate in the various auctions due to take place this year. The following bullet points are provided to provide a summary of our comments throughout this paper:

- The same level, if not greater, of 2007 DC contracts should be made available to the market in 2008.
- In the context of the current environment there is a requirement for the same level of baseload CfDs
- The availability of 2 Mid-Merit and 2 Peak products would add a significant degree of innovation in the market. However should these be made available in the NDC/PSO auctions than this would suffice.
- There is a genuine requirement for monthly hedge contracts.
- Innovation in pricing should be encouraged e.g. the introduction of option pricing on a Peak product.
- Standard DCs should allow for deviation in relation to different counterparties eg not all counterparties should have to have the same credit arrangements in place to deal with ESB/NIE, particularly if they meet the standard set of criteria that ESB/NIE would apply in a non-regulated commercial environment.
- Due to the different nature of the pricing basis (and resulting exposure levels) for the 3 categories of CfD auctions, a longer subscription window than that currently proposed should be in place for Directed Contract auctions.
- Full information on all auctions should be provided to market participants a number of weeks before the commencement of the first auction. In addition, all legal contracts should be made available to market participants as soon as possible to allow for ample time to clear them for signature.