

Single Electricity Market Committee

Contracts for Differences (CfDs) in the Single Electricity Market (SEM)

The 2009 Contracting Process

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Table of Contents

1. Introduction	3
2. Experience to Date.....	3
3. Feedback from Market Participants and RAs' Position	4
4. Directed Contracts	8
5. Non Directed Contracts (including Ireland PSO Contracts).....	9
6. Establishment of a Contracts Trading Platform	9
7. Indicative Contracting Timetable for 2009.....	10

1. Introduction

The Commission for Energy Regulation and the Northern Ireland Authority for Utility Regulation (the Regulatory Authorities or RAs) have developed a single all-island electricity market, the Single Electricity Market (SEM), which came into operation on November 1st 2007. Further details on the project can be found on the AIP website (www.allislandproject.org).

Risk Management is an integral element of the efficient and effective operation of the SEM. To date there have been offerings of a substantial volume of 2-way Contracts for Differences (CfDs) which have enabled generators and suppliers to manage price risk in the SEM. The availability of CfDs is also an important means of delivering both wholesale and retail competition to the ultimate benefit of final customers.

The purpose of this paper is to outline the SEM Committee position with regard to the conduct of the SEM contracting process from 2009.¹ An indicative timetable is provided for participants' information and the SEM Committee expect more detailed timelines and relevant information such as volumes and products to be communicated to participants over the coming weeks.

2. Experience to Date

Over the past two years contracts have generally been offered through what is known as the Directed Contract (DC) and the Non Directed Contract (NDC) processes. While we understand that bilateral contract trading occurs between independent participants, such commercial contracting does not come within the remit of the RAs.

Also, while only the DC process is directly regulated by the RAs, we do have a broader role in promoting market liquidity through the NDC process and/or a Multi-lateral Trading Facility (MTF) as well as a role in ensuring that any participation in the offering of CfDs by the incumbents is fair and transparent.

¹ The SEM Committee is established in Ireland and Northern Ireland by virtue of section 8A of the Electricity Regulation Act 1999 as inserted by section 4 of the Electricity Regulation (Amendment) Act 2007, and Article 6 (1) of the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 respectively. The SEM Committee is a Committee of both CER and NIAUR (together the RAs) that, on behalf of the RAs, takes any decision as to the exercise of a relevant function of CER or NIAUR in relation to an SEM matter. In this paper the terms 'SEM Committee' and 'RAs' are used interchangeably.

To date, the overall process has started with the offering of DCs, which are priced by the RAs and imposed on incumbent generators who have market power. The DC process has then been followed by the auctioning of the remaining contracts by the incumbent generators (ESB Power Generation and NIE Energy Power Procurement Business), and then the auctioning of Irish generation backed by the Public Service Obligation (PSO). The latter two come under the NDC process.

The overall contracting process commenced, in both years, approximately 5 months before the start of the regulated retail tariff year and has operated over a limited length of time in order to feed into the annual tariff determination, consultation and approval process. The contracts offered have covered the duration of the retail tariff year, have been for a term of one quarter, a season and one year, and have included four standard products; Baseload, Mid-Merit, Mid-Merit 2 and Peak.

While the contracting processes have operated smoothly, and were suitable for the initial operation of the SEM, the RAs have asked market participants for their views on improvements to, and the development of, the overall process.

3. Feedback from Market Participants and RAs' Position

In December 2008 the RAs hosted a forum with market participants to review the established contracting processes outlined in section 2 above. Participants were asked to formally make submissions to the RAs on suggested improvements or changes to the contracting process.

The key issues raised by market participants, either in their submissions or at the forum itself, are summarised below, along with the RAs' response. The issues raised concerning the incumbent suppliers' retail tariffs, including tariff duration, the correction (K) factor and transparency of procurement practices are part of a separate workstream and are not covered in this paper.

a) Extended Contracting Period

A number of participants preferred a longer hedging window compared to the 2007 (12 weeks) and 2008 (9 weeks) windows. There was also a suggestion that there should be more frequent auctions or more contracting windows.

RA Response

The RAs support the introduction of an extended overall contracting timeline so as to allow market participants the scope to manage and diversify their risks to the benefit of their customers. This should reduce, or smooth, the risk of suppliers hedging during periods or on days of particular volatile or high fuel and other input prices.

The RAs believe there to be scope and advantages to some degree of ongoing contracting and would like to see participants in general adopt a more dynamic approach to diversifying and hedging their underlying pool price risks.

b) Greater Volume of Contracts

All participants called for more volume to be offered, both through the DC and NDC processes.

RA Response

The volume of DCs is determined for the purpose of mitigating market power in the wholesale market. The volume is largely based on an appropriate concentration level for the SEM, as measured by the Herfindahl-Hirschman Index (HHI). Therefore, the aim of this market power mitigation strategy is not to maximise the level of DCs, but to remove incentives to profit from the exertion of market power.

In terms of the NDC process, the RAs encourage both ESB PG and NIE Energy PPB to offer the maximum volume of contracts possible, taking account of the need for prudent risk management practices. The RAs will monitor the reasonableness of the volume of contracts offered by the incumbent generators.

c) Greater Flexibility and Variety of Products

Participants generally said that there was a need for more mid-merit and peak products. Participants also asked for short-term contracts to be offered, with particular reference made to monthly products.

Several participants asked for contracts extending beyond the traditional annual retail tariff year, as far out as 2 years. One respondent felt that multi-year contracts could present competition issues.

One participant suggested that the PSO-backed contracts should be offered through a mixture of baseload and mid-merit products, to reflect the underlying generation profile.

RA Response

The RAs support more flexibility and choice of hedge products in the SEM and the RAs will examine the appropriate mix of products to be offered through the PSO-backed contracts.

However, overall the RAs have not been provided with much detail by participants on the products sought but rather a broad, but helpful, overview. The RAs also note that the prevalence of non-generic products could actually result in less competition in the contracts market.

The RAs would encourage suppliers to be more specific in communicating product preferences to the sellers of contracts and to the RAs. To this end the RAs request the contract sellers to open discussions with industry participants as soon as possible.

The RAs note that the Trading and Settlement Code Modifications Committee is currently considering a modification proposal ('the Dual Rated Generator Amendment' modification, Mod_34_08), which is relevant to the issue of peak prices. This proposal may address the volatility and level of peak prices in the SEM and may well have the effect of reducing the requirement that participants have expressed for peak products.

d) Development of a Contracts Trading Platform

Most participants supported the establishment of the trading platform. One respondent wrote that the trading platform should not take over completely from the established DC and NDC process.

RA Response

The RAs support the development of a robust and cost-effective MTF. The RAs would expect that this would lead to significant gains in terms of enhanced

competition through increased liquidity and transparency, and to administrative efficiencies, to the ultimate benefit of customers.

The RAs would also expect that the established DC process would continue as long as there is a need to mitigate market power and that the NDC process will proceed in parallel with the trading platform, at least for this year. The RAs also believe there may be scope for bilateral trades, particularly for non-generic products. Such trades involving the incumbent suppliers would be subject to strict regulatory oversight. The ultimate goal in the medium- to long-term however should be for most contracts to be traded openly on an MTF.

e) Concerns with NIE Energy PPB not offering contracts

A number of participants expressed their concerns that NIE Energy PPB may not be in a position to offer contracts in 2009 due to their compliance concerns with the EU's Market in Financial Instruments Directive (MiFID).

RA Response

The RAs agree with participants that this scenario would present a backward step in terms of the development of competition in the market. The RAs have discussed this issue with NIE Energy PPB and have been advised that the establishment of an MTF will address their MiFID concerns. This appears to be the practical solution for this year.

In principle, the RAs' position is that NIE Energy PPB (and ESB PG) should be in a position to offer contracts to the market in an open, transparent and cost-effective manner.

f) Transparency

Participants asked for clarity on prospective CfD volumes and timing of contract auctions. They also called for the publication of auction results in a timely fashion.

RA Response

The purpose of this paper is to provide clarity on the general timing of the contract processes for 2009. The RAs expect ESB PG and NIE Energy PPB to

clarify the timing of the relevant contracting rounds and the associated volumes and products as a matter of urgency.

Auction results, at least in terms of strike prices and volumes, should also be made available to participants in a timely manner. The RAs will work with incumbent suppliers to publish an appropriate level of information to further support the development of retail competition.

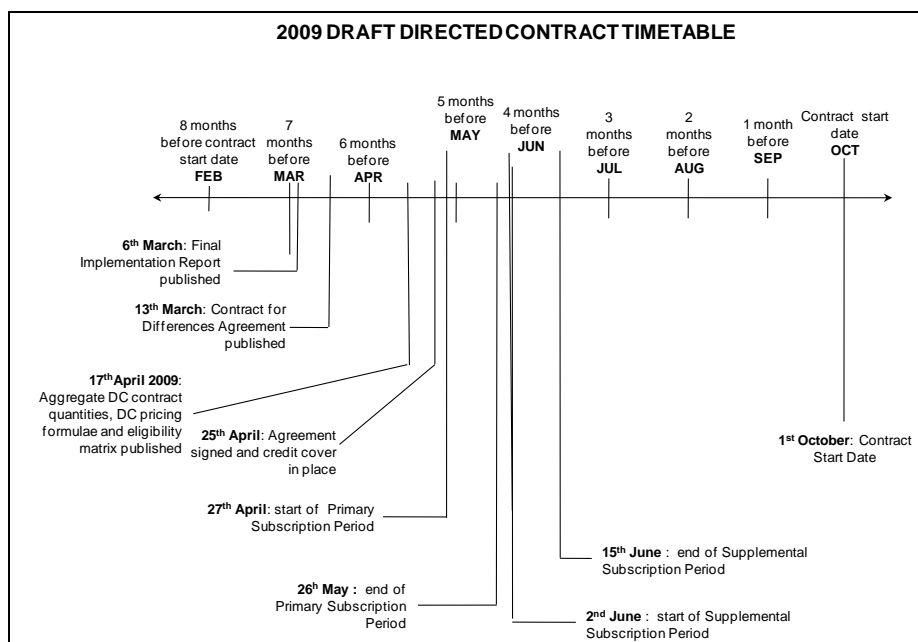
4. Directed Contracts

The SEM Committee will shortly issue a consultation paper on the implementation of DCs in 2009. The consultation paper describes, in detail, the tasks that will be performed by the RAs, as well as by the parties to the DCs.

The report also proposes the timing of each stage of the implementation and subscription process. This year the RAs are proposing to extend the subscription window to 6 weeks, compared to the 4-week window which was in place last year. The RAs are also proposing to increase the maximum daily volumes of DCs that suppliers can nominate to purchase.

The RAs also expect that the NDC process and MTF will commence in advance of the DC subscription process.

The proposed DC timetable is shown in the figure below:



5. Non Directed Contracts (including Ireland PSO Contracts)

While the RAs' legal remit largely extends to DCs, the RAs believe that sellers should offer NDCs to market participants from the earliest possible date from now. This process should be initiated by ESB PG and should commence well in advance of the DC process.

While the RAs would expect most of the volume to be offered over a period of several months, the RAs would encourage ESB PG to offer volume for within-year trading and for short-term products. This should take place either through the NDC process or on the trading platform (or both) and should take account of the preferences of suppliers in terms of product types and durations.

The RAs expect ESB PG to commence the NDC process in late February. The auctioning of PSO-backed contracts is expected to take place from mid-June to mid-August but the RAs are considering bringing this timeline forward.

6. Establishment of a Contracts Trading Platform

The RAs are aware of, and welcome, market participants' efforts to establish a trading platform for SEM contracts. We note that trials are currently underway with a commodity broker and that the platform should be operational from mid- to late-March. The RAs will continue to be involved in, and assist with, this process.

The establishment of a robust trading platform should introduce a greater degree of liquidity, transparency and flexibility in the contracting process. The trading platform will also provide an opportunity for other generator participants, apart from ESB PG and NIE Energy PPB, to make contracts available to market participants.

The RAs have received assurances from both ESB PG and NIE Energy PPB that they will make every reasonable effort over the coming weeks to assist in the establishment of, and participate in, a functional and robust trading facility. The RAs understand that a meaningful volume of contracts (over 6 TWhrs) will be made available on a trading platform this year.

7. Indicative Contracting Timetable for 2009

The indicative 2009 contracting process is outlined in the figure below. The RAs expect that the DC and PSO subscriptions/auctions will be discrete processes in 2009. The RAs support the adoption of a more dynamic approach in relation to ESB PG's NDC process and through the MTF, and would therefore expect these processes to include some ongoing auctioning of contracts.

