Single Electricity Market Committee

Contracts for Differences -

Option for Directed Contracts 2011/'12

A Consultation Paper

SEM-11-007

17th February 2011

Table of Contents

1. Introduction

1.1 Background

Since 1st November 2007 the Northern Ireland Authority for Utility Regulation (NIAUR) and the Commission for Energy Regulation (CER), together referred to as the Regulatory Authorities or RAs, have jointly regulated the all-Island wholesale electricity market known as the Single Electricity Market (SEM) covering both Northern Ireland and the Republic of Ireland. Further details on the project can be found on the AIP website at www.allislandproject.org.

The SEM includes a centralised gross pool (or spot) market which, given its mandatory nature for generators (above 10 MW) and suppliers, is fully liquid. In this pool electricity is bought and sold through a market clearing mechanism, whereby generators bid in their Short Run Marginal Cost (SRMC) and receive the System Marginal Price (SMP) for each trading period for their scheduled market quantities, as well as other revenue streams. Suppliers purchasing energy from the pool pay the SMP for each trading period along with other costs.

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 and hedge the wholesale price - i.e. SMP - risk inherent in the SEM. CfDs assist both wholesale and retail competition to the ultimate benefit of final customers. This is because the ability of generators and suppliers to enter into and access contracts enhances the financial certainty, flexibility and innovation of participants in both the wholesale and retail markets.

1.2 Purpose of this Paper & Request for Comment

A background to the current types of CfD, including Directed Contracts (DCs), is provided in section 2 of this paper. The purpose of this paper is to consult on one key issue:

- The process/timeline for offering DCs for the forthcoming tariff year. Two scenarios are presented in section 3 of the paper for comment - DCs for the 2011/'12 tariff year could be offered either annually (only) in Q2 of this year, as had been the case to date, or they could also be offered on a shorter-term basis.

The RAs invite interested parties to submit comments on which DC option should be adopted, by **17:00 on Friday 4th March 2011**, preferably in electronic form, to the contacts shown on the next page.

Please note that, as discussed in section 2, other (non-DC) aspects of CfDs will be published separately and so we request that respondents focus solely on their preferred option for the DCs. These other aspects include clarity around the sustainability of PSO-related CfDs which the RAs are currently considering from a legal perspective. The RAs hope to clarify the situation regarding PSO-related CfDs over the next week or so in a separate paper. In any event, market participants will have the opportunity to consider our position in relation to PSO CfDs in advance of the comment deadline to this DC paper (we will extend the comments deadline if necessary).

Finally, section 4 of this paper provides, for information, an overview of the fuel sources that are intended to be used as part of this year's DC process.

The SEM Committee intends to publish all comments received to this paper. Those respondents who would like certain sections of their responses to remain confidential should submit the relevant sections in an appendix market as confidential.

Following the consultation period, and taking account of the responses received, the SEM Committee[1] will issue a decision paper in late March on which DC option will be adopted, along with details on the implementation timelines and processes also provided.

Response Contacts:

Kevin Hagan
Commission for Energy Regulation
The Exchange
Belgard Square North
Tallaght
Dublin 24
E-mail: khagan@cer.ie

and

Colin Broomfield
Northern Ireland Authority for Utility Regulation
Queens House
10-18 Queen Street
Belfast BT1 6ED
E-mail:colin.broomfield@niaur.gov.uk

[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.

2. Background to Contracting

A general overview of CfD liquidity in the SEM, including the different types of CfD offered to date, is provided at SEM-10-057 at the following link:

http://www.allislandproject.org/GetAttachment.aspx?id=e83a335f-8366-416c-a6fe-96a0d54b1721

For a brief background, there are there are three types of CfD currently being offered in the SEM:

- DCs: Incumbent generators with large shares of control over generation in the SEM are required by the RAs to offer DCs, in order to mitigate their market power. As they are "directed", it is the RAs, after consultation with industry, who decide on the methodology, pricing and quantity of these DCs. For further information on DCs for the current tariff year please see SEM-10-022 at the following link:

  http://www.allislandproject.org/GetAttachment.aspx?id=3652c2fd-4904-44af-a88d-06d7197e8b3e

  The primary purpose of this paper is to consult on the approach to DCs for the next tariff year, i.e. from October 2011 to end September 2012 - see section 3.

- In recent years CfDs associated with the Public Service Obligation (PSO) levy in Ireland have been offered. For example, for the current tariff year about 600 MW have been offered as year ahead and within-year products - please see SEM-10-047 for further details at:

  http://www.allislandproject.org/GetAttachment.aspx?id=aa116aec-d607-4376-a42f-6add6c019ade

  However, there is legal uncertainty around the sustainability of PSO-related CfDs into the future as referred to in the market power and liquidity project, including at an RA public workshop held in the CER office on 18th January 2011. The RAs are currently receiving legal advice on this matter and we hope to publish a paper clarifying the issue over the next week or so. In any event, market participants will have the opportunity to consider the final position in relation to PSO CfDs in advance of the comment deadline to this DC paper (we will extend the comments deadline if necessary).

- Non-Directed Contracts (NDCs): In addition to the DCs, generators can offer forward NDCs in the SEM which suppliers are free to bid for. The RAs have no role in setting the pricevolume of these forward contracts, although we do promote their provision. To date there have been two parties who offer NDCs to the all participants in the market, ESB PG and NIEE PPB - please see SEM-10-047 for details of NDCs on offer for this tariff year, at:

http://www.allislandproject.org/GetAttachment.aspx?id=aa116aec-d607-4376-a42f-6add6c019ade

Details of NDCs to be offered for the forthcoming tariff year will be published by the RAs in by early April.

3. DC Option for Consultation

To date in the SEM, every year the RAs' have offered DCs on an annual basis for the forthcoming tariff year - for example last year the subscription window was from late April to early June, covering each quarterly product for the entire 2010/'11 tariff year (see SEM-10-022 for details). If the RAs continue with the same approach as last year, the DC subscription window will commence from **late May** (further details will be available in the paper published in late March, following this paper).

This year the RAs are offering an alternative to this standard practice for DCs, and will make a decision informed by feedback to this paper. The alternative would be to offer DCs on a more regular basis before and during the tariff year, rather than just once for the tariff year. With this option, the broad methodology and products used in previous years for determining DCs would remain (see SEM-10-057), but specifically the following would change

1. The DC subscription windows would not be held only before the tariff year for the entire year, but instead each of the quarterly DC products would be offered **both** for the entire year **and** shortly before the quarter in question, over a short window (see point 3), five or six weeks in advance.

2. A suggested approach is as the below table, whereby half (instead of 100%) of the DCs would be offered for each quarter of the whole tariff year, in advance of the year (late May), with the remainder offered as shorter-term quarter-ahead products during the year (offered five or six weeks in advance).

	% of Total DC Contracts Offered			
Date Offered /Subscription Window	**Q4 2011**	**Q1 2012**	**Q2 2012**	**Q3 2012**
Late May 2011	50%	50%	50%	50%
Late August 2011	Remainder / 50%			
Late November 2011		Remainder / 50%		
Late February 2012			Remainder / 50%	

Late May 2012				Remainder / 50%

3. Each DC product would have a primary and supplemental subscription window within the above table timelines, with similar supplier eligibility rules for the supplemental window as at present. A primary window would have two auctions in week 1 (say one on Tuesday and one on Thursday), with one supplemental window auction in week 2 (say on Tuesday).

4. The RAs' DC concentration model, which determines the volume of DCs on offer, and the eligibility model, which determines the eligibility of suppliers for the DCs, would likewise be determined both annually and quarterly by the RAs, with eligibility details made available to suppliers **early** in the months DCs are offered (in the table above). For the shorter-term products, the volume of DCs and supplier eligibility would be based on data as of about 3 months before quarter in question; and,

5. For practical reasons, with this option there would no longer be the publication of a DC pricing regression formulae, and instead the prices would be determined by the RAs by use of Plexos modelling only, with no regression formulae (based on results from the Plexos model) published. This means that it will not be possible for market participants to perfectly determine/replicate the DC price even with the use of Plexos, as part of the validated plexos model is confidential, for example generator Variable Operation and Maintenance (VOM) data. On the other hand, by modelling more of the quarterly prices closer to real time (including latest fuel prices), the DC prices will tend to be more accurate than when modelling it further in advance.

This approach would allow the shorter-term DC quantities on offer and supplier eligibilities to be more up to date to market share forecasts and supplier Maximum Import Consumption (MIC) data than would be the case if DCs were determined further ahead for the whole tariff year (as is currently the case). This may suit suppliers to a greater extent than the current approach, given the customer churn rates.

At this stage comment is requested from market participants as to whether they would prefer the RAs to proceed with this new approach to DCs or keep the current annual subscription window (only) process.

Taking account of the comments received, in late March the SEM Committee will issue a decision paper on which option to proceed with, including more detail on the exact DC process/timelines to be followed.

4. Forward Fuel Sources

Separately, and for information, on cost grounds the RAs have reviewed their subscriptions to the forward fuel indices used as part of forecasting SEM prices and intend that the following will now be used for this year's DC process:

- Fuel Oil – Reuters (subscription Eikon package), rather than Platts as used last year;
- Gasoil – Reuters (subscription Eikon package), rather than Platts as used last year;
- Carbon – BlueNext (free web source), rather than Leba as used last year.

The Gas and Coal sources, the ICE (free web source) and the Argus (subscription), respectively, will be unchanged.

More details on each of the particular fuel sources will be published in the detailed paper to follow this consultation.