SEM 2011/'12 Contracting Process

Information on Plexos Validation Workshop, DC Timelines & PSO-related CfDs

<u>An RA Information & Decision Paper</u>

SEM-11-027

1st June 2011

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1. Introduction

1.1 Background

Since 1st November 2007 the Northern Ireland Authority for Utility Regulation (Utility Regulator) 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 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 Types of CfDs Available

There are currently three types of CfD being offered in the SEM. Details on the different types are provided at SEM-10-057 at the following link:

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

In brief, the three types of CfDs available are:

- Directed Contracts (DCs), whose volume, price and eligibility is set by the RAs. Information on DCs for the next tariff year was published in the RAs' "Directed Contracts Implementation for 2011/'12" paper published on 13th April 2011, SEM-11-017.

- CfDs associated with the Public Service Obligation (PSO) levy in Ireland. On 13th April the RAs published a paper "2011/'12 Contracting Process, including PSO-related CfDs", SEM-11-020, which confirmed the continuation of PSO-related CfDs and provided information on the volumes available for the next tariff year. This paper also consulted on the PSO-related CfD offerings/products for the next tariff year; and,

- Non-Directed Contracts (NDCs), where generators can offer CfDs which suppliers are free to bid for. To date there have been two parties who offer NDCs to all participants in the market, ESB PG and NIE Energy PPB. NDCs offered by NIE Energy PPB are related to the PSO levy in Northern Ireland (NI). The latest available information on NDCs for the next tariff year was published in SEM-11-020.

1.3 Purpose of this Paper

The purpose of this paper from the RAs is:

- To update on the DC implementation process and timeline provided in SEM-11-017, specifically to provide information on the **RA Workshop on Plexos Validation**, and the exact **timetable for the DC process** including that dates for the DC Primary and Supplemental Subscription Windows. Please see section 2 of this paper for information on this;

- Following earlier consultation in SEM-11-020, to decide on the **PSO-related CfD offerings/products** for the next tariff year. Please see section 3 of this paper, which includes a summary of comments to the consultation and the RAs' response.

The quantity and type of ESB PG NDCs that are anticipated for the next tariff year remain as estimated in SEM-11-020. This will be updated by ESB PG after the DC subscription windows, to take account of the DC volumes determined/sold.

2. Plexos Workshop / DC Timelines

Information on the detailed implementation of DCs for the next tariff year, including DC timelines, products, volumes and eligibilities, was provided in SEM-11-017 published by the RAs on 13th April.

This section of this paper now provides an update on one aspect of this – the planned timelines between now and the end of the DC Supplemental Subscription window, which were provided previously at an indicative and high-level only. This is being provided now for information, and the dates for the Subscription Windows will also be included in the paper on DC quantities and prices (to be published in the week starting 13th June, as below).

The planned timelines for the Plexos Workshop and for DCs are as per the table below. Please note that the **Workshop explaining the validated Plexos model will be held in the CER office in Tallaght, Dublin 24, at 15:00 on Monday 13th June**.

Spaces for the Plexos Validation Workshop are limited so parties interested in attending should contact Kevin Hagan at the CER as soon as possible to secure a place, at khagan@cer.ie .

As part of the timelines, the RAs publish with this paper and for information, versions of the DC Master Agreement, including a version in track change from last year. ESB PG will also issue a version to relevant suppliers.

Key Plexos / Contracting Milestones	Dates
RAs publish DC Master Agreement (with and without track changes)	Today, with this Paper
RA Workshop on Plexos Validation, CER	Monday 13th June, 15:00 to 17:00 at CER Office
DC Seller(s) send Subscription Guidelines to eligible suppliers	Week Start 13th June
RAs publish paper on DC quantities and pricing, and inform suppliers of DC eligibility	Week Start 13th June
RAs publish detailed DC rules by DC Seller(s), incl. track changes from last year	Week Start 13th June
DC Primary Subscription Window	Monday 27th June to Monday 11th July inclusive (11 working days)
DC Supplemental Subscription Window	Monday 18th July to Friday 22nd July inclusive (5 working days)

3. PSO-related CfDs for Next Tariff Year

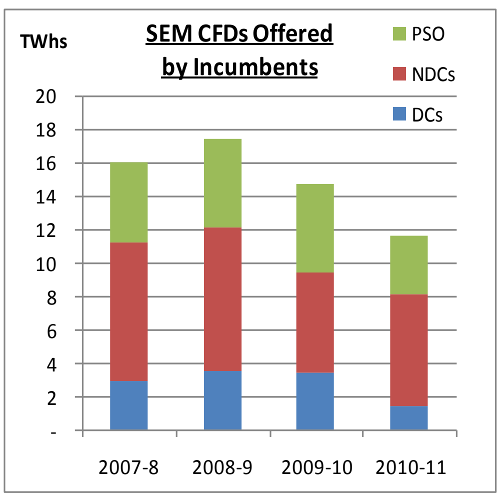
3.1 Background

In recent years CfDs associated with the PSO levy in Ireland have been offered in the SEM for contract liquidity purposes. Please see SEM-10-047 for further details at:

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

There have been about 600 MW of Irish PSO-related CfDs offered to the market and this relates to output from various peat plants - Lough Ree, West Offaly, Edenderry - and from Tynagh and Aughinish Alumina. These CfDs have been offered for auction by ESB PG, with the reserve price for these contracts set by the CER. Please note that ESB PG had agreed with the CER to offer these CfDs in the past on a voluntary basis. ESB passes through all the costs that are associated with the PSO and any CfD difference payments paid or received are incorporated into the Irish PSO levy, i.e. the Irish customer.

The offering of these Irish PSO-related contracts has the benefit of improving liquidity in the contracting market and they have composed circa 25% to 30% of total CfD volumes in the SEM in recent years, as shown below. The contracts can also have the effect of reducing the volatility associated with the PSO levy.



In addition, NIE Energy PPB have a number of Generator Unit Agreements (GUAs) with different power stations in Northern Ireland, and it acts as an intermediary for these power stations in the SEM. The difference between the costs under the GUAs and the revenues received through the SEM pool, is passed on to the PSO in Northern Ireland. NIE Energy PPB offers NDCs to market participants as part of their efforts to minimise the Northern Ireland PSO. The Northern Ireland PSO faces the ultimate benefit or cost of this hedging, in a similar manner to the Irish PSO.

3.2 Legal Review & Decision

The RAs informed market participants during their market power and liquidity project, in the "State of the Nation" Information Paper of August 2010 (SEM-10-057) and CEPA's paper of 16th December 2010, and at a public workshop on 18th January 2011, that there was a concern regarding the appropriateness from a legal perspective of the PSO-related CfDs being supported by the Irish PSO levy.

The SEM Committee[1] since examined this matter from a legal perspective in conjunction with its independent legal advisors Shepherd and Wedderburn. Based on the legal advice received, and as detailed in SEM-11-020 published on 13th April, the RAs decided that PSO-related CfDs can continue to be offered.

It was decided in SEM-11-020 that ESB will offer a total of 3.6 TWh of Irish PSO-related CfDs across the next tariff year, i.e. for the period from 1st October 2011 to end September 2012, and that these CfDs will be offered at least quarterly. In other words 0.9 TWh will be offered, at least quarterly (see next), for each quarter and suppliers can choose which months' 0.3 TWh product to buy.

3.3 Consultation on PSO-related CfD Products

There were two issues on which comment from market participants was sought in SEM-11-020, namely:

- Whether there is a supplier appetite to even further increase the regularity of PSO-related CfD offerings, so some/all would be offered monthly instead of quarterly; and,

- The mix of products to be offered, for example would they be broken down 50% as baseload and 25% for mid-merit 1 and mid-merit 2 respectively as in the current tariff year.

3.4 Summary of Comments and RA Decisions

Seven parties submitted responses to SEM-11-020, namely:

- ESB Electric Ireland
- NIE Energy Supply (NIE ES)
- Endesa Ireland
- Bord Gáis Energy (BGE)
- Airtricity
- Viridian Power and Energy
- ESB Energy International

[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.

The responses received are published with this paper where they were not stated as confidential. A summary of comments received is provided below, along with the RAs' response.

Regularity of PSO-related CfD Offerings

There was a varying response from market participants regarding the frequency of PSO-related CfD offerings.

One respondent was in favour of a mixed offering of PSO-related CfD products being offered given the dynamic retail market, with their preference for mixed offerings between annual and monthly on a say 25:75 ratio basis. Another party would like the products to be offered half quarterly and half monthly.

A respondent suggested that there be two offerings/auctions held each month, with product for the current and near quarters sold on a monthly basis and product further out sold on a quarterly basis. Furthermore, it said that it would be beneficial if the products could be offered on a continuous rolling basis with a window length of 12 to 24 months. This would assist all supply companies in taking a longer term view of their hedging and remove any uncertainty relating to the PSO-related products.

Another respondent said the mix of contracts should be offered on a 12-month rolling basis to allow suppliers manage their portfolio. Further refinement of positions could be facilitated by use of monthly auctions, in advance of given quarter, as with the current process.

A respondent was in favour of contracts being offered on a quarterly basis with the retention of monthly products to provide suppliers with flexibility. Likewise, another party stated that it would not favour a move towards month-ahead auctioning of products. It said month-ahead products are of extremely limited value for hedging purposes as the value of hedging reduces significantly close to the "delivery period". More generally it recommends frequent auctions carried out on a rolling basis with start dates staggered in advance, with monthly product auctioned for M+1 to M+6 during each month M and volume weighted towards products offered furthest out.

RA Response & Decision

Taking on board the mixed consultation responses, the RAs have decided that all PSO-related CfD products for the forthcoming tariff year will be offered on a quarterly (as opposed to monthly) basis, about a month in advance of the quarter in question.

This is in light of the DCs being offered on an annual basis as detailed in SEM-10-017, and the fact that a significant volume of NDCs will likewise be offered a year-ahead (see SEM-11-020). Hence, the RAs believe that quarterly offerings for PSO-related CfDs will compliment the longer-term DCs and NDCs well. The quarterly offerings will also include the ability for suppliers to choose which month(s) in each quarter that they wish to purchase, thereby providing the flexibility for suppliers to synch their hedging volumes with monthly demand/customer volume predictions.

Hence 0.9 TWh of PSO-related CfDs will be offered quarterly, for each following quarter and suppliers can choose which months' 0.3 TWh product to buy in this quarter. The dates for the auctions are as follows:

- Q4 2011 product will be offered by ESB on Thursday 1st September 2011;
- Q1 2012 product will be auctioned by ESB on Thursday 1st December 2011;
- Q2 2012 product will be offered by ESB on Thursday 1st March 2012; and,
- Q3 2012 product will be offered by ESB on Thursday 31st May 2012.

Type of PSO-CfD Products

There were also contrasting views from respondents regarding the mix of PSO-related CfD products to be offered, for example would they be broken down 50% as baseload and 25% for mid-merit 1 and mid-merit 2 respectively as in the current tariff year.

One respondent viewed a greater SMP risk at the higher regions of electricity demand and so it requested a greater weighting towards mid-merit 2 product. It asked for the baseload, mid-merit 1 and mid-merit 2 product distribution to be circa 25%, 30% and 45% respectively. Similarly, another party advocated taking 10% out of baseload and putting it into mid-merit 2. It said this would provide a more balanced product mix, noting the availability of baseload products elsewhere and that mid-merit 1 volumes are only useful to those suppliers with a significant volume of load at weekends.

In contrast, a respondent considered the current mix of products as appropriate but urged the RAs to assign a greater proportion of volume to mid-merit 1 rather than mid-merit 2 as this does not have adequate weekend cover. Another observed that the mid-merit 2 plant appears to be the least favoured product. It therefore also suggested that the volume of mid-merit 2 product on offer be reduced and that the volume of baseload and mid-merit 1 be increased.

One party would welcome peaking products as well as separate weekday and weekend products. Another party would also like to see a peak product included.

RA Response & Decision

The RAs note that the PSO baseload, mid-merit 1 and mid-merit 2 products have all seen high demand from suppliers in the current tariff year, with baseload seeing the highest price premium over reserve price. At the same time, we understand that the availability of mid-merit products is also important for suppliers selling to business and industrial customers. As regards the comment regarding peaking product, we do not believe it is appropriate to offer this through the PSO for the next tariff year because, firstly it to would reduce PSO-related CfD volumes overall and, secondly peaking product has or will be available elsewhere, through NIE PPB offerings on the Tullett Prebon website and, likely, through the DC process.

Therefore the RAs do not see any merit in reducing PSO-related CfD baseload volumes and we believe that the current mix of products is about right.

Hence, for the next tariff year, the RAs have decided to continue with the current distribution of PSO-related CfD products, i.e. baseload, mid-merit 1 and mid-merit 2 product will be broken down on a 50: 25: 25 capacity (MW) basis for each of the offerings (referred to above).

Other Comments

Most of the respondents specifically welcomed the RA decision that PSO-related CfDs would continue for reasons including their importance to contract liquidity, to suppliers and to the mitigation of price spikes for end customers.

Given recent retail de-regulation, one party urged the RAs to monitor the forwards market closely to ensure competition is not being hampered, specifically to monitor the pricing of and biding for unregulated hedge contracts to the same extent as in the spot market. In relation to trading, the party also said that the trading platform under development by ESB Power Generation in conjunction with Tullet Prebon has not yet been made available to the wider market. It said that although an improved platform would be welcomed it should be developed in consultation with industry, including the regulators, to improve liquidity.

One respondent noted that the intended volume of PSO-related CfDs for the tariff year is 3.6 TWh, an 8% reduction on the 3.9 TWh that will be offered for the current tariff year. It said this is an unwelcome development and it is not clear on what basis this decision has been taken considering the volumes produced by PSO plant.

Another respondent asked the RAs to make it clear to the market that ESB derives no market power from the provision of the PSO-related CfDs, that ESB has provided them voluntarily, that the RAs set the volumes, shape, reserve price etc of the CfDs sold, the sales process and timing, that ESB has conducted the PSO-related sales process free of charge and that ESB passes through any gains or losses from the sales of PSO-related CfDs.

RA Response

The RAs monitor the NDC and PSO-related CfD prices and have seen no evidence to date of the exercise of market power. This issue, along with trading platforms, is also being reviewed and considered as part of the RAs' "Market Power and Liquidity" project.

As for the total volume of PSO-related CfDs on offer for the next tariff year, this was decided on taking account of the likely running of the relevant plant, and taking a deliberately conservative view on their output. This was in order to mitigate the financial impact to the end customer of the contracts being "out of the money". Even with this measure, PSO-related CfDs are only slightly down on this tariff year. It is also noted that

ESB's NDC volume may slightly increase on this tariff year, as referred to in SEM-11-020.

As requested, the RAs confirm that ESB derives no market power from the provision of the PSO-related CfDs, that ESB has provided them voluntarily, and that the RAs set the volumes, shape, reserve price of the CfDs sold, etc. Any gains or losses from the sale of these PSO-related CfDs are passed on to the end customer.

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