Single Electricity Market Committee

Contracts for Differences -

Option for Directed Contracts 2012/'13

A Consultation Paper

SEM-12-009

8th February 2012

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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 contract year and possibly beyond. Two scenarios are presented in section 3 of the paper for comment - DCs for the 2012/'13 contract year could be offered either annually (only) in around Q2 of this year, as had been the case to date, or they could also be offered every quarter on a rolling basis.

The RAs invite interested parties to submit comments on which DC option should be adopted, by Friday 9th March 2012, preferably in electronic form, to the contacts shown on the next page.

The SEM Committee[1] 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.

[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

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

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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 contract year please see SEM-11-045 at the following link:

  http://www.allislandproject.org/en/market_decision_documents.aspx?article=ab4bc686-7ece-41e3-a84a-02802f666ac3

  The purpose of this paper is to consult on the approach to DCs for the next contract year, i.e. from October 2012 to end September 2013, and possibly further out - see section 3.

- In recent years CfDs associated with the Public Service Obligation (PSO) levy in Ireland have been offered. For the current contract year approximately 0.9 TWh is being offered for each quarter, as monthly products, with the auctions taking place about a month in advance of the quarter in question, - please see SEM-11-061 for further details at:

  http://www.allislandproject.org/en/market_decision_documents.aspx?article=743d1a96-dc25-4981-8df5-63affcb7cb70

- Non-Directed Contracts (NDCs): In addition to the DCs, generators can offer forward NDCs in the SEM which suppliers are free to bid for. To date there have generally been two parties who offer NDCs to the all participants in the market every year, ESB PG and NIEE PPB. The RAs have no role in setting the price or volume of these forward contracts, although we do promote their provision. The extent and frequency of NDC trading has increased considerably in recent times with:

  - Contracts and hedging now extending out beyond the traditional trading year.

  - Tullett Prebon now hosting regular "Over the Counter" (OTC) windows on its Brokered Market. This allows for greater interaction between generators and suppliers with respect to NDC prices and quantities, assisting in price discovery.

3. DC Option for Consultation

To date in the SEM, every year the RAs' have offered DCs on an annual basis for the forthcoming contract year - for example last year the subscription window was from late June to mid July, covering each quarterly product for the entire 2011/'12 contract year (see SEM-11-045 for details). If the RAs continue with the same approach as last year, the DC subscription window will commence in approximately June (further details will be available in the decision paper planned for late March, following this paper).

This year the RAs are offering an alternative to this standard practice for DCs, and will issue a decision paper (planned for late March) informed by feedback to this paper. The alternative would be to offer DCs on a more regular and rolling basis before and during the contract year, rather than just once for the contract year. The volume of Directed Contracts will rise significantly this year as a result of the SEM Committee's decision to allow ESB to horizontally integrate (see SEM-12-002[2] for more details). This increase in Directed Contract volumes will increase the total proportion of contracts made available that are regulated by the RAs and so this alternative, to have DCs offered more regularly, is being put forward for the views of market participants. With this option, the broad methodology and products used in previous years for determining DCs would remain the same but specifically the following would change

1. The DC subscription windows would not be held only once a year for the entire contract year, but instead would be held every quarter with DCs being allocated on a rolling basis. The suggested approach is as per the table below.

	2012 Q'2	2012 Q'3	2012 Q'4	2013 Q'1	2013 Q'2	2013 Q'3	2013 Q'4	2014 Q'1	2014 Q'2	2014 Q'3	2014 Q'4	..... Etc ..... Etc
			1	2	3	4	5	6	7	8	9	..... Etc
			1	1	2	3	4	5	6	7	8	..... Etc
			1	1	1	2	3	4	5	6	7	..... Etc
			1	1	1	1	2	3	4	5	6	..... Etc
DC Auction	1	2	3	4	5	6	7	8	9			

2. The RA's Concentration model would be run every quarter. Each box in the table above represents 25% of the outturn volume of DCs for the relevant quarter from the relevant DC auction. In the initial "front loading" auction, auction number 1 in the table, the RA's DC Concentration model would be run for the four quarters from Q'4 2012 to Q'3 2013. For Q'4 2012 the full outturn volume of DCs would be allocated.

[2] http://www.allislandproject.org/en/market_current_consultations.aspx?article=682a98fe-9c18-4c73-8fa3-57e75d24d85e

For Q’1 2013 75% of the outturn volume of DCs would be allocated. For Q’2 2013 50% of the outturn volume of DCs would be allocated. And for Q’3 2013 25% of the outturn volume of DCs would be allocated.
For every subsequent quarterly DC auction the Concentration model would be run again for four quarters, starting two quarters ahead, and 25% of the outturn DC volume would be allocated for each quarter.

The same applies for the supplier eligibility model which would also be run quarterly by the RAs.

3. The DC allocation windows would be much shorter than the traditional process, e.g. the Primary Window would be over one week with the Supplemental Window, having similar supplier eligibility rules as at present, occurring on one day the following week. This would not apply to the initial “front loading” auction.

4. For practical reasons, the DC pricing regression formulae could not be calculated and published quarterly. There are two ways the DCs could be priced:
   a. The DC Regression Formulae could be calculated and published once a year, as it is now, and be used to price the contracts for the next four auctions/quarters.
   b. The prices could be determined by the RAs by the use of direct Plexos modelling, with no regression formulae (based on results from the Plexos model) published. This means that it would 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 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 only once a year (as is currently the case). This may suit suppliers to a greater extent than the current approach, given the customer churn rates.

It should be acknowledged that Master Agreements, credit agreements, etc would have to be updated if this option is chosen.

At this stage comment is requested from market participants as to whether they would prefer the RAs to proceed with the above new approach to DCs or to keep the current annual subscription window process. Responses should take account of the general mix of contracts on offer between DCs, NDCs and PSO-Related CfDs.

If market participants have any other ideas or alternatives these will be considered also.

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.