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Contracts for Differences – Option for Directed Contracts 2012/13 (SEM-12-009)

Dear Kevin and Andrew

Thank you for the opportunity to respond to the above consultation.

Introduction

We note that the purpose of the paper is to elicit views on the process / timeline for offering DCs for the 2012/'13 contract year, and possibly beyond. Two scenarios are presented for comment:

- Option A - DCs could be offered annually (only) in around Q2 of this year; or
- Option B - DCs could also be offered every quarter on a rolling basis.

Respondents are invited to comment on which DC option should be adopted. The consultation paper also states that if market participants have any other ideas or alternatives these will be considered.

Energia has a strong preference for a variation of option B which, if necessary, could be combined with option A under a hybrid approach, as discussed in further detail below.

Energia's preference for option B – the alternative approach

It is crucially important that all market participants and their customers should benefit from improved liquidity options as a result of ESB's horizontal reintegration. We recognise that DC volumes should materially increase and this is to be welcomed but this alone is insufficient to ensure suppliers have an opportunity to maximise the benefits of the DC product. We welcome last year's initiative by the regulatory authorities (RAs) to consult (in SEM-11-007) on an alternative option for the DC process involving the offering of DCs on a rolling quarterly basis as well as being offered annually. We note that all non PES suppliers, including Energia, welcomed the additional flexibility of this option for accommodating hedging needs and changing market conditions. It is also our experience that customers want prices that more closely reflect underlying market conditions and the alternative DC option would have helped to facilitate this. We were therefore disappointed it was not adopted last year and would strongly urge the RAs to implement an alternative DC process this year, especially in light of the higher proportion of DCs relative to other CfDs. It is our considered view that an appropriate mix of long-term and short-term offerings would exist should the alternative option of offering DCs on a rolling quarterly basis be implemented and offered in early September and thereafter every three months.

Suggested amendments to option B

Whilst strongly supporting the alternative approach (Option B above) it is very important, for price transparency and predictability, to continue using the DC regression pricing formulae to the extent possible. We therefore suggest:

- For the quarterly process use PLEXOS to set base prices for each product in each quarter, published at the start of each quarterly subscription period, but use DC formula to adjust base prices for fuel movements each day.

- This approach gives suppliers more certainty on price but reduces the effect of potential errors in the DC formula.
- If there is substantial market change then the DC formula could be revised and re-issued for the quarterly process.

As noted in our response to SEM-11-007 last year it is also important for market participants to have certainty about DC volumes and eligibilities for the year ahead for planning hedging strategies. We suggest this can be addressed under Option B by

- Applying a DC volume and eligibility floor based upon the annual calculation. This would importantly give ESB no less volume obligations as under Option A but would allow buyers and ESB to benefit from the sale and purchase of additional volumes should additional DC provision be required when the concentration analysis is re-ran for the quarterly process. We are strongly of the opinion that given the lack of liquidity in the SEM contracts market that participants must have certainty around the minimum DC volumes to facilitate hedge planning and retail product development.

The hybrid option

If it is considered absolutely necessary to provide more long-term offerings through the DCs we suggest below how this can be done without entirely losing the benefits of the alternative approach, in what we call the hybrid option.

- Hybrid option: combining options A and B – suppliers could be given the choice of taking volume through an annual DC process held in July (Option A) or through a quarterly process commencing in early September (Option B) and thereafter held every three months such that any volume not taken by suppliers through the annual process would become available to them through the quarterly process. Unsubscribed volumes could then be offered up in a supplementary window when there remained no future opportunities for suppliers to subscribe to their eligible volumes.
- The hybrid option could be implemented in a relatively straightforward manner with the DC formula used to price contracts during the annual process but a combination of PLEXOS and a DC type formula used to price contracts for the quarterly process – see suggested amendments to option B above relating to pricing mechanics.

- The hybrid approach outlined would provide greater flexibility for suppliers, capturing the benefits of option A and option B, and would ensure that **all suppliers** were in a position to benefit from the increase in DC volumes.

Conclusions

Energia welcomes this consultation and much needed efforts to improve the DC process, especially in light of the increased in DC volumes following ESB's imminent horizontal reintegration. Energia strongly favours option B - offer DCs quarterly on a rolling basis - but in the interests of supporting consumer choice we would also support the hybrid option presented. Whilst strongly supporting option B it remains very important, for price transparency and predictability, to continue using the DC regression pricing formulae for the quarterly process and Energia has suggested above how this could be done. It is also important for market participants to have certainty about DC volumes and eligibilities for the year ahead for planning hedge strategies and developing new retail products to improve consumer choice and we have therefore suggested that a DC volume and eligibility floor should be applied based upon the annual calculation.

Please do not hesitate to contact us if you would like to discuss any aspect of this response.

Yours sincerely

K Hannafin

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