ESB POWER GENERATION

Single Electricity Market Committee

Contracts for Differences
Option for Directed Contracts Consultation
2012/'13

ESB POWER GENERATION RESPONSE

March 9th 2012

Kevin Hagan
Commission for Energy Regulation
The Exchange Belgard Square North
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and

Andrew McCorriston
Northern Ireland Authority for Utility Regulation
Queens House 10-18
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Contracts for Differences - Option for Directed Contracts Consultation 2012/'13

Dear Kevin/Andrew,

ESB Power Generation is pleased to have this opportunity to respond to this very important consultation paper and acknowledges the positive action of the SEM Committee in bringing it for consultation with the industry. ESB in its response to the RA Consultation on Market Power & Liquidity (SEM 10-084) in December questioned if the traditional DC timing was still appropriate. In our view this proposal represents a very significant step in bringing the DC process into line with recent developments in the SEM.

This approach would ensure that DC pricing was based on fuel prices spread out across the year. It would allow for fuel hedging of smaller tranches on a quarterly basis rather than the full annual allocation is a short number of weeks. It better reflects Supplier demand for CfD's by allocating DCs further out the curve. The fact that the DC allocation would be completed two quarters ahead allows for further refinement of positions through the NDC and OTC processes.

ESBPG is supportive of the alternative approach outlined in this consultation once it is adopted in its entirety with quarterly running of the RA's concentration model and Supplier Allocation process. Most critically if the alternative model is to be adopted, the pricing methodology of DCs must continue so that the contract prices are set in a way that is transparent and understood by the market and which remain reflective of prevailing market conditions.

ESB PG has provided significant liquidity to the market to date through various initiatives and it will be important to ensure when progressing the DC issue that

ESBPG's capacity to participate in ongoing regular NDC auctions/OTC is maintained.

Yours Sincerely

Rory McGowan

Manager
ET&R

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Introduction

Directed Contracts were introduced at the start of SEM primarily as a mechanism to mitigate market power by reducing the amount of generation from which incumbents would receive spot-based prices from the pool. They are also an integral element of risk management in SEM allowing both Generators and Suppliers to hedge pool price risk. On that basis every year since the beginning of SEM the RAs have consulted on and directed that DC's be allocated on an annual basis for the following tariff year. Despite significant developments in the evolution of the market, aside from some minor modifications, the fundamental allocation of an annual DC volume during one very short window has remained un-altered to date.

SEM market development

- The process of fully completing the DC allocation process before NDC's and PSO which was a feature of the early years of SEM has changed significantly.
- The concern raised at the beginning of the market regarding annual contract prices for a significant volume of power being based on fuel prices from a very short snapshot window remains to be addressed.

More recently

- Full market opening has resulted in significant customer migration and churn and the requirement for Suppliers to manage their hedge requirements more dynamically than in the past.
- Tariff deregulation of ESB Customer Supply in April 2011 has removed the requirement for annual price setting by CER and as a consequence reduced the focus on September to October as the tariff year[1].
- Generator and Supplier trading behaviour and strategies have evolved with customer contracts and hedging extending out beyond the traditional trading year.

The RAs recognised that it was appropriate to consider the timing of the DC process last year as presented in their consultation Option for Directed Contracts 2011/12. On that occasion the decision by the RAs was on balance to stay with the traditional approach for SEM year 2011/12. In ESB PG's view the recent developments and changed circumstances since then require that a modified process is now implemented for 2012/13.

The Proposed Alternative Approach

ESB PG supports the proposed rolling quarterly process as progressive and reflective of the significant evolution of SEM in recent years. In our view, if the proposal is to be adopted and it should be implemented in its entirety. An a là carte approach, depending on how constructed, has the potential to expose ESB PG to unacceptable price and volume risk.

We recognise the necessity for front loading in order to create the required profile going forward. It is worth noting that given the likely higher level of DC's for 2012/13 due to the imminent horizontal integration of ESB's SEM generation assets and the aforementioned front loading, there will likely be a greater volume of DC's for distribution in May/June than the 1.66 TWh allocated for the whole of SEM year 5.

[1] It is recognised that NIE's regulated tariffs continue to be set on an annual basis

ESB PG is also supportive of the schedule identified in the table presented as it ensures that each DC quarter is completed two quarters ahead. i.e. Q4 2013 is completed in Q2 2013 etc. This will allow Generators and Suppliers to complete any required refinement and fine tuning of their respective positions through NDCs auctions/OTC one month ahead. i.e. Q3 2013 for Q4 2013.

ESB PG also supports the proposal that the RA's concentration model will be run on a quarterly basis. Power Generation sees this as absolutely critical as this new approach must take into account ESBPG's available uncontracted volume when each quarterly DC allocation process is staged. If, for example, the new approach was adopted but the RA's concentration model was only run annually, a significant shift in the merit order mid year could result in a requirement for PG to allocate DC volume that it no longer had. This aspect will arise anyway from time to time as a feature of the Quarterly approach and must be addressed in parallel with the resolution of this process.

The proposal to determine Supplier eligibilities quarterly based on more up-to-date MICs while not a significant issue for ESB PG is also regarded as positive as it will ensure a more accurate allocation to Suppliers, taking account of increased customer churn.

While the initial allocation window is likely to be somewhat similar to the annual process, ESB PG agrees that the subsequent quarterly allocation windows should be shorter. The proposed quarterly running of the process should result in increased streamlining and a more efficient and cost effective end-to-end process for all participants.

It does require Master Agreements to be modified and some system and process changes for market participants and the RA's, but this requirement was recognised and accepted by the RA's in their proposal for 2011/12 and is necessary if the DC process is to progress in line with market evolution.

DC Pricing

This aspect is of primary concern to ESB PG. The option outlined in 4a of the RA's Consultation paper is unacceptable to ESB PG as it would expose ESB PG to a wholly unacceptable market price risk. Under option 4a an annual ESTSEM would be developed which three quarters later would still be used to price power five quarters further out. i.e. An ESTSEM calculated in Q2 2012 would be still in use in Q1 2013 to price power out as far as Q3 2014. During time the DC pricing formula could become inconsistent with prevailing market conditions but would still be used to price contracts.

ESB PG would consider the approach outlined in option 4.b. However it would be incumbent on the RA's if adopting this approach (4.b) to construct the process in such a way as to give confidence and surety to the market regarding the accuracy and reliability of the forward curves produced.

In the absence of an ESTSEM it will also be incumbent of the RAs to publish a forecast price curve on a monthly basis for margining and credit management purposes.

Conclusion

ESBPG is supportive of the alternative approach outlined in this consultation once it is adopted in its entirety with quarterly running of the RA's concentration model and Supplier Allocation process. Most critically if the alternative model is to be adopted, the pricing option 4(a) is unacceptable. The pricing process outlined in section 4(b) is worthy of consideration once that pricing methodology is constructed by the RA's in a way that provides confidence and surety to the market regarding the accuracy and reliability of the forward curves produced.

We recognise that its implementation will require changes to Master Agreements, systems, processes etc for both the RA's and market participants but believe that with commitment and co-operation these issues can be resolved efficiently.

ESB PG will continue to promote market liquidity and has provided significant volumes of NDCs through both Auctions and OTC both in advance of DC's and further out the curve. ESB notes the RAs support for the provision of market liquidity and will engage with the RAs when addressing overall DC volumes to ensure that the issue of available volume is taken account of when DC quantities are being calculated. ESB PG has provided significant liquidity to the market to date through various initiatives and it will be important to ensure when progressing the DC issue that ESBPG's capacity to participate in ongoing regular auctions/OTC is maintained.