



2011/12 Contracting Process, including PSO-related CfDs

An RA Information & Consultation Paper

SEM-11-020

13th April 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. For further information on DCs for the next tariff year please see the “Directed Contracts Implementation for 2011/12” paper published today with this paper;
- CfDs associated with the Public Service Obligation (PSO) levy in Ireland. Information on this issue is detailed in this paper; 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 the 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 is provided in section 3 of this paper.

1.3 Purpose of this Paper

The purpose of this paper from the RAs is:

- To confirm and clarify the continuation of PSO-related CfDs for the next tariff year and to provide information on the volumes available - please see section 2 of this paper;
- To consult on the PSO-related CfD offerings/products for the next tariff year - please see section 2 of this paper; and,
- To provide information, based on latest estimates, of the quantity and types of NDCs that will be available for the next tariff year - please see section 3 of this paper.

Comments on the PSO-related CfD offerings/products (see section 2.5) should be sent by **17:00 on Friday 6th May 2011** to:

Andrew Ebrill
Commission for Energy Regulation
The Exchange
Belgard Square North
Tallaght
Dublin 24
E-mail: aebrill@cer.ie

and

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

The RAs intend to publish all comments received. Those respondents who would like certain sections of their responses to remain confidential should submit the relevant sections in an appendix marked as confidential.

Shortly after the comment deadline the RAs will update the market on the matter via an Information Paper, including details on the auction dates and products to be offered.

As stated above, information on DCs is provided in a separate paper "Directed Contracts Implementation for 2011/'12", published today.

2. PSO-related CfDs for Next Tariff Year

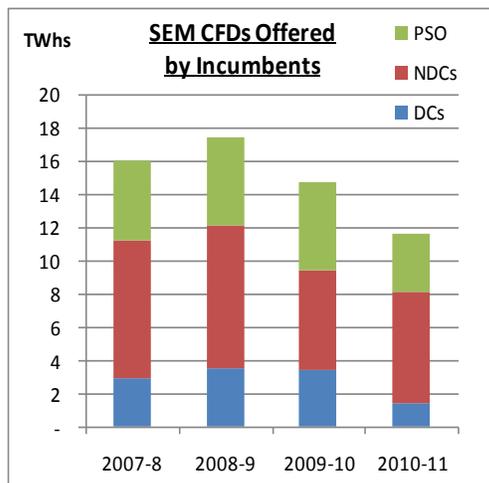
2.1 Background

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.

2.2 Legal Review

The RAs informed market participants during the market power and liquidity project, in both the “State of the Nation” Information Paper of August 2010 (SEM-10-057) and CEPA’s paper of 16th December 2010, that there was a concern regarding the appropriateness from a legal perspective of the PSO-related CfDs being supported by the Irish PSO levy.

This concern was also referred to at an RA public workshop on the market power and liquidity project, held in the CER office on 18th January 2011. At this public workshop the RAs acknowledged market participant comments that the removal of PSO-related CfDs could cause significant contract liquidity issues for suppliers. The RAs committed to examining the matter from a legal perspective and issuing a final decision.

2.3 Review Outcome & Decision

The SEM Committee¹ has since examined this matter from a legal perspective in conjunction with its independent legal advisors Shepherd and Wedderburn.

As part of the legal review, the governing European and Irish legislation, specifically Directive 2009/72/EC, the Electricity Regulation Act, 1999, the Electricity Regulation Act 1999 (Public Service Obligations) Order 2002 (SI No. 217 of 2002), the "Notification of Public Service Obligations to be imposed on ESB" dated November 2000 and AIP/SEM/07/431 "PSO Benchmark Price Setting Methodology: A Decision Paper" dated 31 July 2007, were examined.

Based on the legal advice received, the RAs have decided that PSO-related CfDs can continue to be offered.

Details on the volumes and products on offer for the forthcoming tariff year are provided in the next section.

2.4 Irish PSO-related CfD Offerings - For Information

It is intended 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. This is only slightly lower than the level of PSO-related CfDs available for the current tariff year.

This CfD offering is derived from and is lower than ESB’s estimate of the total output of the relevant PSO plants for the tariff year. While PSO-related CfD money flows tend to run contra-flow to the “core PSO plant” money flows, often reducing the volatility associated with the PSO levy, there is a particular risk/impact of the PSO customer facing a cost exposure (or benefit) if the quantity of CfDs is greater than the plants’

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.

output. In order to mitigate this risk, a prudent view has been taken on the level of PSO-related CfD offerings.

These CfDs will also be short-term, i.e. they will be offered at least (see next section) quarterly, about one month in advance of the quarter in question. Regular offerings of the CfDs, with their reserve price set based on latest SMP estimates in a similar manner to recent years, reduces any possible risk/impact of a CfD cost exposure to the Irish PSO customer arising from SMP being higher than expected.

In other words 0.9 TWh will be offered for each quarter - suppliers can choose which months' 0.3 TWh product to buy in each quarter (if offerings are quarterly - see next section), with each month's PSO-related CfD reserve price set by the RAs in a similar manner as at present.

2.5 Irish PSO-related CfD Offerings - For Consultation

From a market perspective the regular offerings of Irish PSO-related CfDs will complement well the longer-term offering of DCs (see the paper on DCs published today) and many NDCs (see section 3 in this paper).

There are two issues on which comment from market participants is sought, 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 product to be offered, for example would it be broken down 50% as baseload and 25% for mid-merit 1 and mid-merit 2 respectively as at present.

Comments on these two issues should be sent to the RAs by 17:00 on **Friday 6th May 2011** (see section 1 for contact details).

Shortly thereafter the RAs will update the market on the matter via an Information Paper, including details on the auction dates and products to be offered.

2.7 Market Power and Liquidity Project

Contract liquidity for tariff years following the 2011/'12 tariff year will be examined as part of the RAs' "Market Power and Liquidity" project, the consultation for which closed recently – please see the following link for details:

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

3. NDCs for Next Tariff Year

3.1 Background

Section 3.2 below provides, for information, the latest estimates of NDC offerings for the next tariff year from ESB PG (which provides the majority of NDCs in SEM). These estimates, which show slightly higher NDC volumes to the present tariff year if DC levels are also similar, have been provided by ESB PG to the RAs upon request. Any specific queries regarding this information should be directed to ESB PG.

NIE Energy PPB expects to publish NDC volumes, which are related to the NI PSO, in the next couple of weeks.

Further information will be provided by the RAs on NDCs as more relevant information emerges in the coming months, for example when the quantity of DCs is known (see paper on DCs published today).

More generally, the RAs note that a trading platform is available for any market participant who wishes to provide and trade in CfDs.

3.2 ESB PG Estimate of NDCs

For the current SEM tariff year ESB PG has sold 3.86 TWh of NDCs so far, as detailed in the following table.

GWh	Q4 2010	Q1 2011	Q2 2011	Q3 2011
Baseload	774	848	665	361
Midmerit	238	316	135	55
Midmerit 2	156	149	77	83
Peak	0	2	0	0
Total	1,168	1,315	877	499

It should be noted that auctions are still taking place for NDCs from May 2011 to September 2011 and the volumes offered in these auctions will depend on ESB PG's forecasted production. ESB PG expects to offer up to an extra circa 1.1 TWh between now and the end of this tariff SEM year, as shown in the table below. Between NDCs sold and NDCs estimated to be offered, the total volume of NDCs available for this tariff year from ESB PG is therefore circa 5 TWh.

GWh	Q2 2011	Q3 2011
Baseload	300	375
Midmerit	30	370
Midmerit 2	40	30
Peak	0	0
Total	320	775

The volume that ESB PG will have available to sell as NDCs for the next tariff year depends on a number of factors including its forecast production. This is currently greater than last year as relative coal and gas prices mean that Moneypoint is forecasted to produce significant volumes of power. ESB PG NDC levels also depend on the level of DCs imposed on ESB PG by the RAs - these volumes have varied from 1.4 TWh to 3.4 TWh.

Below in the tables are two estimates of potential ESB PG NDC volumes for sale assuming two different levels of DC sales. Based on these estimates, total ESB PG NDC offering levels for the next tariff year will vary from circa 5.2 TWh assuming 1.4 TWh of DCs (as this year), which is slightly higher than the 5 TWh of ESB PG NDCs this tariff year, to 3.7 TWh if DCs increase to 3 TWh.

Assuming DC level of 1.4 TWh

DC Volume

GWh	Q4 11	Q1 12	Q2 12	Q3 12
MM	259	209	423	291
Peak	113	73	0	0
				1,368

NDC Volume (Including Initial Window)

GWh	Q4 11	Q1 12	Q2 12	Q3 12
BL	829	1,196	819	773
MM/MM2	401	464	354	358
				5,193

Assuming DC level of 3 TWh

DC Volume

GWh	Q4 11	Q1 12	Q2 12	Q3 12
BL	487	480	437	486
MM/MM2	275	219	407	134
Peak	73	62	0	0
				3,060

NDC Volume

GWh	Q4 11	Q1 12	Q2 12	Q3 12
BL	497	764	437	442
MM/MM2	469	384	238	426
				3,656

These are estimates only - ESB PG will publish an Auction Notice prior to each auction and will give final volumes in this notice. ESB PG will also give periodic updates to its expected volume of NDC sales to the RAs.

ESB PG expects to offer at least half of the available NDCs as year-ahead products. The exact breakdown will depend on ESB PG's forecast shape and supplier requirements.

ESB PG expect to hold further NDC auctions once DC volumes are finalised and will sell residual CfDs during the year either by auction or via a brokered platform.
