

**NIE Energy Limited  
Power Procurement Business (PPB)**

**Review of K factors & Supply Margins  
and Tariff Structure Review**

**Consultation Paper**

**CER-09-093**

**Response by NIE Energy (PPB)**

11 September 2009.



## **Introduction**

NIE Energy – Power Procurement Business (“PPB”) welcomes the opportunity to respond to the consultation paper which seeks views on various proposals following a review of K factors & Supply Margins and of Tariff Structures.

## **K Factor and Supply Margins**

The Skyplex paper sets out three proposals for reform of the arrangements for K factors and Supply Margins. On the issue of K factors PPB do not consider options 2 or 3 to be practical solutions and will either create additional risks or unintended consequences were they to be adopted.

For example, it is likely that option 2 would create a large disincentive to under-recover since recovery either retrospectively or in the subsequent tariff would be difficult. Therefore the result is that it would tend to incentivise the suppliers to set charges to over-recover through the year but to rebate any over-recovery just prior to year end to minimise any asymmetric penalty.

Similarly, option three would appear, particularly where no allowance is made for CfDs, to create a major exposure for suppliers that they could only manage through either vertical integration or through one-way CfDs or through spot price related contracts/tariffs with customers. Therefore the option imposes a major distortion on the functioning of both the contract and retail markets.

PPB’s view is that Option 1 is most feasible option but would suggest that it could be extended such that there is a progressive removal of price controls (and K factors) for larger customer groupings that are currently covered by regulated tariffs and K factors.

In the longer term, it will remain difficult to remove K factors while the incumbent supply business are restricted from using vertical integration as a tool to manage price and volume risk. It is clear from the recent CfD auctions that ESB CS and NIEES are the main purchasers in the contract market since nearly all of the other suppliers either already have access to, or are building, generation assets to provide internal hedges. Therefore if removal of K factors is an objective in the medium term, there may be a requirement for longer term contractual relationships to be created by the former PESs with existing generation to create a proxy for vertical integration.

## **Retail Tariff Structure Review**

### **General Comments**

PPB’s comments on the review of the retail tariff structures concentrate on those areas that impact on the wholesale contract (CfD) market since suppliers and generators must work together to ensure that there is an increase in participants confidence and the liquidity in this market. However as a general comment on the various proposals, our view is that they generally appear to be very prescriptive which we consider, will tend to reduce flexibility and the capability for competitive agility and innovation. Furthermore, it is not apparent

that this will deliver what customers actually want and there is a risk that suppliers shall be constrained in their quest to respond to a diverse range of customers who are seeking innovative tariffs to manage their electricity costs.

As an example, we noted from the recent Northern Ireland retail tariff forum that there was considerable confusion among large industrial customers over the electricity prices they are paying and in particular the movement in wholesale and other elements of their final electricity prices. Such customers are generally acknowledged to be among the more knowledgeable and if they are struggling, it does not offer much confidence, for example, that separation of wholesale and other charges for domestic customers would be a beneficial imposition – if customers demand or see benefit in a particular supply arrangement or tariff structure then one would expect suppliers to respond accordingly.

Our comments in relation to specific questions are set out below.

#### **Question 4 : Contracts for Differences – Liquidity**

The paper hypothesises that a more liquid contract market is required so that suppliers can shape its hedging requirements to the envelope of its customers demands. The paper proposes the Electricity Forwards Agreement as a means of improving liquidity in the CfD market. Whilst PPB concur that it is vital the liquidity in the CfD market is improved we do not believe that introducing a diverse range of CfD products will help to improve liquidity in a market which, relative to gas and oil markets, will always be very thinly traded. We have a major concern that splitting the existing product range will potentially increase the risk to participants as they may not be able to trade out of a hedging position without being exposed to considerable basis risk. PPB believe that a limited range of products sold in a prompt market would however be a welcome addition to the annual/quarterly CfD auctions.

PPB believes that there are a number of major issues which must be addressed in order to improve liquidity in the CfD market these are:

1. Building and maintaining confidence;
2. Credible and robust reference prices;
3. Vertical Integration;
4. Concentration in the generation market and information asymmetry; and
5. Optimising the product market

#### ***Building and maintaining confidence in the Contracts Market***

CfDs are a crucial element of the SEM market, enabling participants to effectively manage their market risk and enable new entrants to gain confidence in forward pricing, which otherwise would be a major barrier to entry. The greatest risk for participants relying on the wholesale market to manage their market risk is the inability to manage their hedged position.

On 12 May 2009, Tullett Prebon launched the Ireland Power Auction platform. The Ireland Power Auction platform is a multi lateral trading facility (MTF) which offers trading entities the ability to offer and bid in auctions for financial swaps (i.e. contracts for differences or CfDs) which are indexed/referenced to the physical spot electricity prices in the Single Electricity Market (SEM). The

operation and management of the Ireland Power Auction platform, by a third party entity, is an important development which should help to ensure market participants and investors build confidence in the contracts market which we believe is an essential part of stimulating liquidity in the market. It is therefore imperative that regulators and market participants continue to support the operation of an independent MTF.

In many wholesale markets trading is facilitated by a number of brokers and exchanges in parallel. However it is important in a thinly traded market, such as for SEM CfDs, that trading is concentrated through a single auction platform to minimise the costs and fees for participants. The fee for trading on the Tullett Prebon MTF is currently 4p/MWh, payable only by the buyer, however it is hoped that this can be reduced once Tullett Prebon implement a fully automated trading platform. It is therefore necessary for regulators and market participants to agree that the MTF, in the short to medium term, is the optimum solution for increasing confidence and liquidity in the CfD market.

Further confidence in the market may also be achieved by eventually moving to a power exchange, which acts as a central counter-party. However we believe that the first step is to ensure existing participants gain confidence in the MTF offered by Tullett Prebon. If trading levels increase and the market attracts participants without inherent physical positions then consideration should be made of moving the market to a power exchange. Pure financial traders will only enter a market when they are comfortable with the level of activity and consider that they can get in and out of trading positions relatively easily.

### ***Credible and Robust Reference Prices***

A lack of liquidity may have many negative effects such as: a high volatility of prices, which increases the cost for hedging and a lack of trust that the MTF price reflects the wholesale market (reduced reliability of the price signal). The establishment of credible and robust reference prices must be a key objective for the contract market. The timely and accurate publication of traded prices is necessary in improving transparency and price discovery in this market. PPB would welcome the publication of all aggregate trade volumes and prices through the MTF as soon as possible following the close of each auction.

### ***Vertical Integration***

A lack of liquidity potentially initiates a vicious circle as market participants cannot rely on the contract market to manage their SEM market risk and must therefore rely on vertical integration as their primary means of managing market risk. This can be a significant barrier to entry as new entrants face higher risks when markets are volatile and are unable to match, at least in the short run, market offers from vertically integrated competitors and are able only to attract capital at higher costs due to the risks associated with their business model.

ESBPG and PPB are the only two generators which have to date offered to sell products in a transparent manner either through their own fax based auctions or this year through the MTF. Other generators have relied on vertical integration or OTC products which have been negotiated in private. As the market share of ESBPG and PPB decreases the sustainability of the CfD

market will only be assured if private generators also offer products through the organised market (either the MTF or a future exchange). The only financial incentive for vertically integrated companies to purchase CfDs is if either they have not enough generation to meet their customer demand or if the clearing price of the CfDs is lower than its own marginal costs.

### ***Concentration in Generation and Information Asymmetry***

There is a risk that because of the concentration in generation in SEM this may affect participants confidence in the contracts market. Regulators must ensure that this is not the case as any perceived potential for price distortion will stifle liquidity in this market. Whilst Directed Contracts are the current regulatory mechanism for managing this risk the publication of generator outage plans on a rolling basis and at least 18 months in advance would help reduce the significant level of information asymmetry between market participants and allow participants to model the market with a greater level of confidence.

### ***Optimising the Product Market***

Contracts which are currently traded in annual CfD auctions are:

- Base load; Annual; 2 Seasons; and 4 Quarters
- Mid Merit; Annual; 2 Seasons; and 4 Quarters
- Mid Merit 2; Annual; 2 Seasons; and 4 Quarters
- Peak; Winter and 2 Quarters

The paper hypothesises that trading EFA type contracts and a CfD shape that matches the profiles of each customer class will improve the CfD market. Whilst increasing the number of products may help participants to more closely match their supply/demand profile there is a risk that if more types of products are devised, liquidity could be materially affected. There is however a need to establish a market for prompt products which are traded, for example: day ahead; week ahead; balance of month etc. The establishment of a liquid prompt market will facilitate participants' ability to get in and out of trading positions relatively easily, allowing generators to manage changes in generation scheduling or suppliers to manage demand variation and customer switching.

### **Question 9 : Location Price Signals**

On the matter of whether the introduction of a pricing signal for higher distribution voltages would provide a useful signal to encourage appropriate location of distributed generation, PPB is doubtful that this would provide any worthwhile signal. Furthermore, we presume such signals would suffer from the same problems of variability and unpredictability as has been highlighted as a problem with Transmission Use of System charges for generators and TLAfs.

There is already an ongoing review of these matters and consideration of any benefit in respect of distributed generation should be reserved until that wider debate has concluded.

**Question 11 : Term of Fixed Price Contracts**

A limiting factor to offering fixed price energy contracts for terms up to 2 years is that the liquidity in the contracts market for this length of term is likely to be extremely thin. There is probably more scope for vertically integrated companies to offer 2 year contracts as they can manage their market risks through the commodity markets which are more liquid for these time periods. This provides private suppliers, who are vertically integrated, with a competitive advantage over the incumbent suppliers as they can provide customers with a wider range of products without having to rely on the contract market to manage their risk. The incumbent suppliers could explore options to use commodity hedging instruments as a proxy to manage their SEM price risk however as these businesses are not directly exposed to the underlying commodities there may be financial and accounting regulations which may restrict their ability to adopt such mechanisms.