Northern Ireland Assembly

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Power NI: Hedging

1 Introduction

Power NI's price control enables the company to recover an amount equal to the sum of its wholesale generation cost, transmission and distribution costs, renewable obligation cost, correction factor, and supply costs from its regulation customer base. The company is entitled to recover expenditure on hedging contracts as part of its wholesale costs. The Utility Regulator therefore requires the company to outline its hedging policy in advance in a hedging policy statement.

The purpose of this paper is to provide a brief overview of this hedging policy statement and to outline the hedging products available to electricity suppliers within the Single Electricity Market (SEM). It has not been possible to provide specific details of Power NI's historic hedges as this information is commercially sensitive.

2 The purposes of hedging

Power NI allocates cost based upon demand forecasts. The company accept that a number of risks to this forecasting exist, including variations in:

- Customer numbers – e.g. due higher or lower attrition rates;
- Electricity consumption – due to adverse weather conditions, or changes in economic conditions;
- The effect of global settlement;

- Pool prices;
- Fuel price variation;
- Plant availability; and,
- Exchange rates.

The company's hedging policy attempts to mitigate these risks. Hedging enables Power NI to insulate themselves and their customers from future cost rises resulting from wholesale gas price volatility by buying on a forward basis at a fixed price. The cost of purchasing hedges is factored into the p/kWh price of tariffs to which they apply. In practice hedges are applied to quarterly tariffs. They are not applicable to Energy Price Adjusted tariffs were the price customers pay tracks fluctuations in the energy price.[1]

3 Hedging policy

Power NI's decision to hedge is based upon an assessment of the likely impact on prices and price variability. The company's hedging statement outlines three criteria by which the efficiency of a hedge can be assessed:

- If a hedge both lowers the expected price and reduces variability it is likely to be an efficient purchase unless there is an available alternative product that does so to a greater extent;
- Similarly, if a hedge reduces variability without affecting the expected price it is likely to be an efficient purchase unless there is a superior product available; and
- If a hedge raises the expected price but reduces variability, Power NI will need to take a view on the relative values of those impacts. In doing so the company states that it will be *'guided by its view of its customers' preferences'*.

In order to forecast the expected price, the company will model the costs of its SEM purchases, hedges and other costs against customer demand (for each tariff category) and projected pool prices. Price variability is assessed by gauging potential changes in customer demand including responses to weather conditions and by estimating potential changes to pool prices, fuel prices, and exchange rates.

4 Hedging practice

In practice Power NI purchases hedges via directed contracts, non-directed contracts or Public Service Obligation (PSO) auctions. Electricity suppliers will make a commercial decision as to the quantity and type of products they purchase.

[1] Power NI *Tariff Methodology Statement prepared by Power NI* (July 2013), provided by Power NI 12 September 2013

Directed contracts (DCs) are contracts for difference[2] that the Regulators – Commission for Energy Regulation (CER) and the Northern Ireland Utility Regulator – 'direct' the incumbent generators – ESB Power Generation (ESB PG) and Power NI Power Procurement Business[3] (POWER NI PBB) – to offer licensed suppliers on the island of Ireland. This process of imposing contracts upon generators is part of the Regulators' Market Power Integration strategy. The Regulators stipulate the type of contract to be offered, the aggregate volumes to be offered and the method by which the contracts will be priced. They also set the 'subscription process' which outlines how and when suppliers may enter into directed contracts. The decisions made by the Regulators on issues such as pricing and quantity are made in consultation with the industry.[4]

Three types of contracts for difference are offered as DCs:

- Base-load Product: these contracts apply at the contract quantity for all hours;
- Mid-merit product: contracts which apply at the contract quantity for the period 07:00 to 23:00 on business days and 80% of the contract quantity for non-business days; and
- Peak: For Trading Periods arising during the hours beginning at 17:00 and ending at 21:00 on all days during, October, November, December, January, February and March at the Contract Quantity.[5]

Suppliers may purchase directed contracts within subscription windows which are held every quarter and are allocated on a rolling basis five quarters ahead. For example, the September 2013 primary subscription window was held from the 10 to the 12 of September 2013. A supplemental subscription window was held on 19 September. On these dates suppliers were offered contracts covering quarters one to four of 2014. In each subscription period suppliers may purchase DCs for up to a year ahead.[6]

The quarterly purchase of DCs is a relatively new introduction, borne out of a consultation process that ended in February 2012 and which has been in operation since October of the same year. Prior to this change direct contracts had been offered

[2] As defined in the Financial Times Lexicon a Contract for difference simply an agreement between two parties – the investor and the CFD provider – to pay each other the change in the price of an underlying asset. Depending on which way the price moves, one party pays the other the difference from the time the contract was agreed to the point where it ends. http://lexicon.ft.com/Term?term=contracts-for-difference

[3] Power NI PBB is part of the Viridian Group, the company purchases capacity of the contracted generating units and any electricity generated by those units on terms of Power Purchase Agreements. It then sells generated electricity on the single market. The company manages 600MW of contracted generation capacity in Northern Ireland. http://www.viridiangroup.co.uk/default.aspx?CATID=254 and http://www.viridiangroup.co.uk/default.aspx?CATID=219

[4] Single Electricity Market Committee, *Directed Contracts Implementation for 2012/'13 and Beyond A Decision Paper* (April 2012) http://www.allislandproject.org/GetAttachment.aspx?id=2a24bf50-64b5-469c-81b1-841701b63bfc

[5] Single Electricity Market Committee, *Directed Contracts – Q1 2014 to Q4 2014 Quantification and Pricing for September 2013 Auction - Round 6 of Quarterly Directed Contract Auctions Information Paper* (September 2013) http://www.allislandproject.org/GetAttachment.aspx?id=5c5ffd13-337f-4bb2-997a-327b2958f2ce

[6] *Ibid*

on an annual basis – that is suppliers were previously given one opportunity to purchase direct contracts in each year.[7]

In addition to directed contracts, generators offer non-directed contracts. The Regulators play no role in setting the price or volume of these contracts, although they do promote their use. Although, in principle, any generator may offer non-directed contracts, they are generally only offered by ESB PG and POWER NI PBB.

Non-direct contracts are sold via the Ireland Power Auction Platform, which is hosted by Tullet Prebon[8]. There are two methods for buying and selling NDCs:

- The first method is an auction via a Multi-lateral Trading Facility (MTF). An MTF is defined by the Financial Conduct Authority as:

  > *…a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules…*[9]

  This type of auction allows a generator to offer a product, set the volume, contract period and reserve price. Suppliers have a set window of two hours to bid on the product. Bids are made in 5MW bands, at prices above or below the reserve. If the product is oversubscribed (by volume) then bids are taken in descending order by price and product, the product is sold at the price at which the entire volume on offer is taken up. Should a product be under subscribed it is sold at the reserve price.
- The second method of buying and selling NDCs is an Over the Counter sale (OTC). Again, in this type of sale the generator sets the volume, contract period and price. Generators also set a two hour window in which bids can be received. The OTC differs from the MTF, however, in that should a supplier bid at the price set by the generator they are allowed to buy the product instantly. As such, OTC products are sold on first-come, first-served basis. Should a buyer bid below the reserve price, the generator may choose to accept a bid at this price. Commenting on OTCs in November 2012, the Regulators stated:

  > *There have been a number of auctions offering OTC products since October of last year. To date these OTC NDCs have been for short term (monthly) products offered close to the contract periods. OTC NDCs accounted for just under 20% of the total NDCs offered for the 2011/12 contract year, so while the volume is still relatively small this is a positive development for liquidity, given its interactive/flexible nature. It is the RA's*

[7] *Ibid*
[8] Tullett Prebon plc is an inter-dealer money broker.
[9] Financial Conduct Authority *Handbook* (accessed 02 October 2013) http://www.fshandbook.info/FS/glossary-html/handbook/Glossary/M?definition=G2354

> [Regulatory Authorities] *understanding that, to date, ESB are the only generator to offer OTC NDCs.*[10]

The final hedging products available to suppliers in the SEM are PSO-related non-directed contracts for difference. These are contracts associated with the Republic of Ireland PSO. Contracts are offered by ESB PG, with any cost associated with the contracts and any difference payments paid or received pass through to the customers in the Republic of Ireland via the PSO levy. These contracts are offered for auction on a quarterly basis by ESB with the reserve price for these contracts set by the CER. PSO-related non-directed contracts are generally offered quarterly one month before the delivery quarter.[11]

It should be noted that all of Power NI PBB's NDCs are also PSO linked and could therefore be categorised as PSO-related NDCs. Power NI PPB is a regulated business and any net costs or benefits are recovered from or rebated to customers through the Public Service Obligation (PSO) in Northern Ireland.[12]

5 Regulation

As noted in the previous section, the joint Regulators of the SEM have a role in regulating DCs. In doing so, they set the type, volume and price of contracts on offer. They also set the parameters of the subscription process. It is also evident from the above that the CER is responsible for regulating the PSO-related contracts associated with the Republic of Ireland PSO. In the Northern Ireland the Utility Regulator (the Regulator) is responsible for regulating Power NI PPB.

The Regulator also has a role in regulating Power NI's hedging practices. It approves the company's hedging statement. Moreover, as stated in that statement:

> *Power NI will report to NIAUR* [the Regulator] *the hedging purchases and sales it has made on behalf of its regulated customer base (including those relating to currency) with respect to any time period both in advance, when tariffs are set, and after the event. If Power NI were to transfer any hedges between its regulated and deregulated market, the transfer would be made at the fair value at the point of transfer and NIAUR will be notified of the transaction.*[13]

[10] Single Electricity Market Committee *Contracting in the SEM 2007-2013* (November 2012) http://www.allislandproject.org/GetAttachment.aspx?id=18ace1f1-a60a-45d8-8bd3-32241833f9c1

[11] *Ibid*

[12] *Ibid*

[13] Power NI *Tariff Methodology Statement prepared by Power NI* (July 2013), provided by Power NI 12 September 2013

6 Points raised by Power NI

Power NI's hedging statement 2012 notes that:

> *In hedging costs related to tariffs for the 2012-13 year, Power NI is conscious of both the current lack of sophistication of products and also the limited volumes of hedges available to do so. It will not be possible to hedge its generation purchases completely, even if it were otherwise sensible to do so.*[14]

In email correspondence with RaISe the company has also stated that whilst DCs provide a *'dampening effect on price movements as volume is purchased over numerous price points'*, the time restraints placed upon the purchase of DCs – i.e. that they can only be purchased 12 months ahead of delivery date at maximum – limits this effect. As such the company supports extending this period to 18 or 24 months to *'allow suppliers to lock prices further out the price curve, enhancing* [the] *smoothing effect'.*[15][16]

The company has also argued that the timing of PSO-related NDCs – which are offered one month before the delivery quarter – *'provides limited cover against underlying fuel price movements or much tariff stability for customers'.*[17]

On a more general note, the company has also stated:

> *Given the majority of Power NI's customer base are on fixed price annual tariffs, ideally we require the ability to lock into a significant proportion of hedges prior to the tariff setting period. Optimal hedging levels would then be achieved throughout the year. This can be facilitated by offering some CfD* [contracts for difference] *volume further out the price curve, with the ability to refine positions closer to delivery.*[18]

[14] *Ibid*

[15] Email correspondence with Power NI 03 October 2013

[16] Power NI also made this point in its submission to the joint Regulators consultation on the approach that would be applied to DCs – i.e. quarterly or annually. As noted in section 4 the outcome of this consultation is the current arrangements.

[17] Email correspondence with Power NI 03 October 2013

[18] *Ibid*