

# **Energy Retail Competition Work Programme:**

## **General Overview and Rationale**

### **Consultation**

**April 2009**

## CONTENTS PAGE

<b>Executive Summary</b> .....	<b>3</b>
Summary .....	3
Consultation.....	4
List of Consultation Questions .....	5
Section 75 of the Northern Ireland Act 1998 .....	5
<b>Introduction</b> .....	<b>7</b>
Purpose of this document .....	7
Legal framework .....	7
Consumer preferences .....	7
Measures taken to date .....	9
<b>Evidence about impacts of retail energy competition</b> .....	<b>11</b>
Sources .....	11
Where is competition active? .....	11
Financial impacts .....	12
Non-price impacts.....	14
<b>Conclusions and Policy Lessons</b> .....	<b>17</b>
Impacts of wholesale market structure and regulation .....	17
Market segmentation and treatment of non-switchers .....	18
Consumer empowerment .....	20
Costs must be minimised.....	21
Consequences for Utility Regulator Work Programme .....	22
<b>Appendix</b> .....	<b>27</b>
<b>Bibliography</b> .....	<b>30</b>

# Executive Summary

## Summary

1. The Utility Regulator exists to protect consumers, and promoting competition is a key means to achieve that goal. Recent wholesale market reforms, in particular the launch of the Single Electricity Market, have created a sounder platform for energy retail competition, and are leading to growing interest from new suppliers in market entry. Market development has also highlighted the importance for wholesale competition of a de-concentrated and competitive retail sector. The time is ripe, therefore, for a refreshed regulatory focus on boosting choice for end-users.
2. This document reviews the rationale for a programme of regulatory intervention to address entry barriers and enable choice. It sets out evidence about current consumer expectations in Northern Ireland, about the current legal framework for retail competition, and about costs and benefits so far. It also draws together international evidence about costs and benefits, since retail competition is a reality (in theory or reality) in many jurisdictions in the EU and around the world.
3. The review of evidence suggests that no simple conclusion can be drawn: it does not support a view either that retail competition is always, or is never, to consumers' benefit. Nor does it enable *ex ante* conclusions to be drawn about the scope for retail competition in Northern Ireland. This paper therefore suggests that the key question is not *whether* retail competition is the right goal for Northern Ireland. Rather – and recognising that EU law requires us to provide choice – we should focus on *how* we promote retail competition. Policy must maximise the competitive potential of the market, optimise the chances of fair outcomes, and empower consumers to exercise choice. The paper sets out for consultation a set of key issues for future action, or to be closely monitored in case action is required.
4. To deliver competition therefore requires a regulatory programme that has a clear sense of direction, but that is pragmatic and effectively monitored. We have set up a dedicated team within the Utility Regulator, and that team is already beginning work to deliver a programme that was defined following consultation, and is being published in our Forward Work Programme for 2009/10. Although this work programme is already under way, it will be kept under review in the light of this consultation and ongoing review of implementation success.

## Consultation

5. If you wish to express a view on the specific questions below or other matters raised in this paper, we would welcome your response by 12:00 noon on Wednesday 1<sup>st</sup> July. Responses should be addressed to:

Elena Ardines  
Utility Regulator  
Queens House  
14 Queen Street  
Belfast  
BT1 6ER  
e-mail: [elena.ardines@niaur.gov.uk](mailto:elena.ardines@niaur.gov.uk)

6. Individual respondents may ask for their responses, in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.
7. As a public body and non-ministerial Government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1 January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in consultation responses can be put into the public domain. Hence, it is now possible that all responses made to consultations will be discoverable under FOIA – even if respondents ask the Utility Regulator to treat responses as confidential. It is therefore important that respondents note these developments and in particular, when marking responses as confidential or asking the Utility Regulator to treat responses as confidential, should specify why they consider the information in question to be confidential.
8. If you have any queries concerning the issues raised in this document, please contact:

Kevin Shiels  
Utility Regulator  
Queens House  
14 Queen Street  
Belfast  
BT1 6ER  
Tel: 02890 311575  
e-mail: [Kevin.shiels@niaur.gov.uk](mailto:Kevin.shiels@niaur.gov.uk)

## List of Consultation Questions

### Question 1

Respondents are asked to comment on the impact of this paper with regard to equality of opportunity and good relations (paragraphs 9 to12).

### **Consultation question 2**

General comments are invited on our overall approach to analysing the cost, benefits and options relating to supply competition.

### **Consultation question 3**

To what extent is segmentation of the retail sector inevitable and indeed healthy?

What kinds of segmentation (or inequality of outcome) would respondents see as undesirable, and at what level might regulatory intervention be justified?

### **Consultation question 4**

The paper suggests that the Utility Regulator should monitor with particular care levels of competition for rural customers, pre-payment customers and those not on the gas network. Also that we should monitor closely whether current meter-reading obligations are sufficient.

Comments on these priorities are invited. Do respondents wish to suggest other areas that require particular attention from us?

### **Consultation question 5**

Comments are sought on our proposed approach to continued regulation of tariffs in the coming years (paragraphs 75 to 78).

## **Section 75 of the Northern Ireland Act 1998**

9. As a public authority, the Utility Regulator has a number of obligations arising from Section 75 of the Northern Ireland Act 1998. These obligations concern the promotion of equality of opportunity between:
  - a. persons of different religious belief, political opinion, racial group, age, marital status or sexual orientation;
  - b. men and women generally;

- c. persons with disability and persons without; and
  - d. persons with dependants and persons without.
10. The Utility Regulator must also have regard to the promotion of good relations between persons of different religious belief, political opinion or racial groups.
11. In the development of all its policies the Utility Regulator also has a statutory duty to have due regard to the needs of vulnerable customers i.e. individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low incomes and individuals residing in rural areas. Some of the above equality categories will therefore be covered by these vulnerable groupings.
12. Initial screening has been carried out on this paper to identify any equality impacts. Our initial view is that the high-level character of this paper is such that it is not an appropriate subject for Equality Impact Assessment. Where such assessment is required, it should be of specific regulatory interventions, which would be the subject of specific consultation at a later stage. It has therefore been decided that this document should not be subjected to an Equality Impact Assessment. The decision not to carry out an Equality Impact Assessment will be reassessed following the analysis of the consultation responses.

## Introduction

### Purpose of this document

13. This paper has two main objectives:

- a. It sets out evidence, from Northern Ireland and internationally, about the impacts of retail competition (costs, benefits and other impacts). This evidence should underpin future regulatory interventions. The paper therefore draws out of this evidence base a series of issues that seem key to determining how vigorous competition might be, how much consumers might benefit, and how fairly benefits might be distributed; and
- b. On the basis of this issue-analysis, it defines areas where the Utility Regulator must either act, or (where forbearance is the appropriate initial stance) must monitor closely.

### Legal framework

14. Competition has long been at the heart of the EU, UK and Northern Irish vision of energy markets. A range of steps at all three levels have sought to promote wholesale and retail competition. Regarding retail, the most directly relevant are probably the following.

15. The statutory remit given to the Utility Regulator places a high value on competition as a means to deliver consumer benefits. An appendix to this paper sets out our statutory duties. It will be noted that competition figures highly, particularly in electricity where it is the Utility Regulator's primary statutory objective to protect consumers, where appropriate by promoting effective competition;

16. EU law is even more explicit about the central role of competition to deliver consumer benefit. Article 3.1 of Directive 2003/54/EC (the 2<sup>nd</sup> internal market directive for electricity) requires Member States to achieve a "competitive, secure and environmentally sustainable market". Article 3.5 specifically requires Member States to "ensure that the eligible customer [which now includes all households] is in fact able to switch to a new supplier." Directive 2003/55/EC contains equivalent provisions for gas<sup>1</sup>.

### Consumer preferences

17. Northern Ireland consumers would like to have more choice. The Utility Regulator has abundant anecdotal evidence for this preference, based on the frequent complaints we receive from businesses and household customers, and their representatives, about limited or non-existing supply competition.

---

<sup>1</sup> The official English version of the gas directive uses the word "effectively" able to switch, rather than "in fact" in the electricity directive. We do not consider this difference as significant.

18. We also have some limited quantitative evidence to this effect. Millward Brown Ulster carried out a survey for the Utility Regulator in February 2008 covering a range of questions about consumer awareness and attitudes. These questions were included in an omnibus survey, covering a fully representative cross section of the NI adult population. A total of 1000 face to face interviews were conducted in-home. Geographic spread was assured by the selection of sampling points, and the sample was quota controlled for gender, age, socio-economic group and working status.
19. To investigate levels of support for possible developments within the utility sector, respondents were asked to rank five possible developments from 1 to 5 in order of the developments they supported most to least. Reduced utility tariffs for vulnerable customers such as pensioners received the highest level of support with a mean score of 3.70 out of a possible 5.00. However, new companies competing to provide electricity, gas or water services in Northern Ireland received the next highest level of support with a mean score of 3.01 out of a possible 5.00. The other possible developments about which respondents were asked were: further expansion of renewable energy such as wind farms; metering of water to determine household water charges, and putting indicators on household appliances which show in real time their energy consumption. These were scored with mean scores of 2.81, 2.80 and 2.71 out of a possible 5.00 respectively.
20. This finding suggests moderate widespread support for more competitive choice. However, a relatively small part of the sample thought more choice was the most important development they would like to see: while 42% ranked reduced utility tariffs for vulnerable customers such as pensioners first, and 19% ranked further expansion of renewable energy such as wind farms first, only 15% ranked new companies competing to provide electricity, gas or water services in Northern Ireland as the most important development.
21. Support for new companies competing to provide electricity, gas or water services in Northern Ireland was highest amongst the 35 – 49 age group; 21% of those from this age group ranked this development first compared to 15% overall. Support for this development was highest amongst those from an ABC1 background (18% ranked this development first) and lowest amongst those from a DE background (10% ranked this first).
22. As regards willingness to switch, the majority of respondents (59%) stated that they would consider switching to a new supplier if more electricity and gas companies were available in Northern Ireland. Willingness to consider switching was highest amongst those aged 25 – 34 (69% would consider switching to a new supplier) and lowest amongst those aged 65+ (38% willing to consider switching). Willingness to consider switching was highest amongst those from an ABC1 background (68%) and was lower amongst those from C2 (52%) and DE (50%) backgrounds. Willingness to consider switching was highest amongst those from the North of Northern Ireland (73%) and lowest amongst those from the West (47%).



23. In other questions, the majority of respondents (64%) were very or fairly satisfied with the service provided by utility companies. However, 9% were actively dissatisfied. Of this group, the reasons given for dissatisfaction were 77% because of price (gas or electricity); 24% because of a lack of competition; and 21% because of the standards of service provided by utility companies.
24. It should be borne in mind that this survey was conducted before the significant price increases of 2008. The Utility Regulator intends to repeat the survey in the coming months.
25. With that caveat, the tentative policy conclusions we would draw from this research are:
- a. That there is indeed widespread consumer appetite for more retail competition;
  - b. That this appetite may be based on a view held by some respondents that competition will deliver lower prices (which, overall, are a high priority for consumers). Consumer interest in choice may, therefore, be provisional depending whether competition unlocks real savings;
  - c. There is widespread willingness to give switching a try;
  - d. There is some risk that switching rates and, potentially, consumer benefits from competition, might be uneven between different socio-economic and age groups.

### **Measures taken to date**

26. A number of steps have been taken over the last 10-15 years, and particularly in the last 3-4 years, to facilitate retail competition:
- a. From 1999, industrial consumers became eligible to change supplier, and the structures to manage legacy contracts and levies were altered so these applied across incumbent and competitor customers;
  - b. The Utility Regulator has issued 18 electricity supply licences. However, some of these are dormant, have withdrawn from the market, or essentially only supply affiliated power stations. Licence holders who remain active in the market are NIE Energy (NIEE), Airtricity, ESB Independent Energy, Bord Gais Eireann, and Energia;
  - c. From 2005, small and medium business customers were able to change supplier, with the advent of the "FEMO" switching system. The total FEMO market opening costs were £18m, which is now being recovered through network charges;
  - d. In November 2007, household customers were able to change supplier and the switching system to enable this became operational. The cost of this system (£24m) is now being recovered through network charges. This system has some operational limits that restrict the

number of switchers (each month, and in total). Work is now under way to remove these limits.

- e. Also in November 2007, the Single Electricity Market went live. This ensures that all suppliers have access to electricity at a price that fairly reflects the clearing price for all generation across the island of Ireland<sup>2</sup>. These twin benefits of liquidity and access provide a sound foundation for supply competition, although further development of liquid arrangements for risk management may be required to enable a fully level playing field;
  - f. Phoenix Industrial and commercial gas customers have been able to change suppliers for several years now, and since 2007 all customers have had this right. The first gas customers switched last year. However, so far only a handful of industrial and commercial gas customers in greater Belfast have changed supplier.
27. We therefore are currently seeing quite limited competition in the gas sector, and none at all at household level.
28. In electricity, there is some competition and over 70% of non-domestic consumption is now supplied by non-NIEE suppliers. However, the majority of customers, particularly those in the SME sector, continue to be supplied by NIEE. There is also currently no competition to supply households with electricity, although some companies have indicated willingness to enter this sector.
29. The Utility Regulator published a review of retail competition in April 2008<sup>3</sup>, where can be found further information about developments to date.

---

<sup>2</sup> Except *de minimis* generation below 10MW.

<sup>3</sup> “Consultation on Electricity and Gas Retail Market Competition in Northern Ireland”, Utility Regulator, April 2008.

## Evidence about impacts of retail energy competition

### Sources

30. Supply competition is now legally in place in a large number of jurisdictions in Europe, the US, Canada, Australia and New Zealand. Faced with 30-40 potential case studies, we have relied heavily on published comparative analyses, at least for facts if not necessarily for the accompanying opinion or analysis. The bibliography to this document lists the main sources consulted in preparing this document.
31. Comparisons are more useful when they are with similar jurisdictions. Comparisons between NI and Great Britain are therefore of quite limited value, and we have sought to set out below evidence about a wider range of markets.

### Where is competition active?

32. We have examined evidence about the following markets:
- Great Britain;
  - The Netherlands;
  - Texas;
  - Alberta;
  - New Jersey;
  - New Zealand; and
  - Australia.
33. Following the guide of the EEE/Cornwall study, we have assumed that supply competition is as yet too immature in other EU markets for these to present useful comparisons.
34. Switching levels vary. EEE/Cornwall groups markets into “reasonably competitive” and “intermediate”. These categories are apparently determined more by factors relating to the size of savings now available and current switching rates, not just by how many customers have historically switched.

**Table 1: % of household customers that have switched supplier**

“Reasonably competitive”	Intermediate
Norway – 28%	Finland – 21%
Sweden – 40%	New South Wales – 20%
Britain – 40%	New Zealand – 32%

Texas – 41%	
Victoria/S Australia – 40%	
Alberta – 20%	
NL – 22%	

**Source: EEE/Cornwall. Note that the reference date varies, so 2009 switching levels may be different.**

35. Relatively high levels of switching have been achieved in a number of markets. Average demand levels are high in some of these markets, but in others are on a par with NI levels. Moreover, some of these markets are large but others are relatively small (Finland, NZ). (They are not, of course as small as Northern Ireland – but then, few autonomous energy jurisdictions in the world are as small as Northern Ireland, whether competitive or not.)
36. EEE/Cornwall make some observations about the factors that have prevented other jurisdictions from developing retail competition to any significant level at all. They highlight the following:
- a. Poor market structure (excessive vertical integration and lack of wholesale liquidity, embedded local monopolies);
  - b. Tariffs set below costs;
  - c. Limited regulatory powers.

### **Financial impacts**

37. We begin with financial impacts. As shown in the previous chapter, NI consumers are heavily focused on the cost of energy. In a society characterised by low productivity and low incomes, this is likely to remain a permanent state of affairs. This does not mean that we consider other issues to be of trivial importance. On the contrary, many consumers place at least as much emphasis on service as on price, and we would consider that giving consumers choice is of value in its own right. However, consumers seem to regard price as, overall, the most important factor.
38. There is no doubt that introducing competition involves significant costs. These will include:
- a. The costs of switching systems. As noted above, NIE has already made these investments in electricity, although more will need to be spent to replace some of the underlying IT systems that are obsolete. Further investment in gas switching systems will also be required;
  - b. The on-going costs of marketing and variable costs arising from switching.
39. The benefits of competition would include:

- a. Competitive pressure to procure wholesale energy efficiently. This is an important driver to maintain wholesale competition, as well as being the vehicle by which wholesale competition benefits are passed to consumers;
  - b. Competitive pressure on supply margins;
  - c. Better ability of customers to reflect their own preferences in how they buy.
40. Disaggregating these effects and modelling them would be an extremely complex task. Moreover, the value of any estimates of future costs and benefits would depend not only on their accuracy, but also on what counterfactual is used for the comparison. We have taken the approach in this chapter of examining international evidence not so much about costs and benefits separately, as the net effect: the impact of competition on consumer end-prices. We summarise here the country reports from EEE/Cornwall.
41. **Norway.** Competition here appears to have exerted a beneficial effect to squeeze retail margins. The market allowed customers to choose spot-related products (see non-price benefits). These have been popular, so questions of lagging or speedy pass-through of wholesale trends are less pressing than in other markets. Overall, prices seem to be down as a result of competition.
42. **Sweden.** Opening the retail market has allowed entry and as a result consumer prices have converged towards lower Norwegian prices.
43. **Finland.** Energy bills initially fell sharply as competition was introduced. However, reductions in energy prices were balanced over time by increases in network charges; it is not clear whether this was a rebalancing exercise, or a result of weak regulation of network charges. Bills have risen overall, partly a result of higher taxes, and partly because of higher wholesale costs. There are some concerns that the market is settling to oligopoly, and that wholesale cost reductions are passed through slower than cost increases.
44. **Britain.** Most evaluations suggest that GB consumer prices are lower as a result of competition, compared to price levels immediately before liberalisation and adjusting for subsequent wholesale movements. Benefits to switchers were assessed around 2000-2003 as between 8% to 17%, and Ofgem's analysis also suggested that competitive pressure meant non-switchers' bills were also around 8% lower.
45. The main criticism that has been made of this approach is of the counterfactual. Maclaine considered that more robust price regulation of supply would have been likely to generate more consumer savings, and that the way that competition was implemented in GB was expensive. There have also recently been criticisms that growing vertical integration risks allowing oligopolistic behaviour, and that not all consumers are benefiting equally. Indeed, Ofgem's own recent review of retail markets gives some support to some of these claims.

46. **Texas.** Competition here appears to have reduced consumers' bills, with savings of 16%-31% available in 2007.
47. **Alberta.** EEE/Cornwall report that savings are available to customers who switch, but suggest these are not a relevant benchmark since they arise from a low-cost power purchase agreement (we take as read that the agreement is not low-cost because of the pressures of a competitive market, but that this is in some sense a windfall benefit).
48. **New Zealand.** The picture here appears to be of a complex market (many separate networks and tariffs) which generates high entry costs; and a history of non-regulation which has enabled high margins on some customers. In this scenario, competitors have scope for entry and many customers can benefit significantly (10-15%) by switching. However, this raises again the question, whether more benefit could have been achieved through different regulatory approaches and market structure.
49. **Australia.** Customers who have switched have benefited significantly relative to regulated tariffs, particularly in Victoria and S. Australia, but also in New South Wales. Savings in S. Australia are reported at up to 12% in 2007. However, EEL/Cornwall again raise the question, whether a counter-factual of lower regulated tariffs would be more appropriate.
50. **Netherlands.** Because the NL market has only recently been restructured, we have not found data on consumer prices under competition.
51. In conclusion on "price impacts": not all of the markets with significant levels of switching have also seen accompanying customer savings, but many have. The size and scale of price benefits appears to be a function of:
- a. The extent of real competition, and scope for continued exercise of pricing power;
  - b. Efficiency of implementation (whether entry barriers are addressed);
  - c. Whether entrants are competing against artificially high regulated tariffs.

### **Non-price impacts**

52. It is undoubtedly more difficult to differentiate electricity and gas as products than, for example, consumer electronics. However, experience in various jurisdictions suggest that consumers do have varying preferences as to risk tolerance, marketing approach, and standards of customer service; and that competition enables the market to expose and differentiate to serve these preferences.

### *Risk tolerance*

53. The pre-competitive approach to setting tariffs is similar in almost all jurisdictions: on the basis of predictions of cost over a period (sometimes based on auctions), the tariff is fixed for that period. Risks of cost-movements within the period are broadly borne by the incumbent company (although they may hedge these risks, and there may be provision for carrying costs forward or reopening the control, which shifts the risk to the consumer); risks of movements between periods lie entirely with the consumer. However, in the competitive arena, a variety of approaches are in use, which allow the customer more choice of risk-profile, and may allow a smoother sharing of risk:

- a. Pool-related tariffs. These have been a major feature of the market in Norway, with around a fifth of household customers on such deals. They have also been introduced elsewhere in Scandinavia. Large customers in Northern Ireland also frequently buy their energy on such a basis, and in the Republic of Ireland a regulated pool-pass-through product is also available for smaller business customers.
  - b. Fixed price contracts. For instance, the Texas retailer StarTex serves around 35%-40% of its customers with 1-year fixed price deals, 10-20% of customers with 3-month or 6-month fixed deals, and 5-10% with 2 and 3 year fixed prices. In Finland, around 16% of customers are reported to buy through 1-year fixed deals, and 44% through 2-year fixed deals. In Sweden, 37% of contracts signed in October 2004 were reported to be for a price fixed for over 3 years. Such contracts are also a feature of NL and GB markets.
  - c. Variable tariffs. These are closest to the traditional regulated tariff, but might see variations in prices more often than annually. The variable tariff is generally accompanied by a “smoothing” of wholesale movements, with both rises and falls passed through progressively over time. However, this can lead to customer concerns that cost reductions reach them slower than cost increases, or not at all.
54. A re-allocation of risk between companies and consumers can ensure a better match to consumers’ preferences. It can also ensure that risk is held by the party best able to manage that risk, so that the risk is managed better which reduces the overall cost.
55. The fundamental point is that risks should be correctly priced. Consumers should not pay suppliers to bear a risk that in reality is borne by the consumer. Symmetrically, where consumers seek stability of price, they must recognise that this requires the supplier to assume risk, and that this has costs. (These costs may be embedded in the cost of capital that the company must pay in order to finance itself (through debt or shareholder equity); they may arise in the form of higher working capital; they might arise in the operational cost of risk-management systems; or in other forms.)

## *Marketing*

56. Our review of international experience shows widespread experimentation with how best to reach customers: door-knocking, mail-shots, media advertising, email, sales through letting agencies, bill-boards, in-bound call-centres, viral marketing, issues-based collaborations, network marketing, and bundling of energy with a wide variety of products. (Some related, such as heating/cooling repair or servicing plans, others less so.)
57. We have seen evidence from several jurisdictions that the majority of consumers rarely take active steps to seek out a better deal, but instead rely on marketing. This is also true where switching offers the potential to save the consumer quite a lot of money.

## *Standards of service*

58. Entrant suppliers frequently cite better standards of service as one of the factors that mean consumers will prefer them. However, our review of international evidence has provided relatively little information about changes in service standards arising from competitive differentiation.
59. There are, however, frequent instances in the literature of new change-of-supplier processes throwing up problems, for instance:
- a. Problems matching addresses (arose in Texas, in GB, in New Zealand);
  - b. Billing problems arising from a lack of opening and closing reads matched to correct addresses;
  - c. Lack of clarity as to roles and responsibilities;
  - d. Ineffective communications protocols, which have generally been addressed by creating clear protocols, often in Electronic Data Interchange systems;
  - e. In Texas, movers-in initially found that the distribution operator was disconnecting properties where the previous owners had terminated a contract.
60. In many cases, these were teething problems and were resolved in the first year or two of competition. However, some markets still have significant levels of complaints.



## **Conclusions and Policy Lessons**

61. We see nothing in the evidence laid out in the previous chapter to suggest that retail competition is inappropriate for Northern Ireland. Although attracting entry might well be harder in small markets than in large, there is no clear correlation between the size of the market and the extent of switching or of customer benefit.
62. Instead, the evidence suggests a series of issues to which we should pay close attention as retail markets develop further here. This chapter maps out the policy lessons we draw from the international evidence.

### **Impacts of wholesale market structure and regulation**

63. One of the main lessons from the literature review is that retail competition will only deliver benefits if it is part of a wider competitive sector. In the absence of vigorous wholesale competition, supply is likely to be oligopolistic, and vice versa.
64. As a starting point, it is fundamental to have confidence that prices are set against a benchmark that actually reflects the clearing price for the whole market. This was a key factor leading us to a gross mandatory pool structure for SEM, since this design maximises liquidity. Without a trustworthy marker for retail prices or investment decisions, entrants cannot buy on a level-playing field with vertically integrated groups.
65. Within the pool, it remains important to ensure competition is not distorted by anti-competitive behaviour or structures. The SEM is monitored on a daily basis by the regulators, who look at bidding patterns that could distort price or dispatch patterns. Over the first year of the market, the regulators are confident that the SEM price has been set by competitive pressures, and we will shortly publish an Annual Report giving more information on this. We have also during the first year seen good progress towards improving the competitive structure of the market, with divestiture of plant by ESB.
66. Aside from the pool price, however, supply economics are also dominated by the costs of risk management. Risks can be managed by vertical integration, or through financial hedges. Liquidity in the secondary market for such hedges is so far inadequate, although it has been developing well since the SEM was launched. We hope to see further developments in the coming year, with a more flexible approach to auctions, and the launch of a trading screen to centralise offers and demand. The SEM Committee will continue to monitor these developments closely.
67. Liquidity in the hedging market is important, because the alternative is to look to vertical integration for risk management. Given the small size of our market, it can only accommodate a limited number of vertically integrated groups. However, we do not consider that low liquidity is itself necessarily a consequence of high levels of vertical integration, but would see this as a conduct issue, not just a structural one. One might compare the British

situation to Germany. The latter has higher levels of integration in electricity, but has generally had much greater liquidity. The reason is that when the German vertically integrated groups have needed to trade, they generally have done it through public markets; in contrast, when the GB integrated groups trade, they do it through private, bilateral transactions. (See DG Competition's sectoral inquiry report for more information on this.)

68. The importance of effective retail competition for fair wholesale markets is a point that is sometimes not emphasised enough. In the absence of retail competition, wholesale investment decisions may be dictated by who is best able to pass costs to down-stream customers, rather than who can minimise costs overall. (British Energy, the only non-vertically integrated major GB generator, has long argued this case.) Moreover, the lack of competitive pressure on retailers means they may adopt a hedging strategy that aims not so much to minimise cost, but only to keep level with other companies; this could raise consumer costs, and also contribute to a lack of wholesale liquidity.

### **Market segmentation and treatment of non-switchers**

69. It is observed in most jurisdictions where competition has taken hold that there are deep-rooted differences in consumers' propensity to switch. Moreover, suppliers can often predict where the non-switchers will be found and so price-discriminate. Ofgem's recent probe into the operation of the GB market casts particular light on the current segmentation of the GB market.

70. Market segmentation seems to arise from a complex interaction of consumers' and suppliers' choices.
- a. Supplier preferences seem to relate to differences in cost. For instance, there is less switching among electricity-only households; this may be a result of lower levels of marketing activity among these customers since the fixed-cost of sales can be recouped from only one, not two, revenue streams;
  - b. Similarly, the PPM sector has long been less attractive to suppliers, partly because the obsolescent electricity PPM technology in use in most of GB creates higher costs-to-serve for suppliers. (Although Ofgem has identified that the lack of competition in this sector has now enabled higher margins which might make it more attractive in future.)
  - c. Switching rates also continue to be lowest in the most rural parts of GB (notably northern Scotland), which probably relates to the cost of doorstep sales where households are geographically dispersed.
71. To some extent, these differences are individual to the household – a matter essentially of personality type or life experience. After many years of direct sales, the consumers who have not switched can be broadly treated as non-switchers, and this risks making it practical for suppliers to price-discriminate against them.

72. To the extent that market segmentation arises in GB from extra costs for pre-payment meters, we hope that we are well placed in NI to avoid this problem since such meters are not costlier for suppliers here.
73. We do see some danger of competition developing first in those parts of Northern Ireland (predominantly greater Belfast) where a dual-fuel sell is possible. Although dual-fuel is not a universal pattern in jurisdictions where it would be possible, it is extremely common since it provides two margin streams to cover costs that are to some extent shared. If competition starts in Belfast but soon is generalised across Northern Ireland, this may not be a problem, however, and the Belfast market is so small that we doubt any entrant could afford to set up purely to serve the Belfast conurbation. We therefore consider we are unlikely over time to see a market structure where dual fuel is the norm, with electricity-only a less attractive minority segment.
74. However, some of the other potential drivers of segmentation apply here: rurality, in particular. We would need to monitor carefully whether any clear category of non-switchers emerged over the first years of active competition, and whether identifiable barriers were keeping them from the market.
75. The Utility Regulator is not contemplating removing all retail price controls over the next few years. Although such a vigorous de-regulation might assist competition to develop, we would also have concerns about the prices that might be paid by non-switchers. If we saw vigorous competition established, we would want to consider lifting price controls, but would wish to do that in a way that bore in mind the interests of all consumers, including non-switchers. Most likely, therefore, is progressive deregulation involving a number of stages. Some way-points along that path might include:
- a. As a first stage, set prices that accurately reflected risk-allocation that is the same for incumbents as for new entrants;
  - b. Backstop price controls, that were designed not to deliver cost-oriented prices but to prevent gross abuse of non-switchers;
  - c. Relative price controls, that pegged non-switcher prices to competitive prices; and/or
  - d. A general non-discrimination condition.
76. One particular point raised by our literature review is the question of headroom. EEE/Cornwell point out that, in some jurisdictions, regulated tariffs were set deliberately above cost, so as to create headroom for market-entry. This is not the Utility Regulator's current intention.
77. We are currently reviewing the allocation of risk between customers and suppliers. Our traditional approach to annual tariff setting has placed the bulk of risk onto consumers, since they are fully exposed to year-to-year changes, and in-year changes are largely carried from one year to the next. This approach seems less appropriate in current volatile market conditions, and we are reviewing whether it would be more appropriate to expect the company to carry some risk (recognising that this risk will have a cost).

78. Further consultation in 2009/10 will cover risk allocation and begin to sketch out an evolutionary path for tariff regulation.

### **Consumer empowerment**

79. For consumers to make good tariff choices, they need accurate information about their own energy consumption and costs. Competition might need to be accompanied by an improvement in the quality of information to customers.
80. At the least, we should ensure that the quality of information should not be reduced. We have no plans to reduce obligations on suppliers to read meters or to introduce meter competition, since these actions seem elsewhere to have reduced the accuracy of information provided to consumers. On the contrary, we might consider whether meters should be read more frequently (particularly for gas direct debit customers).
81. The smart metering agenda is clearly relevant here: giving consumers rich data about their own consumption we would empower them to buy better, as well as to save energy. We will collaborate with DETI in the coming year in their analysis to assess costs and benefits of smart-meter roll-out.
82. The literature review tends to suggest, however, that even when consumers have good information about their current situation, market development tends to be driven by supplier marketing not customer “pull”. From the review we draw the tentative conclusions:
- a. Diversity in marketing is a good thing. Different consumers like to be approached in different ways. Consumers might place real value on bundles (because of the saving of time or reassurance involved);
  - b. Most forms of marketing make limited calls on the consumer, and in exchange might offer significant benefits. In our information-overloaded society, it is common in many markets for consumers to rely on prompts from companies. However, it is clearly of fundamental importance that when a consumer is offered a prompt, the information contained in the prompt is true, clear and fair; and that further information is available to consumers who wish to make pro-active comparisons;
  - c. Relying on prompts means that although customers should save when they switch, they might not switch to the very best deal available. This feature of energy retail markets also appears to be a common feature of other markets in which the costs to consumers of shopping around might outweigh the perceived benefits.
83. We would, on the other hand, have serious concerns if customers frequently switched to more expensive deals. This happened relatively frequently in the early years of the GB market. The main reason in GB was that suppliers offered unattractive deals to pre-payment customers because they did not want them, but these customers were nevertheless scooped up in relatively

indiscriminating marketing campaigns. We think this is less likely in Northern Ireland, since we do not expect suppliers to adopt high-price deals for pre-payment so as to avoid recruiting these customers. This is partly because, unlike in GB, pre-payment in NI is not more expensive for suppliers; and partly because pre-payment is more prevalent here, which means suppliers would be less likely to regard these customers as representing a concentrated bad-debt risk. Nevertheless, this appears to be an issue that the Utility Regulator should monitor carefully.

84. Unethical marketing and mis-selling are clearly not acceptable. Currently, suppliers are asked by the Consumer Council to sign up to a voluntary code, and we will consider whether this is sufficient to avoid bad practice and safeguard consumer confidence. GB arrangements introduced around 5 years ago have broadly been very effective at reducing mis-selling, and we will consider whether it would be appropriate to adopt similar arrangements here.
85. Ofgem's Supply Probe suggested that particular problems might relate to internet marketing where this becomes a key battle-ground for the most volatile customers:
- a. Internet prices are often keenest, which can systematically exclude less-IT confident consumers, who may be among the oldest consumers and/or vulnerable for other reasons; and
  - b. Ofgem identify that online comparisons are not always honest, with some concerns that offers are "bait and switch" deals where the prices rise soon after a customer has signed up.
86. It is our policy intent that the benefits of competition should be shared by all consumer groups. The trends mentioned above tend to suggest that we could see unequal outcomes, with internet-savvy or more financially literate consumers benefiting more than other less active groups. While to some extent such a pattern might duplicate the overall trend in society, we have specific statutory duties to certain groups (see Appendix). We should be alert to opportunities to ensure they achieve a fair share of benefits.

### **Costs must be minimised**

87. It is always important to ensure that costs are as low as possible. Given our small size, and that some of the costs of retail competition are fixed overheads, this is of fundamental importance if we are to ensure that customers derive benefit from the market.

#### *Switching systems*

88. Our review in the previous chapter set out the evidence about costs and benefits on a "whole programme" basis. However, in Northern Ireland we are not now at the beginning of creating retail markets. On the contrary, much of the systems implementation is already complete in electricity (although some further work will be required on the NIE systems to create an enduring

solution, and the current manual Phoenix system is probably not sustainable). If we were at this point posing a go-no go question about retail competition, it would be appropriate to regard the bulk of the fixed costs as sunk, and therefore irrelevant.

89. On a forward-looking basis, it is of fundamental importance to avoid a data mess in the switching systems:
- a. Clear roles and responsibilities are essential. We would foresee a continuing lead role for the network companies in data management and meter reading, and maintenance of a central database;
  - b. Proper testing programmes are essential before systems are released;
  - c. Manual systems (based on email exchanges and data held on spreadsheets, for instance) are to be viewed with suspicion.
90. Looking at the continued development of domestic switching systems (in electricity and in gas), we consider that there may be opportunities to improve or maintain high standards of customer service, in exchange for minor reductions in the overall flexibility of the system that have little real impact on consumers. For instance, one of the systems that works fairly well is in Norway. In that country, customers can only change suppliers on a Monday and this rule creates a regular rhythm to companies' interactions.

#### *Marketing costs*

91. Some jurisdictions (Britain, for instance) see continuing high levels of marketing cost. These costs are, in aggregate, at a level that represent a significant proportion of the overall supply margin. There might be benefits in a market involving more longer-term contracts, if these reduced the overall cost of customer acquisition, and so long as these were not used to stifle consumer choice or competition (for example, by suppliers with market power).

### **Consequences for Utility Regulator Work Programme**

92. As this paper has stressed, we are not at the beginning of developing energy supply competition in Northern Ireland, although we may be at a turning point because of increasing market entry and intensifying regulatory effort. Necessarily, therefore, this overview paper needs to take into account work already underway.
93. Following an extensive programme of consultation and research, we published a Decision Document alongside our November 2008 consultation on a 5-year strategy. We have subsequently evolved the findings of that Decision paper into a work-programme covering both the electricity and gas sectors that is included in our recently released Forward Work Programme for 2009-10.
94. Recognising the importance of inter-jurisdictional co-operation in relation to energy markets, and in light of the potential importance of market scale to

delivering more effective retail competition, we are also in the process of discussing this retail work programme with CER to determine the extent to which projects may be better pursued on an all-island basis. Indeed, we are already co-operating on several aspects of the work programme e.g. joint studies on “K” factors and supply margins and on regulated tariff structures.

95. In recognition of the potential benefits of competition, in March 2007 CER and NIAUR (the Utility Regulator) signed an addendum to the original 2004 MoU, which included 3 relevant parts:

*“CER and NIAUR share a strategic objective to achieve competition for all customers. To that end we will work to ensure that no party may hold significant market power in the generation market or a large market share in the retail market. We consider that no party (including affiliates) should have more than 40% share in either case.”*

Also:

*“we will work to promote effective retail competition. In segments of the market where we judge that there is sufficient competition we will phase out regulated tariffs.”*

And finally:

*“CER and NIAUR will apply a transparent, consistent and harmonised approach to the regulation of the wholesale and retail markets in a manner which supports effective competition and equal treatment of participants and customers regardless of their location. Such approach will encompass application of the same principles of regulation to:*

- *ESBPG and PPB, including ring-fencing arrangements;*
- *PES in both markets, including:*
  - *Ring fencing arrangements*
  - *Tariff/revenue regulation*
  - *Economic Purchasing Obligations*
  - *Operation of PSO arrangements*
  
- *For all suppliers:*
  - *Supplier switching arrangements/requirements*
  - *Codes of practice”*

96. As we go forward with the projects outlined in our retail work programme, we will consult on individual future projects and use this as a means of incrementally assessing way forward on a project basis. In addition, we will hold the programme under review in the light of this current consultation.

97. In broad terms, the work programme for the coming period includes the following main project areas.



<b>Project</b>	<b>Main tasks</b>	<b>Status</b>
<b>Incumbent regulation</b>	<b>Analyse and implement appropriate way forward in relation to “k factors”, allowed margins and regulated tariff structures in terms of helping to deliver effective retail competition.</b>	<b>Research underway. Consultation early 9/10.</b>
	<b>Supply price controls completed transparently and to facilitate competition where necessary.</b>	<b>Ongoing</b>
<b>Data transparency</b>	<b>Develop policy/strategy on data transparency in relation to delivering more effective retail competition.</b>	<b>Underway</b>
	<b>Elec and Gas Directorates to ensure all suppliers have access to the appropriate information to allow them to compete on an equal basis.</b>	<b>Ongoing</b>
<b>Incumbent tariff approvals</b>	<b>Ensure accuracy and transparency of tariff approvals.</b>	<b>Ongoing</b>
<b>Wholesale market liquidity</b>	<b>Promote a more liquid contract and secondary hedging market in electricity; trading screen/platform work.</b>	<b>Underway</b>
<b>Standards of performance</b>	<b>Review and implement Supplier Standards of Performance to ensure they meet best practice.</b>	<b>9/10 &amp; 10/11</b>
<b>Customer Switching Systems</b>	<b>Deliver Enduring Solution system for electricity switching.</b>	<b>Underway – 10/11</b>
	<b>Examine options and spec for way forward on gas customer switching system.</b>	<b>Underway</b>
<b>Branding separation</b>	<b>Assess and deliver optimum way forward in relation to branding of incumbent businesses.</b>	<b>Underway</b>

<b>Supplier marketing</b>	<b>Assess and deliver best-practice operation of supplier marketing procedures to customers in a competitive environment.</b>	<b>10/11</b>
<b>Annual Retail Market report</b>	<b>Produce an annual report on the extent and state of retail competition in energy markets.</b>	<b>9/10 &amp; annual thereafter</b>

## Appendix

### Excerpt from the Energy (Northern Ireland) Order 2003

#### The principal objective and general duties of the Department and the Authority in relation to electricity

12.—(1) The principal objective of the Department and the Authority (the Utility Regulator) in carrying out their respective electricity functions is to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission or supply of electricity.

(2) The Department and the Authority shall carry out those functions in the manner which it considers is best calculated to further the principal objective, having regard to—

- (a) the need to secure that all reasonable demands for electricity are met; and
- (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Electricity Order or this Order; and
- (c) the need to secure—
  - (i) that the prices charged to tariff customers by public electricity suppliers for electricity supplied under Article 19(1) of the Electricity Order to premises in any area specified in an order made by the Department are in accordance with tariffs which do not distinguish (whether directly or indirectly) between different parts of that area; and
  - (ii) that public electricity suppliers are not thereby disadvantaged in competing with other persons authorised by a licence or exemption to supply electricity to such premises.

(3) In performing that duty, the Department or the Authority shall have regard to the interests of—

- (a) individuals who are disabled or chronically sick;
- (b) individuals of pensionable age;
- (c) individuals with low incomes; and
- (d) individuals residing in rural areas;

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

(4) The Department and the Authority may, in carrying out any electricity functions, have regard to the interests of consumers in relation to gas.

(5) Subject to paragraph (2), the Department and the Authority shall carry out their respective electricity functions in the manner which it considers is best calculated—

- (a) to promote the efficient use of electricity and efficiency and economy on the part of persons authorised by licences or exemptions to supply or participate in the transmission of electricity;
- (b) to protect the public from dangers arising from the generation, transmission or supply of electricity;
- (c) to secure a diverse and viable long-term energy supply;
- (d) to promote research into, and the development and use of, new techniques by or on behalf of persons authorised by a licence to generate, supply or participate in the transmission of electricity; and
- (e) to secure the establishment and maintenance of machinery for promoting the health and safety of persons employed in the generation, transmission or supply of electricity;

and shall have regard, in carrying out those functions, to the effect on the environment of activities connected with the generation, transmission or supply of electricity.

(6) In this Article “electricity functions” means—

- (a) functions under Part II of the Electricity Order; and
- (b) functions under this Order relating to electricity

### **The principal objective and general duties of the Department and the Authority in relation to gas**

**14.—**(1) The principal objective of the Department and the Authority in carrying out their respective gas functions is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland.

(2) The Department and the Authority shall carry out those functions in the manner which it considers is best calculated to further the principal objective, having regard to—

- (a) the need to protect the interests of consumers of gas;
- (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Gas Order or this Order;
- (c) the need to secure that the prices charged in connection with the conveyance of gas through designated pipe-lines (within the meaning of Article 59) are in accordance with a common tariff which does not

- distinguish (whether directly or indirectly) between different parts of Northern Ireland or the extent of use of any pipe-line; and
- (d) the need to protect the interest of gas licence holders in respect of the prices at which, and the other terms on which, any services are provided by one gas licence holder to another.

(3) In performing that duty, the Department or the Authority shall have regard to the interests of—

- (a) individuals who are disabled or chronically sick;
- (b) individuals of pensionable age;
- (c) individuals with low incomes;

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

(4) The Department and the Authority may, in carrying out any gas functions, have regard to the interests of consumers in relation to electricity.

(5) Subject to paragraph (2), the Department and the Authority shall carry out their respective gas functions in the manner which it considers is best calculated—

- (a) to promote the efficient use of electricity gas;
- (b) to protect the public from dangers arising from the conveyance, storage, supply or use of gas;
- (c) to secure a diverse and viable long-term energy supply;
- (d) to facilitate competition between persons whose activities consist of or include storing, supplying or participating in the conveyance of gas;

and shall have regard, in carrying out those functions, to the effect on the environment of activities connected with the conveyance, storage, supply or use of gas.

## **Bibliography**

“Consultation on Electricity and Gas Retail Market Competition in Northern Ireland”, Utility Regulator, April 2008.

“The Practices and Principles of Electric Retail Mass Markets: Final Report of a Multi-Client Study,” EEE Limited and Cornwall Energy Associates.

“Giving Domestic Customers a Choice of Electric Supplier, Report by National Audit Office to Public Accounts Committee, January 2001

“Determining the limits of competition. A critical evaluation of the process to introduce electricity supply competition,” D. Maclaine, DPhil thesis, University of Sussex, April 2003

“Competition in electricity retail analysed”, Ofgem, December 2002

“Domestic Gas and Electricity Supply Competition – Recent Developments”, Ofgem, June 2003

“Energy Supply Probe – Initial Findings Report”, Ofgem, October 2008.