Airtricity Response to Consultation on

Phoenix Supply Ltd Price Control from 2009

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Introduction

Airtricity welcomes this opportunity to respond the Authority's consultation on the future price control regime for Phoenix Supply Ltd. As our own entry to the Northern Ireland retail gas market is imminent, we are keen to see regulatory control exercised in a manner that delivers value to customers without undermining the ability of new entrants to compete effectively. We note the Authority's recognition that "a price control can serve as a proxy for effective competition in terms of controlling costs and margins" and our comments on these proposals include an assessment of whether or not individual proposals act in this way.

Consultation response

Question 1 – Is there a rationale for increasing the scope of the price control to cover all customers and if not what should the threshold be?

Large customers generally have expertise in managing complex operations, of which energy purchase is only one aspect. While there are technical and investment impacts surrounding a customer's decision on fuel substitution, we believe that businesses are perfectly capable of addressing these in a manner appropriate to their own particular circumstances.

If the price control is extended to cover large gas users, then this will inevitably introduce friction into the process of competitive price responsiveness and signal the Authority's expectation that competition will fail to develop in this sector. Under current arrangements, potential market entrants have a good understanding of the margin that is available to compete away and do not face the regulatory risk of differential cashflow/margin impact, between incumbent and competitors that results from price control regulation. Any change in regulatory policy would introduce an element of uncertainty (and therefore risk) to market participation.

Customers are used to operating under the current arrangements and some have found alternative suppliers. Current market arrangements are attractive to potential entrants with established retail gas operations in the GB market, as products and prices can be more flexible and determined by competition, rather than being constrained by regulatory perception of correct price and margin levels.

While it is reasonable for the Authority to keep this sector under review, we believe it would be inappropriate at this stage, to extend the scope of price control into the >25,000 therm sector without evidence of abuse of market power by the incumbent coupled with failure of further competitive development in the sector. If price control is being contemplated then, to avoid regulatory uncertainty, the Authority should publish specific incumbent market share parameters that could trigger future regulation.

Question 2 – Do respondents agree with the proposal to set the price control for a period of three years? If not how long should the price control run for?

We agree that full competition is unlikely to develop in the <25,000 therm market sector within three years and accept the need for price control to be in place in the medium term. Of the 21.5 million domestic gas customers in GB, over 3.6 million customers switched in the three years up to 2001. It should therefore be logistically possible for the 30,000 customer switches required to achieve a similar level of competition in NI, to take place over the proposed 3-year price control period. However there are several potential barriers to delivery of this scale of retail gas market switching;

- a dual fuel offering is the only feasible route to effective supply competition in the small NI gas market,
- inter-dependence of gas and electricity markets – in GB one third of gas customers buy their electricity from the same supplier,
- complication in domestic retail electricity market arrangements. eg the FEMO 2007 electricity project did not migrate domestic electricity customers from legacy NIE systems to the new interim solution. Acquiring suppliers must manually use NIE account number to generate a meter point ID via a web interface – preventing automated customer signup and increasing customer acquisition costs,
- capacity of retail market systems (the retail electricity market has a limit of approximately 24k CoS transactions a year),
- meter reading charges must be unbundled from UoS charges, to avoid double-charging for collecting data from dual fuel customers.

In principle, we agree with the Authority's proposal for a 3-year price control, as this period offers a reasonable balance between continuity and competitive development; it will allow time to assess whether competition is in fact developing. However, alongside price control, it is essential that the Authority takes a proactive approach to dealing with emerging market system and process blockages that impede competition.

Question 3 – Should there be an economic purchasing obligation on PSL and if so what would the benefits be?

In a properly competitive market, suppliers would have a natural incentive to purchase gas efficiently. An economic purchasing obligation is therefore a reasonable component of the regulatory framework for small gas users. However, since decisions taken in competitive markets can only ever be based on current circumstances and best available forecasts, any obligation should not allow the Authority retrospectively to disallow costs, based on later information or outturns and apply "corrections" to prices in future years.

Question 4 – Do respondents agree with the items that are retrospectively adjusted and the retrospective mechanism employed?

Any retrospective adjustment to prices, as a result of over/under-recovery by the incumbent, has a differential effect on unregulated suppliers and therefore distorts competition. This is because;

- incumbent and unregulated suppliers have different sales mixes and are therefore differentially affected by any incumbent "correction",
- a growing customer base of market entrants is particularly penalised by regulatory "repayments",
- unregulated suppliers have to face the consequences of their decisions, without recourse to ex-post compensation mechanisms.

Competitive markets do not deliver retrospective compensation. In these markets, participants face stranded costs, losses, budgetary errors and bad debt, as normal consequences of their operations. Competition prevents recovery of losses, since raising prices results in a loss of customers. If their cost of operations is lower than that of their competitors, then participants benefit from increased margins in spite of offering lower prices.

It is not clear that the existing interest rate arrangement for Phoenix actually provides much of an incentive for accurate cost recovery. However the pricing-distorting effect it introduces is likely to have a more significant impact on the viability of independent participants through undermining their margins. A true proxy for competition would be to ensure that customer charges directly reflect the transaction costs associated with their supplies as they are incurred, rather than Phoenix being granted a budget that is subsequently "corrected". This approach is unrepresentative of any competitive process, so should not form part of an price control that seeks to act as a proxy for competition. Any over-recovery associated with a particular class of customers should be rebated in cash, directly to those affected, to prevent pricing distortions impacting competition..

Airtricity is opposed to the use of any retrospective mechanism in the price control.

Question 5 – What are the views of respondents on the application of the efficiency factor?

The efficiency factor is a proxy for the effect of competition on driving down operational costs. In the absence of competition, it is reasonable to include this component in the overall price control. However the selected value of 2.5% may be far greater, or smaller, than could be achieved by a competent business. Real competition would be a much better driver for inspiring innovative efficiency measures, but clearly this is not yet in place.

We believe that a progressive reduction in the efficiency factor should be implemented, in line with delivery of defined market share reductions. When combined with removal of retrospective price adjustments, the effect would be to incentivise a more competitive response, while reducing the collateral regulatory impact on market entrants. Delivery of real competition would be evidenced by incumbent retail prices dropping below the maximum allowed price, rather than being assumed on the basis of a pre-defined market share.

Question 6 - What are the benefits for customers in the long run of the proposed margin?

The achievable margin for a business depends on the contestability of the market. Where sunk costs are low, prices will tend towards marginal cost, whereas markets with high entry costs will tend to have high margins[1]. The recent regulatory authorities' publication on the cost/benefit of the CAG project completely failed to take account of the supplier cost of participation in the new arrangements. Experience in the deregulation of electricity markets on the island of Ireland is that central market delivery projects take little account of the impact of design decisions on participants. If central market costs are "exported" to (potential) participants in this way, then the sunk cost of market entry increases, contestability is reduced and customers pay higher charges as a result.

The clear conclusion is that there is a relationship between the appropriate supply margin and the cost of participating in the market. The retail electricity market central project was delivered on the basis of least cost, resulting in a bespoke NI market design and high participant costs. As a result, competition has been undermined by the insufficiency of available margin to cover both investment and acquisition costs, in the context of discounted prices.

For the gas market, it is essential that this mistake is not repeated. Market arrangements for gas should join the NI market to that in GB, in order to benefit from a proven and operational market design, low operating costs, a pool of existing active suppliers and minimum supplier entry costs. Market development should focus on making central market supplier registration systems conform to those of the larger market.

As far a long run customer benefit is concerned, suppliers will only participate in the market if they can earn a return for their shareholders. If choice is important and customers want to benefit from improved service and better value for their money, then the market must offer a reasonable margin commensurate with competitive risk. In assessing margin it is wrong to look only at incumbent costs, since competitors incur the additional cost of customer acquisition while offering discounts compared with incumbent prices.

In determining the allowed Phoenix margin, we believe the Authority must take account of the cost of market participation and the discounts offered by competing suppliers, in addition to ensuring that market CoS arrangements do not unreasonably restrict the rate at which suppliers can grow their businesses to achieve worthwhile economies of scale.

[1] Baumol, Panzar & Wiilig (1982), "Contestable Markets and the Theory of Industry Structure", Harcourt, Brace, Jovanovich, San Diego