Airtricity Response to

Consultation on Proposed Extension of NIE Energy Price Control to 2009/10 (dated 25th March 2009)

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Summary and conclusion

Airtricity does not accept the arguments for extending the current price control for a further year, (or perhaps two depending on progress with other workstreams). The previous extension was based on uncertainty as to progress with full market opening and how to regulate NIEES in the context of the SEM, while the current proposal is based on uncertainty as to the outcome of work on supply margins and the k-factor. We believe that these are excuses for procrastination. **The current price control should end and be replaced with one that is consistent with a competitive market**.

In any case, it is not clear what is meant by "a further continuation of NIE Energy Supply's current price control". The original 2000 – 2005 supply price control is not readily available on the Authority's website, but documents describing previous extensions to the Control suggest that it incentivised installation of prepayment metering. Even though independent suppliers pointed out, during a previous round of market opening, that the chosen technology did not fully support competition it appears that this incentive may still remain as part of the price control and continue to influence development of the market environment. The current consultation is not exhaustive in the detail it contains so, as with previous extension proposals, no-one apart from NIEES and the Authority can be sure of the full scope and incentives that will result. **The Authority should provide proper transparency so that the incentives on NIEES can be properly understood.**

The regulation of incumbent electricity businesses in the light of market opening and in advance of changes to the wholesale market arrangements were fully explored by Ofgem in its 1999 consultation[1]. This emphasised, for example, that price controls "should not prevent, restrict or distort the development of the competitive market[2]" and "should also aim to be consistent with the effects of a fully competitive market[3]". Regulation of NIEES has hitherto been concerned with minimising cost to customers through creation of a shallow supply business model, use of pass-through cost elements and k-factors to pass all risk back to customers. In light of experience in GB, one of the most effective and competitive electricity

[1] Reviews of Public Electricity Suppliers 1998 to 2000 Supply Price Control Review, Ofgem, October 1999.

[2] Section 1.7, page 5

[3] Section 1.8, page 6

markets in the world, we believe that the onus should be on the Authority to explain why it believes further investigation is required to develop a new price control methodology for NIEES. The Authority should explain why the uncertainties of the future are any less significant than the uncertainties of the past that prevented implementation of a new price control in either 2005, or 2007. On past performance, why should independent suppliers believe that the original 5-year price control, extended to seven, then nine and probably ten years (maybe eleven) is not an enduring approach intended to avoid difficult decisions on regulating for a competitive market? **The Authority should explain why k-factor regulation is superior to the price cap form of regulation used successfully in GB and why it believes customers are best placed to carry energy market price risk.**

In answer to the specific consultation questions, we;

- strongly oppose extension of the existing price control for a further year (or perhaps two),
- do not believe that the asymmetry of power, market process and operational costs under the interim market arrangements justify removal of a further group of customers from the price control regime,
- accept the proposed X-factor,
- believe the proposed reduction in level of net margin compared with the SEM decision, based on k-factor cushioning and desk analysis of working capital requirement, is not consistent with a fully competitive market, and
- believe that allowed revenue should reflect the AIP/SEM/304/07 decision, plus the cost to serve customers in the >150 MWh/annum sector.

Specific questions

<u>Extension of the existing price control</u>

As stated above, no case has been made as to the materiality of future uncertainties in comparison with those used to justify previous extensions of the control, nor is there any assessment as to whether previously advanced justifications for extensions actually turned out to be at all material. In addition, the current price control has been running for so long that efficiency rewards envisaged as being retained by NIEES up to 2005 are now to be retained until 2010 (or possibly 2011). However, on past form, it is difficult to say whether further price control extensions may not lead to NIEES enjoying these benefits on a more or less permanent basis. Furthermore, the proposed reduction in scope of the price control means that “extension” is a misnomer; the control is being changed on an ad hoc basis, without proper consultation on the overall impact on either customers or competition.

So much has taken place in the way of retail market opening costs, SEM delivery costs, new IT systems, changes in cashflow and collection costs, and changes to environmental obligations since 2000, that the time must surely have come to assess today's market deficiencies, properly analyse the scope of the control, reset the pricing baseline and start a new price control – in particular to level the competitive playing field by eliminating the distortionary k-factor[4]. There will always be reasons to put off making changes; this consultation has not provided any substantive reason for further delay in addressing the issue of a new price control.

<u>Operating cost adjustments</u>

The current, interim market arrangements treat incumbent and independent suppliers differently, in the change-of-supplier-process. Independent suppliers have to install online HH meters as part of this process, but NIEES is allowed to continue to supply using existing metering. Independent suppliers also incur the cost of customer acquisition through their sales and customer registration teams.

These requirements cause disruption to customers, expense to suppliers and act as a barrier to competition. Any suggestion, that part of the market should be deregulated because the incumbent has lost significant market share, is flawed if fails to consider the wider competitive context. NIEES enjoys a number of advantages from being the original monopoly service provider, in terms of avoiding costs that independent suppliers have to incur and access to data so it is essential that any change to the current regulatory framework should be properly consulted on <u>before</u> the Authority accepts any NIEES proposal on the scope of price control. We do not believe this market change follows the Ofgem recommendation; that the price control should be consistent with the effects of a fully competitive market.

Without a level playing field in the competitive <u>process</u>, deregulating <u>prices</u> will only lead to a different form of competitive distortion in the market and we oppose the underlying proposal. Instead and to provide an incentive to deliver level-playing-field competition, we propose that NIEES should not be allowed to deregulate the >150MWh/annum market until the final market solution is implemented. NIEES must be treated in the market, in all respects, exactly the same as any other supplier. The Authority must consider the market holistically and recognise that there is more to competition than market share.

Airtricity strongly opposes further deregulation of the electricity market in the absence of a proper consultation on the proposal and guarantee of a level competitive playing field.

[4] AIP/SEM/304/07 only committed to a k-factor for the first year of the SEM. The supporting argument, based on volume uncertainty because of the high proportion of domestic customers, did not explain why NIEES should be in a particularly adverse situation in this regard compared with suppliers with a similar customer portfolio operating in the GB market. Demand uncertainty is intrinsic to operating as an electricity supply business.

X-factor

We agree with the proposed X-factor.

Margin

The argument on margin is rather unclear. On the one hand it argues that the 1.8% margin agreed in 2006/07 prices would translate into £7.921m in 2009/10 prices but, on the other, fails to provide any explanation as to why indexation is at all relevant to setting a margin based on turnover. The consultation then goes on to discuss the issue of working capital, before proposing to add this cost onto the net margin to increase "the real margin from the current price control".

This is confusing. Firstly the quoted decision paper AIP/SEM/304/07 doesn't mention a figure of 1.8%; the decision was that, "the RAs have also decided, for the time being, not to change the supply margins currently operated by ESB CS and NIES as the existence of the k-factor significantly removes the level of risk faced by both suppliers". However, the current consultation states that this meant the net margin should be 1.8%.

It is difficult to follow how this net margin of 1.8% translates into a fixed (but somehow indexed) amount of £7.921m (equivalent to a margin of 1.27%), to which a working capital cost should be added to arrive at a final net margin value of 1.68%. If the working capital cost is included on the cost side of the equation instead of on the net side, the stated net margin is even less than 1.27%. As described by the Authority, the basis and nature of margin in the price control is impossible to determine.

The Authority must clearly explain what margin is proposed for this price control and if it assumes continuation of the current k-factor subsidy to NIEES compared with other suppliers.

Allowed revenue

The final table in Appendix 1 provides no explanation of how the cost drivers are combined to give the Allocation %. For example drivers U, R, C and B result in an allocation of 6.5% of MBIS, but 1.8% of service delivery cost. We therefore make no comment on whether the resulting £0.6m is appropriate or not. However, given our belief that the proposed further deregulation of pricing fails to reflect the competitive imbalance inherent in the current market arrangements, we believe the proposed deregulation should not proceed and the proposed reallocation of £0.6m should be reversed.

The stated 2007 decision to allow a 1.8% net margin should be respected and not distorted by inclusion of costs or indexation calculations. Information ought also to be provided on the projected costs of energy and wires charges, so that independent suppliers can assess the threat posed by NIEES' k-factor to their own business margins.

Little detail is provided on MBIS costs, beyond a statement of the forecast values. Without any supporting analysis or assessment of other cost savings, we cannot comment on the validity or otherwise of the proposed value for inclusion in the allowed revenue. Similarly, we are unable to comment on the reasonableness or otherwise of the other cost categories.

Other issues

We believe this consultation should have included an assessment of the degree of business separation that has been achieved by NIE. For example, it is not possible to assess the reasonableness of the proposed allowed revenue of NIEES without understanding whether a separate customer call centre is being properly funded, or whether the outsourcing contract terms include discounts for services provided to other NIE group businesses. We believe that the Authority should also have provided information on how NIEES has benefitted from joint IT projects for market opening and SEM readiness that were delivered as part of wider NIE group activities.

We believe that a regulatory impact assessment should accompany an important consultation such as this. We believe the Authority should explicitly set out its assessment of the impact this proposed price control would have on competition and customers.