NIE Energy Supply Price Control 2009/2010

NIAUR Consultation

NIE Energy Supply's Response

24 April 2009

NIE energy

Response Summary

NIE Energy Supply (NIEES) notes that this consultation proposes a continuation of the form of the current price control for at least 12 months. This approach has been chosen by NIAUR as it facilitates the completion of the key consultation workstreams associated with the further development of retail competition, outlined within NIAUR's forward work plan.

NIEES also notes the additional detail associated with the overall price control proposal:-

- Refinement in scope of price control ie customers below an annual consumption of 150 MWhs
- Duration is set from 1 April 2009 until 31 March 2010 with a possible extension of a further one year to March 2011, subject to a review by NIAUR before October 2009.
- Bad debt cost allowance continues to be based on 0.4% of turnover.
- Additional allowance to cover higher agency charges
- X factor remaining at zero.
- The proportion of St related gross profit apportioned to fixed costs remaining at c67%.
- The energy efficiency target will be set in GWhs as opposed to customer financial savings (ie £m).

Whilst NIEES acknowledges that NIAUR's proposed new target net margin (ie 1.68%) was determined by a logical bottom-up calculation, factoring in an allowance for working capital, it believes that the 1.8% target net margin was an agreed central principle of the existing price control and therefore should have endured through to this extended period.

NIE Energy Supply would welcome clarification on the optional additional 12 month extension (ie April 2010 to March 2011), and to what degree the scope of the price control might be further reduced. NIEES believes the logical next threshold would be 12 MWhs (ie the standard rate VAT threshold). Costs could be allocated using the high level methodology set out in Annex 1 of the consultation.

General Comments

Price Control and a transition to a more competitive market

In NIEES's view there are three main objectives of a price control in a transition to a competitive market such as is the present situation in the all-island market. It should:

- Protect customers from abuse by suppliers with market power and, in particular, ensure that they do not suffer prices that are higher or service quality that is lower than competitive levels;
- Promote competition by allowing entry. This requires that prices be set as they would be in a competitive market – by reference to an entry price and not by reference to the costs of the most efficient company; and
- Encourage efficiency, both productive efficiency by providing incentives for companies to reduce costs and allocative efficiency by ensuring that prices reflect costs. When prices reflect costs, customers are able to make efficient choices that ensure goods and services are consumed when the benefits obtained from them exceed the costs of providing them.

Competitive headroom

NIEES has previously argued that low margins of the level associated with the current price control are not normally found in competitive markets.

The gross margin inherent in the current price control is c5%. This compares with a gross margin of around 7%[1] now allowed for ESBCS and percentage margins in the teens[2] in the competitive market in GB, as reported in Ofgem's Energy Supply Probe – Initial Findings Document (Oct 2008).

Meaningful competitive entry is unlikely in the NI market if NIEES continues to supply at the present margins, and at the margins proposed for the extended period.

This is particularly the case if the available headroom in the rest of the all-island market is so much larger.

Scope

It is better if customers for whom suppliers compete are not price controlled. In GB, for example, the scope of energy supply price controls has been reduced as the market has opened and no controls now exist.

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[1] Allowed supply revenue as a percentage of an estimated 2008/09 turnover. A Bord Gais presentation published by CER recently shows a gross margin for retail gas of 8%.
[2] And at one time 26% in electricity, albeit in unusual circumstances.

In Northern Ireland there is insufficient competition in the domestic market for controls to be removed from domestic prices. However, larger customers could and should be excluded from control (ie >150 MWhs)

A group that might be removed from control in the second year is the c23,000 customers with a demand of over 12 MWh a year, which is the point at which VAT is charged at the standard (rather than reduced) rate.
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Obtaining appropriate hedges

As NIEES is not vertically integrated, it will need to be able to access a wider variety of hedges in a more flexible way than the current NDC and DC process, in order to serve the larger customer market. As customers >150MWhs will want quotes and ultimately supply contracts that may operate to a different timetable than the all-island tariff year, then NIEES will have to be able to secure appropriate hedges to align with any proposed contract period.

Correction factor

The present price control limits the use of the correction factor because the operation of price controls is more difficult in a competitive environment.

There is an asymmetry in that, while a regulatory error in setting the control may force the company to price below the competitive level, an opposite error may not enable it to recover revenue above the competitive price because competition may force it to price below the price control.

The workstream focusing on "k" correction and the potential for limiting its impact on the competitive market should focus on the following important considerations:-

- Relationship between "k" and retail margins
- Scope for the further deregulation of tariffs
- Greater liquidity in contract market
- Volume of contracts available in the all-island market
- Range of products available in the contract market
- Pass through pricing methodology for greater range of customers (supported by smart metering)
- Global aggregation (removal of wholesale differencing errors)

Other potential energy supply activities

We assume that, were there to be any supply outside Northern Ireland or expansion into gas energy supply, these too would be outside the price control.

Specific Comments relating to Licence Modifications

NIEES has given some initial thought to the licence modifications that would be required to give effect to the extension of the price control proposed and has the following comments.

Reduction in scope of price control

The consultation paper sets out the proposal to remove large non-domestic customers (with an annual consumption of more than 150 MWh) from the regulated market. The licence will need to be modified to reflect this. This should be done in a way which would allow the Authority to reduce the consumption threshold in the future without having to make a further licence modification.

The consultation paper sets out that costs associated with the deregulated market will be subtracted from the Allowed Revenue covered by the "S" term. The licence will need to be modified to reflect this, by the introduction of a new term within the "S" term. Initially, this term would be the amount of the reallocated costs specified in the consultation paper, i.e. £0.605 million, but if the scope of the deregulated market is extended, the amount would need to be determined using the same methodology used to determine the £0.605 million figure (as set out in the Annex to the consultation paper).

The second paragraph of the "G" term needs to be amended to make it clear that only those receipts from Contracts for Differences which relate to the regulated market will be subtracted from the costs recoverable under the "G" term. This is a drafting point.

Revised Energy Efficiency Target

Currently NIEES's target is to achieve £6 million of customer lifetime savings over the two-year period 2007-2009 (i.e. £3 million of savings per annum) and the maximum penalty for failing to meet the target is £6 million less the value of the savings achieved. When NIEES's target changes to "energy savings" (i.e. an amount in GWhs) rather than "customer final savings" (i.e. an amount in pounds), this will translate to approximately £70,000 (i.e. £3 million divided by 42.64) per GWh of energy savings not achieved.

This penalty is excessive and disproportionate given that the budget for expenditure on energy efficiency measures is £202,000 (i.e. £4,737 per GWh) and the incentive payment under the Energy Efficiency Levy is £1,000 for each GWh of energy savings achieved in excess of the target. This would be a good opportunity to fix this anomaly. A penalty of £4,737 per GWh of energy savings not achieved would be proportionate.

RPI

Since the figures that have been proposed for P_f and P_c take into account RPI for 2009/10, the drafting in the "S" term will need to reflect this by providing that rpi_t will be equal to zero.

Enduring Solutions Project

NIEES is engaged in facilitating the Enduring Solutions project and the costs associated with this will need to be recovered. The "E" term will need to be amended to clarify this.

In order to avoid similar modifications to the "E" term being required in the future, the "E" term should also be amended so that similar costs can be recovered under it with the Authority's approval.