

Review of K factors & Supply Margins and Tariff Structure Review

Proposals for Consultation

22th June, 2009

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1.0 INTRODUCTION

1.1 Purpose of this document

This paper presents consultation papers that have been commissioned on an all-island basis by both Regulatory Authorities (RA's), the Commission for Energy Regulation (CER) and the Northern Ireland Utility Regulator (NIAUR):

1. Review of K factors and Supply margins, by external consultants Skyplex; and
2. Review of Tariff Structures, by external consultants Poyry.

The purpose of this paper is to illicit responses from interested parties with regards to the issues raised and the questions asked in the two consultation papers.

2.0 REGULATORY AND POLICY BACKGROUND

2.1 SEM Memorandum of Understanding

The Single Electricity Market (SEM) came into effect on the 1st November 2007, introducing a single wholesale market for electricity on the island of Ireland. In recognition of the potential benefits of competition, in March 2007 the RAs signed an addendum to the original 2004 MoU¹, section 6 states that:

“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:*

¹[Regulatory Authorities published a joint Memorandum of Understanding](#)

- *Ring fencing arrangements*
 - *Tariff/revenue regulation*
 - *Economic Purchasing Obligations*
 - *Operation of PSO arrangements*
- *For all suppliers:*
 - *Supplier switching arrangements/requirements*
 - *Codes of practice*

Since then, the Regulatory Authorities have implemented a number of measures, such as the common Retail Tariff Timetable, to promote harmonisation with the retail markets in the SEM.

The RA's see the potential benefits of retail competition to include competitive pressure to procure wholesale energy efficiently (a vehicle by which competition benefits are passed to consumers); competitive pressure on supply margins and operating costs; innovation in tariff design and wider electricity "product" offerings; and better ability of customers to reflect their own preferences in how they buy.

However the RAs are fully aware that close attention is required to the market context and behaviour in order to ensure electricity retail competition delivers a net benefit to all electricity customers. It is the intention of both RA's to deregulate in such a way as to ensure that it delivers the optimum benefit for all customers. The RA's will continue to monitor market activity (and publish an annual retail market reports), taking appropriate action if customers are being treated unfairly.

EU law is explicit about the central role of competition to deliver consumer benefits. Article 3.1 of Directive 2003/54/EC (the 2nd 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. The 3rd Internal Energy Market package, adopted by the European Parliament in 22nd April 2009, puts an even greater emphasis on the retail market and customers. It is against that background that the RA's are both working to develop retail competition on an all island basis.

2.2 Functions & Duties of NIAUR

The statutory remit given to the Utility Regulator places a high value on competition as a means to deliver consumer benefits. It should 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;

As set out in the Utility Regulator paper in April 2009², our Energy Retail Competition Work Programme is well underway. In recognition of the importance of inter-jurisdictional co-

² [Energy Retail Competition Work Programme: General Overview and Rationale](#)

operation in relation to energy markets, and in light of the potential importance of market scale to delivering more effective retail competition, the RAs are co-operating on several aspects of the NIAUR Forward Work Programme. These are important topics that fit into our wider retail strategy. In Spring 2008 the Utility Regulator consulted on barriers to energy retail competition with the objective of assessing barriers to entry and fostering more supply competition. The outcome of which included barriers noted as being k factors, supply margins, information transparency and switching systems.

2.3 Functions & Duties of CER

The Commission for Energy Regulation ('the Commission') is the independent body responsible for overseeing the regulation of Ireland's electricity and gas sectors. The Commission was initially established and granted regulatory powers over the electricity market under the Electricity Regulation Act, 1999. The enactment of the Gas (Interim) (Regulation) Act, 2002 expanded the Commission's jurisdiction to include regulation of the natural gas market, while the Energy (Miscellaneous Provisions) Act 2006 granted the Commission additional powers in relation to gas and electrical safety.

These safety powers are being implemented from January 2009 through the establishment of new statutory-based regulatory systems for electrical contractors and gas installers. The Electricity Regulation Amendment (SEM) Act 2007 outlined the Commission's functions in relation to the Single Electricity Market (SEM) for the island of Ireland. The Commission is working with NIAUR to ensure that consumers benefit from regulation and the introduction of competition in the energy sector.

2.4 Joint Work Programme

In January 2008 the RA's set out a work programme for the regulation of retail markets in the SEM, this identified key Day 2 issues which included a strategic review of the application of k-Factors and Supply Margins and Retail Tariff Structures. In support of this element the RA's engaged Poyry to undertake this review to examine how tariff structure in both jurisdictions might be harmonised with a view to promoting competition and Skyplex to examine k-Factors and Supply Margins.

3.0 PROPOSALS

3.1 K FACTORS AND SUPPLY MARGINS

Background

In late 2008, the RA's issued a tender for consultancy support to conduct a review of K-Factors and Supply Margins in the retail markets in NI and ROI. The scope of this work included the following requirements:

- Identification and quantification of existing and potential k factors within electricity tariffs in Ireland and Northern Ireland;
- Assessment of the impact of k factors on retail competition in the all-island market;
- Recommendations as to the treatment or elimination of k factors, to include the nature of price or revenue regulation to be adopted;
- Assessment of the impact of existing supply business profit margins in NI and ROI;
- Benchmarking of supply business profit margins; and
- Recommendations for next steps.

Work completed to date

Skyplex began their work with a review of responses from previous consultations that have dealt with the subject of retail k factors and supply margins. During this process they identified points that were worth clarifying or exploring further with respondents.

This review was followed by several meetings with the incumbent suppliers (NIE Energy Supply and ESB Customer Supply) and independent suppliers both in NI and ROI. Skyplex further explored many issues that had been identified in previous consultations and also identified and developed any further points that arose.. Together with a review on the GB process, Skyplex have brought forward an analysis of issues which is included in their consultation paper.

The Skyplex paper sets out 3 proposals for consultation;

- The first proposal is for minimum change to the current system whereby k-factors are retained with some enhancements, specifically in terms of transparency, to the existing arrangements.
- The second proposal is for the introduction of asymmetric k-factors, where over-recoveries are repaid with a premium and under-recoveries are not fully recovered.
- The third proposal is the removal of k-factors and put in place a maximum revenue restraint determined ex-post.

RAs Supplemental Questions (Margin)

When responding to the issues and questions raised in the Skyplex paper the RA's also ask respondents to include their views on the following;

- Which of the three options they consider to be the most appropriate for the current market. Could these options be introduced immediately?
- Views are sought on whether or not it would be appropriate to increase the regulated margin if either of options 2 or 3 is adopted. Although the PES will have new risk under either option they will also have wide freedom to change tariffs within any year. It could be argued that this tariff setting freedom acts as a counter balance to the new risk and as such the PES can manage its overall risk as effectively as it does today. We would also welcome respondents' views on the impediments to the PES managing risk, and to what extent these impediments can be mitigated by effective management.
- Views are sought on what methodology should be used to calculate the new margin for the PES should option 2 or 3 be implemented (if it is deemed a higher margin would be appropriate). Although the Skyplex paper asks respondents what they feel the appropriate increase in margin should be the RAs would like views on methodology as well.

Following the consultation period, Skyplex will then assess the responses for consultation and prepare a decision paper recommending policy options and actions for the RAs to pursue. The Skyplex review is published with this paper.

3.2 REVIEW OF RETAIL TARIFF STRUCTURES

Background

In late 2008, the RA's issued a tender for consultancy support to conduct a review of Retail tariff Structures in NI and ROI. The scope of this work included the following requirements:

- Review existing PES and other electricity tariff structures and cost allocation methodologies in Northern Ireland and Republic of Ireland (NIE Energy Supply and ESB Customer Supply);
- Benchmark retail tariff structure models where appropriate;
- Develop proposals for the implementation of a harmonised approach to tariff structures together with recommended options;
- Assess the impact of the proposed options in the all-island supply market, on customers and on competition; and
- Produce recommendations on the next steps.

Work completed to date

Following initial meetings with both RA's to define the approach, Poyry began their work by comparing and contrasting the cost allocation methodologies used to derive retail tariffs in each jurisdiction, and compared these with the approaches used in other regulatory jurisdictions. This analysis included comparing and contrasting the different customer classes identified in each jurisdiction and the structure of the tariffs used, with comments on features found in tariff structures in each regulatory jurisdiction. This review was followed by an open forum with independent suppliers from NI and RoI, meetings with the Transmission and Distribution System operators in NI and ROI and several meetings with the incumbent suppliers (NIE Energy Supply and ESB Customer Supply). During these meetings Poyry explored points identified in their comparison research, and also documented further points and issues.

This work was developed through discussions at a workshop with the CER and the Utility Regulator with proposals for changes to tariff structures that could be applied in both jurisdictions, having cognisance of possible future developments in metering.

Poyry has provided a consultation document containing their views and proposals for harmonising the approaches in both jurisdictions, for the purposes of creating consistency and promoting competition through providing choice for customers.

The Poyry Report sets out three main categories of proposals (12 detailed proposals in total):

Group A - All Island Market Structure Proposals:

- Improve CfD liquidity to provide a more liquid hedging contracts market;
- Introduce system of global aggregation to create a more transparent settlement arrangement for suppliers with regard to distribution loss factors;
- Align metering codes of practice through creating a common metering Code of Practice;

Group B – All Island Regulatory Proposals:

- Create common programme of Profile Load Research;
- Create additional SME profiles to more effectively cater for the varying demand profiles of SME customers;
- Adopt a single model for network charging methodologies which would employ geographic cost signals;

Group C –PES Regulatory Proposals:

- Separation of network and wholesale energy costs;
- Use a common Cost to Supply (CTS) model to determine supply cost allocation;

- Enable contract term and indexation to allow for contractual terms between supplier and customer to reflect movements in wholesale prices;
- Employ Time of use tariffs through using a price signal to customer to encourage efficiency.
- Common NI & ROI Tariff Methodology Statements to encourage transparency;
- Reduce the need for k-factors in the PES tariff energy component

Of the above three groups, Poyry propose that Group C would be the easiest to implement, followed by Group B and finally Group A, respectively, being more difficult and requiring longer to implement.

Following the consultation period Poyry will then assess the responses to the consultation and prepare a decision paper recommending policy options and actions for the RAs to pursue. The Poyry review is published with this paper.

4.0 NEXT STEPS

Following the receipt of responses, the RA's will formulate individual decision papers on the issues covered by these parallel consultations in autumn 2009.

The outcome of these consultations will inform the medium and longer term programme for the development of retail competition in NI and ROI. The RAs will implement appropriate measures, guided by the decisions arising from the consultation and the prevailing competitive circumstances within each jurisdiction.

5.0 HOW TO RESPOND

Interested Parties are invited to comment on any of the issues raised in these papers and in particular on the questions raised by close of business on **Friday, 11th of September 2009**. As responses will be published in full on the RA's websites, respondents should include any confidential information in a separate Annex. Submissions on this paper should be forwarded, preferably in electronic format, to:

Barbara Cantley Queens House 14 Queen Street BELFAST BT1 6ER E-mail: barbara.cantley@niaur.gov.uk	Fergus O'Toole Commission for Energy Regulation The Exchange, Belgard Square North Tallaght Dublin 24 E-Mail: fotoole@cer.ie
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6.0 FREEDOM OF INFORMATION

As a public body and non-ministerial Government department, the Utility Regulator is bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1st 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.

This Commission for Energy Regulation exercises its functions in accordance with the requirements of Section 16 of the Freedom of Information Act, 1997.