Energy Retail Competition Work Programme

General Overview and Rationale

NIAUR Consultation

NIE Energy Supply's Response

1 July 2009

Summary and Introduction

NIAUR has sought responses to its April 2009 publication of the "General Overview and Rationale" of its "Energy Retail Competition Work Programme".

NIE Supply generally supports NIAUR's strategy but has the following general comments.

The meaning of and justification for the RAs' overall retail maximum market share target is unclear. There are different retail markets but the nature of the segregation may change over time.

We favour a "backstop" price control partly on the grounds slightly higher prices now should result in competitive benefits in the future but mainly because the existence of competition changes the likely costs of the errors that are inevitably involved in setting a price control and so it makes sense to aim for an easing in the very prescriptive form of price control.

We support NIAUR's view that low liquidity is not necessarily a consequence of high levels of vertical integration.

We also support investigation of the possibility of shifting risk from customers to suppliers, and how suppliers are compensated for bearing such additional risk.

These comments are expanded in the following brief sections in our response:

- **Retail Competition**
- NIAUR's **Policy Statements**; and
- NIAUR's **Work Programme**.

Q1. Equality of opportunity and good relations

NIE Energy Supply (NIEES) agrees that there are no particular implications in this general overview.

Retail Competition

Q2. General comments on the overall approach to analysing the costs and benefits relating to supply competition

NIAUR's overview reviews evidence on the working of energy retail competition in a number of jurisdictions and concludes that no simple conclusion can be drawn. The paper suggests that NIAUR should focus on how retail competition should be promoted, rather than whether, because EU law requires the provision of choice and because the scope for retail competition in Northern Ireland cannot be evaluated ex ante without actual experience of it.

As NIAUR's paper points out, it is difficult to assess the benefits of liberalisation and competition in any market because of the uncertainty as to what would be the counterfactual situation had the competitive liberalisation not taken place.

However, NIAUR's conclusion may be cautious about the benefits.

In particular, as the paper points out at a later point (para 69), retail competition is important in reinforcing the competitiveness of wholesale markets, provided that the structure of the wholesale market can facilitate greater competition.

NIEES believes more work needs to be done on structurally improving the SEM wholesale market, with a particular focus on both liquidity and market dominance.

Policy Statements

Four important policy issues are discussed in the paper and policy statements are made on two of them – maximum market shares and price control "headroom".

Market share

The paper quotes the statement in the 2007 revised NIAUR/CER memorandum of understanding that ***"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."***

We assume that this applies to the supply market in the island as a whole and that an individual market share might be higher in a market segment separated either geographically or by type of customer. However, if the retail market cannot be considered as a single entity, it is not clear how a particular maximum market size limit can be justified.

Q3. 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?

The retail market in Ireland is at present segmented between North and South and between non-domestic and domestic customers.

The segmentation between North and South is mainly traditional and is less marked for non-domestic than domestic customers. The currency risk differs between the two markets and there are differing PSO and data aggregation regimes that also involve different risks. However there is no reason why the degree of segmentation should persist in the longer term.

Segmentation between non-domestic and domestic customers, essentially between high and low volume customers, reflects the different methods of supplying them and different resources used. It is common to most energy markets and likely to persist.

Q4. 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?

There may be some segmentation within the domestic market. Some customers will be more attractive to competing suppliers than others.

Experience in GB suggests that single fuel customers may have less favourable offers than dual fuel ones. To the extent that this is a result of their higher unit costs, including acquisition costs, this is inevitable. It may be that the availability of gas supply is not sufficiently widespread for this segmentation to occur but it should increasingly become a feature.

Rural customers would be less attractive mainly by virtue of being more likely to be single fuel. If doorstep selling were to be widely used it would be less likely to be undertaken in rural areas. Even so, it seems unlikely that there would be segmentation of the rural market per se and so there should be no separate concern about it as distinct from the single fuel market.

The prepayment meter system in Northern Ireland is available to all competing retailers but it is nevertheless the case that the costs of prepayment customers differ from those of, say, direct debit customers. This is both because of the costs of the system itself and because of the costs to the retailer in managing a more complex cash collection relationship. Prepayment customers are to some extent a separate market, but not significantly so, as the keypad prepayment meter is proving a payment mechanism of choice for many customers in Northern Ireland, across all social groups.

Price control “headroom”

Q5. Comments are sought on our proposed approach to continued regulation of tariffs in the coming years

Para 7 of the paper states that it ***“is not the Utility Regulator’s current intention”...to set “regulated tariffs .... deliberately above cost, so as to create headroom for market-entry”***. No reason is given as to why this view has been taken.

It has been the practice in other jurisdictions for price controls to be set at a “safety net” or “backstop” level when retail competition is being introduced and the approach is widely advocated.

This is not only on the grounds that it might be sensible to make a conscious trade-off between customers’ present and future interests in that slightly higher prices now might result in competitive benefits in the future. It also stems from a recognition that the existence of competition changes the costs of the errors that are inevitably involved in setting a price control.

Any price control determination involves a number of subjective judgements that result in a particular outcome being chosen from within a large possible range of outcomes. In a competitive system the costs of an error resulting in too loose a control are mitigated by customers’ ability to move to other suppliers.

On the other hand, an error resulting in too tight a control prevents the emergence of competition. The balance of risks where there is competition is different from that under monopoly regulation, where it is much less skewed, and it therefore makes sense to aim off in a more liberal direction.

We therefore support back-stop controls.

Vertical integration and contract market liquidity

We support NIAUR's view in para 67 that *"**we do not consider that low liquidity is itself necessarily a consequence of high levels of vertical integration".*** This view was also expressed by Ofgem who, while noting that there are risks of integration, said in its supply probe***, "vertical integration can be the result of economically efficient strategic decisions by firms, to reduce transaction costs and facilitate risk management" and "Reducing the extent of vertical integration... does not guarantee increased liquidity"*** .

Moreover, several studies have argued that generator/retail integration tends to mitigate the impact of market power. This can be for a number of reasons including the avoidance of "double marginalisation", a double mark up that arises when unintegrated firms fail to take into consideration the impact of their decisions on the corresponding firm in the other market.

Since integration also helps risk management it could be regarded as beneficial. Supply, especially to households, involves implicit commitments for more than a single year. A supply business will seek a balanced portfolio that includes longer term contracts. These may well be CfDs but their purpose might be to distribute any or all risks between the parties and, in some cases, their effect might not be very different from PPAs. PPAs may also serve as effective hedges.

Contracts can have the effect of "integrating" the interests of generation and supply businesses. Indeed, that is in part their intention. Taking a further step, to actual vertical integration of suppliers and generators, is an obvious means of addressing the risk. It is often easier for upstream and downstream businesses to hedge their opposite market risks through integration rather than through longer term contracts, which are difficult to design to cover all the possible eventualities. Indeed, vertical integration has been the preferred strategy for generators and suppliers in other markets such as GB, New Zealand and Sweden.

Allocation of risk between customers and suppliers

In principle customers should have available a range of tariffs that gives them a choice of taking different amounts of risk. As NIAUR says, para 55, the fundamental point is that they should be correctly priced.

Unfortunately, this is far from easy. Moreover, it is not easy to devise an average overall price control that covers differing charges for differing risks to different customers.

This general topic, which includes factors such as the treatment of the correction factor, is bound to form a significant part of NIAUR's future work programme. NIEES will be keen to assist the programme wherever it can.

Work Programme

The work programme will presumably involve further consultation and so we do not comment on its components here other than by making a general summary indication of our views.

Incumbent regulation
We favour backstop price controls. We also support investigation of the possibility of shifting risk from customers to suppliers, and how such additional risk is reflected in higher margin headroom.

Data transparency
Data availability questions, which of necessity relate to individuals, need to be treated with caution. Aggregate information can be published by NIAUR having been collected from all suppliers under reporting requirements in their licences. Data on individual customers should not be passed between suppliers other than as part of the switching process.

Tariff approvals
As we have pointed out in previous responses, individual tariffs in Northern Ireland do not require regulatory approval, as there is a mechanistic approach to tariff setting, unpinned by cost reflectivity and non-discrimination licence conditions.

Wholesale market liquidity
There is insufficient peak cover in the annual market and the longer term market needs to be developed further.

Standards of performance
Due to the “common services” structure supporting the retail market, with respect to meter operation and meter reading, many of the Standards of Performance will relate to the Northern Ireland Electricity plc. NIEES believes that common service performance standards would benefit from a transactional charging arrangement, other than the bundled UoS charging regime.

Customer switching
We support the plan proposed in advancing the Enduring Solution project.

Branding
NIEES looks forward to constructively engaging in NIAUR’s consultation exercises regarding the optimum way forward on branding of incumbent energy businesses.

Marketing

A marketing code of conduct framework was developed in April 2006 under the auspices of the Supplier Interface Group (SIG). This would need to clearly form part of any such review.