



**Airtricity Response to
Review of K factors & Supply Margins and Tariff
Structure Review (CER/09/093)**

11th September 2009



Introduction

Airtricity welcomes the opportunity to comment on the Regulatory Authorities' (RAs) consultation paper; "Review of K factors & Supply Margins and Tariff Structure Review" (CER/09/093).

We welcome the recent commitment by the CER that they will be shortly consulting on a 'roadmap' for deregulation, and look forward to taking part in this process. This is essential in order to provide both suppliers and customers with a clear signal as to when changes to how the market is regulated will occur.

It is our belief that the aim of regulation is to correct for instances of market failure. Once competition is deemed to be well established in a market we envisage that the role of a regulator will move from that of revenue and tariff setting to one of conduct regulation and compliance monitoring within the market. It is essential that industry have a clear understanding of how this transition will be managed.

We feel that given the scope of this upcoming consultation on the deregulation of the retail market it is hard to provide constructive comment analysis on the current consultations without having a clear indication of what the CER envisage will be covered in this 'roadmap' consultation. It would seem that this upcoming consultation will have profound impact on both topics covered in the current consultations. While we believe that the decisions on these current consultations will provide a key contribution to the 'roadmap' consultation we hope that it will not be impeded by decisions made in them.

We believe that rather than looking at these issues individually the regulators should use this 'roadmap' for deregulation as an opportunity to establish what the competitive market, which is starting to develop, will look like and what necessary regulatory structures need to be put in place to support it.

We would therefore ask that the RA's use the responses/outputs from the current consultations to inform on the development of this 'roadmap'. We would also ask that the RA's give a clear analysis of how any decisions made will achieve the goal of a fully competitive retail market.

In addition to seeking protection of the interests of final customers when developing this roadmap, the RA's must also have regard inter alia, to the need both to promote competition and to secure that licence holders are able to finance their licensed activities and it must do so in a way that does not unfairly discriminate between holders of licences.

Our response on the current consultations follows.

K – Factors

In a competitive retail market K- factors cannot exist.

We have always argued that there are a number of ways in which the use of K-Factors in the current regulatory regime has created a barrier to entry for suppliers wishing to enter the retail market, namely:

- The use of K- Factors distorts incumbent supply tariffs in a given year so that they will not accurately reflect the underlying costs of supply in that year. The fact that prices being charged by the incumbent are not reflective of the costs that an independent supplier would face undermines the ability of a competing supplier to make an economically viable offer to customers.
- The lack of detailed information in the market as to level of hedging employed by the incumbents, means that it is impossible for independent suppliers to predict if there will be a negative, positive or even neutral k – factor being applied in the following year.
- The political pressure, which is understandable especially in the current economic environment, to keep tariffs down means that there is no certainty to the application of the k – factor. This arbitrary application of k – factors places a substantial risk on competing suppliers who are pricing at a discount off the incumbents tariffs.
- K – Factors provide the incumbents with a hedge against their energy purchasing costs. If in a given year the PES gets their purchasing strategy wrong they are still guaranteed recovery of their costs. This hedge is not available to independent suppliers.
- The guaranteed recovery of costs, means that the PES are able to operate with an artificially low margin, thus suppressing to opportunity for suppliers who do not have this ‘free’ hedge to compete in the market.
- As suppliers will have differing customer portfolios the impact of k – factors will vary among licensed suppliers, unless they can match the PES portfolio.
- As recent decisions have shown as competition develops K – factors become uncontrollable. The current revenue cap regulation does not work when customer numbers deviate significantly from forecast i.e. when there are large numbers of customers switching supplier. It also makes it extremely hard if not impossible to ensure that the customers responsible for any over/under recovery are the ones to see the resulting benefit/penalty.

In our opinion the only way to remove these barriers to entry is to discontinue the use of k – factors in the tariff setting process. This has been seen to work in other jurisdictions where competition has been established for longer, for example in GB

Price cap regulation was used successfully to overcome the problems caused by the use of k-factors.

We would suggest that the regulators should **abolish the use of k – factors and in doing so should ensure that a more commercially realistic margin for the incumbent is applied.** This would not, as is often argued, prevent customers obtaining lower prices by switching supplier – increased competitive pressures would ensure that suppliers are incentivised to offer tariffs at compelling levels to customers.

Events over the past year, and in particular the CER's recent decision to disallow k – factors for the 2009/10 tariff year support this. It would seem that by default the CER have accepted that K – factors are uncontrollable and are not appropriate for a competitive market.

While we feel the consultation document identifies most of the issues associated with K – Factors we feel that there are certain areas that require more detailed consideration, we address these below

Hedging Contracts

We feel that in the current consultation not enough attention is given to one of the main underlying cause of K – Factors, **volatility in energy purchase costs.**

Limited opportunities for hedging in the Single Electricity Market mean that energy costs are largely inappropriately fixed at one point in the year, at the fuel prices prevailing at that time.

Suppliers aim to stabilise the cost of wholesale energy through hedging, but available contracts last only up to 12 months and must be bought over a short period four to five months prior to the start of the tariff year. Contracts on offer are insufficient to enable all suppliers to be fully hedged. This drives up the cost of hedging, but still leaves significant exposure to Pool price. To avoid cliff-edge tariff price changes and unexpected mid-year changes, as has happened over the past year, the RA's need to address the quantity and duration of hedging contracts.

As the contracting period lasts only a short while, it does not offer much opportunity to take advantage of dips in fuel prices to build a robust hedging contract portfolio. For example the 2008/9 tariff hedging period during 2008 coincided with rapidly increasing world fuel prices which resulted in suppliers having to lock in at prices that in retrospect were well out of the money. The limitations of SEM hedging contrast with BGÉ's acknowledged good practice use of a rolling hedge structure for its gas business.

Currently there is no functioning secondary market to enable Participants to refine their hedge position. Lack of such a market increases risk and therefore cost to suppliers, which must inevitably feed through to customer prices.

As was seen over the last year, the lack of opportunity for suppliers and in particular the PESs to build a robust hedging contract portfolio can result in the requirement for dramatic and numerous changes to customer tariffs throughout the year. The reason behind these tariff changes was to ensure that the PESs covered their costs in relation to their exposure to wholesale energy prices. In any normal year this exposure to volatile wholesale prices would have been recovered through the following year's k – factor, however given the scale of the both the volatility and apparent scale of PES exposure to the market, it was deemed that there must be a midyear tariff change to try and mitigate the k – factor that was accruing.

More liquidity, variety of duration, and also volume available in the hedging market, would provide suppliers with more opportunities to accumulate and trade directed contracts during a year, thus ensuring that suppliers are able to buy hedging contracts at timely intervals and market reflective prices throughout the entire year. This would reduce the overall end of year k -factors.

Therefore we ask the RA's to address these market failures by;

- **Continuing to support the development of secondary market arrangements that align with the GB market and support inter-market trading**
- **Working with industry to improve liquidity and volume availability in the wholesale contract market.**
- **Developing standard contracts of varying durations, which would be available throughout the year.**
- **Putting in place arrangements to enable PSO generators to trade directly, without losing their PSO support.**

Transparency

We have always stated that the level of information provided on both the hedging position and level of over/under recovery of the PESs' is inadequate.

It is vitally important in a developing competitive market that simple, cost-reflective, tariffs with reasonable cost allocation principles are demonstrated. This is true whether the use of k – factors continues or not.

We believe that there must be clear transparency and rationale with regard to how tariff charges are constructed and the allocation of costs to particular tariff groups, and indeed how these costs are then allocated within each specific tariff group. Given that the wholesale energy costs currently account for ~70% of the final price

paid by consumers, it would seem wholly appropriate that level of information published should enable analysis as to whether these costs are accurately reflected in the tariffs proposed by the both PESs.

We can see no reason for this information to not be made available, and as such would ask that RAs instruct both the PESs to publish clear information on their hedging position. While we note the greater level of detail that was provided on this in the current tariff setting process, we still feel that the level of information provided is inadequate. The information published should contain detailed data with respect to the Directed Contract and Non-Directed Contract purchases made by each PES for the relevant tariff period, including the transaction prices, quantities, delivery profile and delivery periods covered.

Recovery of K - Factors

As stated above we are not supportive of the retention of k – factors however, if it is the RAs decision to retain them we believe that all over recoveries should be passed through to customers in general rather than to only specific customer segments. This is the only way to ensure that customers who contributed to the over recovery see the benefit of the following reduction in tariffs, and to do otherwise would disincentivise customers from switching suppliers. In its recent decisions to pass back over recoveries in this manner the CER have deemed that this method is likely to have the least detrimental impact on competition in the developing market.

Consultation Proposals

The recent decision by the CER, to disallow k – factors in the current tariff year seems to pre-empt the results of this consultation and supports our position that use of k – factors in a competitive market is not appropriate. Notwithstanding this we have the following comments in relation to the proposals set out in the current consultation paper.

1. Proposal 1: Minimal Change

As stated above we are of the opinion that K – Factors should be abolished and as such do not support this proposal.

2. Proposal 2: Asymmetrical K – Factors

As we believe that K – Factors should be abolished we are strongly opposed to this proposal.

While this proposal may go some way in incentivising the PESs to reduce any over or under recoveries, it would further exacerbate the

situation whereby the PES tariffs are not reflective of the costs of supply in a given year.

As stated above in a fully competitive market K – Factors could not exist. We think rather than dissipate the barriers to completion that are currently attributable to k – factors this proposal would actually further enhance these barriers, and we would again reiterate that we are strongly opposed to it.

3. Proposal 3: No K – Factor with Maximum Revenue Restraint determined Ex – Post

This proposal would seem to equate to a situation whereby tariffs would be set on the basis Pool price pass-through. We do not believe that this is answer. This would result in the price risk being passed to the customer; we believe that this risk should remain with suppliers who are best placed to mitigate price volatility.

This proposal also talks about a tariff reduction that would be applied ex – post, we cannot see how this is any different to the current application of a k – factor.

We also believe the level of freedom afforded to the PES in the tariff setting process is inappropriate given the developing nature of competition in the market. We are of the opinion that the premature removal of appropriate pricing controls would damage this developing competition and ultimately constrict consumer choice. In the long term it is this competition that we believe will deliver the best value to consumers.

Conclusion

Airtricity believes that the current use of k –factors should be discontinued. As we have previously stated in a fully competitive market they would not exist. In a fully competitive market the PESs would face the same risks as independent suppliers, and would not be guaranteed full recovery of their costs. They would have to decide whether to absorb/pass back any under/over recovery to customers. With sufficient competition in the market suppliers will be incentivised to pass back the benefit of over recoveries and absorb the loss of under recoveries in order to win/keep customers from other suppliers.

Events over the past year, and in particular the CER's recent decision to disallow k – factors for the 2009/10 tariff year support this. It would seem that the CER have accepted that K – factors are not appropriate for a competitive market.

The falling market demand as well as customer losses due to increased competition this year resulted in a reduction in PES sales and revenue, which was reportedly the main cause of the under recovery by the current tariffs.

As the CER highlighted if the PES was allowed to recover these costs through a k – factor, it would mean that they were effectively insulated from changes in the market place and would have guaranteed recovery of costs regardless of changes in total demand and regardless of losing customers to other suppliers.

As was accepted by the CER this is not appropriate in a competitive market.

We would ask that the RAs use the upcoming consultation on the 'roadmap' for deregulation as an opportunity to establish what the competitive market, which is starting to develop, will look like and what necessary regulatory structures need to be put in place to support it. In the ROI market the current 5 – year revenue decisions are coming to an end and we believe that this is the appropriate time to ensure that the structures put in place for the following 5 – year period support the developing competitive market.

Tariff - Structures

We have always argued that to enable the development of a competitively efficient retail market, it is important that simple, cost – reflective, PES tariff structures and charges are in place and that the principles of appropriate cost allocation are clearly demonstrated.

As an Independent Supplier in the retail electricity market in both ROI and NI Airtricity pays for network usage at regulated rates and aim to cover our retail supply costs. In order to build and maintain a customer base, a discount based on efficiency gains is passed on to customers, thereby incentivising customers to switch supplier. To this end a clear rationale and transparency with regard to the level and allocation of cost components, of PES tariffs is essential in allowing meaningful analysis of how the tariff charges are constructed and the allocation of costs to particular customer groups. Independent Suppliers can then ascertain if they are capable of offering efficiency savings to customers in the form of discounts to the current electricity charges.

Airtricity strongly believes that in a developing competitive market **there is a requirement for a reasonable level of regulatory stability and certainty in terms of determining cost reflective PES tariffs with appropriately allocated costs.** We also believe that tariffs set on these principles provide correct economic signals for the development of a competitively efficient market.

With this in mind we have the following comments on the current consultation.

Regulatory Risk

Non economically-based interference in market pricing increases the level of regulatory uncertainty and sends uncertain signals to institutions and companies seeking to make long – term investment decisions. When pricing is politically driven, there can never be complete certainty that promised margin recovery will actually materialise.

The current level of detail provided does not give respondents the confidence that the proposed tariffs, particularly in the SME sector, are fully cost reflective.

While we understand that, particularly at this time, tariff increases are unpalatable; it is important for the development of competition that **regulated tariffs are consistent and cost reflective.**

We are strongly of the opinion that non economically-based interference in market pricing is extremely damaging to independent supply businesses and will undermine the competition in supply that is now starting to develop.

The level of uncertainty introduced to the market last year due to the numerous unplanned tariff adjustments is unacceptable. Airtricity is **strongly opposed to tariff reviews which are outside the current tariff setting process**. We believe that this enhances market inertia, by causing confusion to customers who are considering a change of supplier. It has been shown that customers are reluctant to change supplier, when they believe that the incumbent supplier will be changing tariffs in the near future, as they are unsure as to whether they will miss out on reductions.

The best incentive that a supplier entering the market can offer to a customer to switch will be a direct discount on the incumbent's tariff. If there is uncertainty as to the level of the incumbent tariffs over the year ahead, it becomes impossible for suppliers to make reliable forecasts to their costs when offering discounts to customers.

Cost Reflectivity & Cost Allocation

The level of detailed information currently provided on PES tariffs is inadequate. From the information currently given it is impossible to ascertain if they are fully cost reflective. There needs to be greater transparency in the allocation of costs both within and between customer categories.

It is vitally important in a developing competitive market that simple, cost-reflective, tariff structures for the regulated entity are delivered and that reasonable cost allocation principles are demonstrated.

We believe that there must be clear transparency and rationale with regard to how tariff charges are constructed and the allocation of costs to particular tariff groups, and indeed how these costs are then allocated within each specific tariff group.

Assuming that pass through costs such as network and market operator charges are appropriately included within in each customer segment, there is not sufficient level of information to show commentators that PES Supply costs or margins are correctly applied across all the tariff categories. We therefore ask the **RA's to provide a clear and detailed breakdown of how all of these costs are individually allocated across the different customer/tariff categories**.

Global Aggregation

In the retail market, the issue of cross-subsidy can only be solved if all suppliers have to compete on the basis of the same market structures; allowing suppliers to compete on an equal footing. This means that the PESs should be included in the Settlement process in the same way as other Suppliers; **the move to global aggregation is therefore essential**.

Consultation Proposals

Group A - All Island Market Structure Proposals:

1. *Improve CfD liquidity to provide a more liquid hedging contracts market;*

Suppliers aim to stabilise the cost of wholesale energy through hedging, but available contracts last only up to 12 months and must be bought over a short period four to five months prior to the start of the tariff year. Contracts on offer are insufficient to enable all suppliers to be fully hedged. This drives up the cost of hedging, but still leaves significant exposure to Pool price. To avoid cliff-edge tariff price changes and unexpected mid-year changes, as has happened over the past year, the RA's need to address the quantity and duration of hedging contracts.

More liquidity, variety of duration, and also volume available in the hedging market, would provide suppliers with more opportunities to accumulate directed contracts during a year, thus ensuring that suppliers are accruing hedging contracts at timely intervals and market reflective prices throughout the entire year.

We are therefore supportive of the proposal.

2. *Introduce system of global aggregation to create a more transparent settlement arrangement for suppliers with regard to distribution loss factors;*

Our comments on this issue of Global Aggregation are detailed above.

We are supportive of this proposal

3. *Align metering codes of practice through creating a common metering Code of Practice;*

In our opinion harmonisation between jurisdictions while not essential is desirable and beneficial in the development of competition in both markets. This type of harmonisation will reduce the cost of entry for suppliers wishing to enter the retail markets in both jurisdictions.

We are supportive of this proposal

Group B – All Island Regulatory Proposals:

1. *Create common programme of Profile Load Research;*

Again we would welcome the harmonisation between jurisdictions that this would proposal would develop.

We do not believe it would be appropriate to just roll out the current ROI profiles on an all island basis. While we accept that this would be the quickest way to implement such a change we are of the opinion that the benefits from carrying out a full study of all customers' consumption behaviour would outweigh the resulting delay in implementation.

In developing this common approach we believe that it would be essential that the whole industry was involved in developing these proposals, independent suppliers would be able to provide useful information on their customer's consumption patterns etc. It would be vitally important that suppliers were directly involved in approving the methodology applied to calculating the profiles and in agreeing sample sizes, categories of profiles etc.

Subject to the above comments we are supportive of this proposal

2. Create additional SME profiles to more effectively cater for the varying demand profiles of SME customers;

We see that there would be benefits to having additional SME profiles, in that it would enable suppliers to design tariffs that more accurately reflect the cost of supplying the different types of customers within this segment.

However we are unsure as to where you draw the line in sub-dividing the categories, for example should there be a tariff category for schools/colleges in general or should they be more specific, i.e schools that run during the summer, have night classes etc.

It would be essential that before implementing this proposal the RA's would consult with industry on the number and type of additional SME profiles that would be developed. Again it would be vitally important that suppliers were directly involved in approving the methodology applied to calculating the profiles and in agreeing sample sizes, categories of profiles etc.

If there were too many categories, the complexity in having a tariff offering for every category might mean that suppliers would be unwilling to offer tariffs to all categories, and would focus only on the ones with large customer numbers.

Subject to the above comments we are supportive of this proposal

3. *Adopt a single model for network charging methodologies which would employ geographic cost signals;*

As above we welcome the proposed harmonisation between jurisdictions.

It would be a welcome development to see a common approach on the island to networking charging. This would help ensure that all customers on the island regardless of jurisdiction were treated in the same transparent manner.

It would also be essential that these network charging methodologies clearly showed how the networks costs were allocated to each individual tariff category.

However we do not feel it is appropriate to introduce locational signals into distribution charges. The majority of customers that connect to the distribution system do not have a choice as to where they connect, and as such the introduction of locational signals at this level would seem to unfairly penalise/reward customers based on criteria that they have no control over. This would be particularly pronounced at the domestic level, customers at this level are highly unlikely to decide where to locate based on the underlying electricity networks charges.

We are supportive of the proposal to harmonise the methodology for network charging subject to the above comments, but would not be supportive of the proposal to introduce locational signals into distribution charges.

Group C –PES Regulatory Proposals:

1. *Separation of network and wholesale energy costs;*

As we have previously stated we believe that in a developing competitive market there is a requirement for cost reflective incumbent tariffs with appropriately allocated costs. The current methodology whereby network charges are not clearly separated out from energy costs makes it impossible for commentators or customers to assess whether the PES tariffs are fully costs reflective and have costs appropriately allocated.

Also for a supplier entering the retail market the most widely accepted way in which to entice a customer to switch is to offer a discount to the rate charged by the incumbent. This means that if a supplier offers a discount on the unit rate they have to offer a discount on all cost components of that rate. This

would include pass through costs, such as networks costs, if as we understand they are currently included in the unit rate.

Therefore a supplier has to offer a discount on costs over which they have no control, and are limited therefore in the discount that they can offer to customers in this area, while ensuring that they break even.

This proposal would also allow customers to clearly see the benefit that they are being offered by moving to an independent supplier.

Finally we would also highlight that this type of breakout is essential if the proposed smart metering project is to be a success, it is key for successful delivery of the type of behavioural changes that this project is trying to encourage, that customers can clearly see the effects of their changes in consumption; both reductions and demand shifting. If the rates that customers are looking at lack clarity and contain fixed costs, it will hinder their ability to see the effect of these changes.

We are strongly supportive of this proposal

2. Use a common Cost to Supply (CTS) model to determine supply cost allocation;

As with the proposal to have a common approach to network charging we welcome the proposed harmonisation between jurisdictions.

This proposal would help ensure that all customers on the island regardless of jurisdiction were treated in the same transparent manner.

While we welcome the proposal to use a common cost of supply model, it would have to be done in a fair and transparent manner. There would need to be clear transparency to as manner in which both supply costs and margin are allocated within the different customer categories and tariffs.

Subject to the above comments we are supportive of this proposal

3. Enable contract term and indexation to allow for contractual terms between supplier and customer to reflect movements in wholesale prices;

We believe the level of freedom that this would afford the PESs is inappropriate given the developing nature of competition in the market. We are of the opinion that this proposal would damage the developing

competition and ultimately constrict consumer choice. In the long term it is this competition that we believe will deliver the best value to consumers.

We are strongly opposed to this proposal.

4. *Employ Time of use tariffs through using a price signal to customer to encourage efficiency.*

We believe that this proposal should be delayed until the completion of the current smart metering trial.

5. *Common NI & ROI Tariff Methodology Statements to encourage transparency;*

As with the proposal to have a common approach to network charging, and supply costs allocation we welcome the proposed harmonisation between jurisdictions.

This proposal would help ensure that all customers on the island regardless of jurisdiction were treated in the same transparent manner.

In the recent consultation on PES tariffs to apply from 1st October (CER/09/151) the CER decided not to approve the ESB tariff methodology statement as it did not clearly set out the PES methodology or how costs are allocated to the various tariff groups, specifically supply costs.

We welcome this decision and look forward to seeing the updated tariff methodology statement in the near future.

Therefore while we welcome the proposal to use harmonised tariff methodology statements, it would have to be done in a fair and transparent manner. There would need to be clear transparency to as manner in which all the PES cost and in particular supply costs and margin are allocated within the different customer categories and tariffs.

Subject to the above comments we are supportive of this proposal

6. *Reduce the need for k-factors in the PES tariff energy component*

Our comments on K – factors are detailed above.

Conclusion

In summary Airtricity believes that there must be clear rationale and transparency with regard to the individual cost components of the published ESB tariffs, both on an overall and individual tariff basis.

The current level of information provided does not enable respondents accurately ascertain if the proposed tariffs are individually costs reflective, and as stated above Airtricity believes that **cost-reflective pricing must prevail in the retail electricity market**, to avoid damaging the competition in supply that is now starting to develop.

We welcome the proposals contained in this consultation and look forward to working with the RA's on their implementation.

To discuss this document please contact:

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