UR's Consultation

Approach to the 2014 Power NI Supply Price Control

Power NI's Response

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1 Introduction

Power NI welcomes the opportunity to respond to the Utility Regulator's (UR) recent consultation paper entitled 'Approach to the 2014 Power NI Supply Price Control'.

The publication of such a paper at the early stage of the review is a useful procedural development which should assist in framing the substantive review process. Power NI believes that a price control determination should be the product of an iterative process with genuine engagement on the substantive issues. The review cannot be a simple roll forward of previous outcomes.

Power NI has and will continue to engage positively with the UR, providing as much supporting information as reasonably possible. CEPA, economic consultants appointed by Power NI, are preparing a number of discussion papers focusing on important areas pertaining to the review.

We would view these papers as being important inputs to the review process, and the basis for genuine engagement on the substantive issues.

Two CEPA papers have been submitted with this response (see appendices A and B) ie :-

- Regulatory precedence on removal of price controls
- A framework for setting retail operating costs in a liberalised market

An additional discussion paper covering financeability and margins will reflect on the BEQ and supporting analysis prior to being finalised, and thus should be available for submission during week beginning 25 March 2013.

2 Executive Summary

Power NI believes that the basis for a sound price control review requires a clear regulatory roadmap for the retail electricity market after April 2014 - one which will be capable of adapting to future developments and will protect the interests of consumers in the medium to long-term by promoting efficient competition. The UR's current general approach regarding retail energy market development, originally set out in July 2011, is now out of date and has not kept pace with market developments in particular the inexorable progress of competition in the market. Without setting out a roadmap, the UR risks failing to reach an appropriate price control decision in 2014. The Consultation Paper displays little or no forward-looking vision.

The regulator, in carrying out its statutory duties, is required to promote competition unless it considers that is inconsistent with these duties.

While the statutory duties do afford the UR with some discretion it is also bound by EU law, and in particular Internal Energy Market legislation. Here the primacy of competition as the methodology to protect consumers is reflected in the European Commission's insistence on timetables for phasing-out regulated energy prices.

Given the relative market shares and associated market metrics, Power NI believes that the whole non domestic market should be excluded from the scope of this price control.

The UR has a duty to ensure that through its price control determination Power NI is able to finance its regulated activities. The UR suggests that this is best achieved through a robust, evidence based calculation of opex and margin. Power NI welcomes the UR's commitment to such an approach.

In relation to the analysis of opex and margin; any robust assessment of opex must be determined in such a manner as to recognise Power NI's relative efficiency and enable the benefits of investment in efficiencies to be appropriately retained and incentivised. The assessment should not cherry pick elements at a line item level, arbitrarily exclude legitimate operating costs or, by setting Power NI's allowed costs at an inappropriately low level, create a barrier to entry and thereby impede the further development of efficient competition.

The margin assessment should determine a level appropriate to a business operating in an increasingly competitive market that remunerates the real risks Power NI faces as a business and replicates the outturns which would be expected by a notional business in an unregulated, efficiently competitive market. The assessment should also recognise the asset light, non vertically integrated nature of Power NI.

3 General Comments

Context

Power NI believes that the UR needs to develop and articulate to stakeholders a clear regulatory roadmap for the development of the retail electricity market after April 2014 which will protect the interests of consumers in the medium to long-term. Without doing so, the UR risks failing to reach an appropriate price control decision in 2014. The Consultation Paper displays little or no forward-looking vision.

Instead, the Consultation Paper focuses on past price controls and historical precedent as a guide for how the retail market should be regulated in future. In a period of considerable change in the market, this approach is unlikely ultimately to protect the interests of consumers. For example, the Consultation Paper includes only a limited discussion of the impact that continued price controls may have on the retail market or of the role of incentive-based price regulation in replicating competitive outcomes.

The UR accepted in 2011 that effective competition can help to achieve better outcomes than regulation for Northern Ireland’s consumers through greater innovation, quality of service and long-term price benefits. [1] At the heart of the 2014 Price Control review should be some consideration of whether future regulation (and, specifically, price controls) will promote or stifle effective competition, to ensure these benefits are delivered to consumers. A clear roadmap for the development of the retail market must include the role of future regulation in promoting competition.

The Consultation Paper focuses narrowly on an approach to setting a “cost-based” tariff for a retail business effectively treated as a monopoly rather than a service provider competing against a variety of other stakeholders. References to monopoly regulation are not relevant to the Power NI scenario and are not helpful in positioning this control for wider stakeholders. The overall impression created is that the Consultation Paper assumes that only continued regulation will protect the interests of consumers, even if this is at the expense of promoting competition in the market. Power NI consider a failure to promote competition will ultimately be detrimental to consumers.

The Consultation Paper states that the UR intends to undertake a wholesale review of the retail electricity market starting in early 2014. It also recognises that the existing scope of Power NI's price control must be considered as part of the review leading towards a new price control starting in April 2014. If Power NI's 2014 Price Control is to be proportionate and targeted to the on-going changes in the retail market, then it is imperative that the thorough market assessment the UR proposes is undertaken as part of the 2014 Price Control review process. By delaying any thorough assessment, the UR will compound existing market uncertainty to the detriment of consumers and other stakeholders during a future period that will undoubtedly require further change, investment and development in the market.

Unnecessary extension of price controls, when demonstrably the market influence has shifted from the incumbent to the competitor community, introduces suboptimal competitive market conditions and thus compromises the regulator's ability to comply with its statutory duty to protect consumers were appropriate by the promotion of stable and sustainable competition.

The non-domestic retail electricity market in Northern Ireland already has more active competition than at the time those markets were deregulated in the Republic of Ireland and Great Britain. As Power NI supplies only 16.7% of the non domestic market the full non-domestic market sector should be removed from the coverage of this control.

Furthermore, the domestic retail market has changed significantly in the past year. The UR needs to consider both the actual market changes that have already occurred and the potential future changes if it is to decide an appropriate 2014 Price Control. This will require an assessment of the state of competition in each market segment, involving a clear definition of each market segment and a dynamic analysis of the numerous factors that, when combined, contribute to reaching a view on whether effective competition exists or how it should be promoted to protect consumer's interests. While this should include a review of structural characteristics, such as market concentration and entry and exit, an assessment of market conduct, perception and performance is also necessary before establishing the appropriate approach to future regulation.

Power NI supports the principle of effective competition and advocates a strong competitive model characterised by a number of players, low market power (in the supply chain), low barriers to entry and exit, well informed sellers and buyers, independent decision making

[1] See UR's 2011 Paper: 'Regulatory approach to Energy Supply Competition in Northern
(footnote continued)

and product differentiation. Regulatory frameworks assist in the development of such characteristics while providing certainty and confidence to the market. Prolonging the price control mechanism fails to deliver benefits either in the form of price or products for consumers. Nor does it assist in the development of effective competition.

Principles

The UR makes reference to the five principles for economic regulation[2]. Power NI considers the approach outlined in the consultation to be inconsistent with these principles –

- Focus
  - *"The role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services by ensuring the operation of well-functioning and contestable markets where appropriate or by designing a system of incentives and penalties that replicate as far as possible the outcomes of competitive markets.*
  - *economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focussed on outcomes rather than specified inputs or tools*
  - *economic regulators should have adequate discretion to choose the tools that best achieve these outcomes."*

In maintaining a price control in sectors which are demonstrably competitive and artificially suppressing outcomes in developing sectors; the UR fails to either ensure a well-functioning market or replicate the outcomes of competitive markets.

- Predictability
  - *"the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence"*

The lack of a retail market development roadmap prevents Power NI developing long term business plans with their associated investment considerations.

- Coherence

Ireland'

[2] As stated in the Department for Business Innovation and Skills paper, Principles for Economic Regulation published in April 2011

- *“regulatory frameworks should form a logical part of the Government’s broader policy context, consistent with established priorities “*

The UR’s lack of a clear retail strategy and assumption that only continued regulation will protect the interests of consumers is inconsistent with the approach of government at both a central and European level.

- Adaptability
  - *“the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time”*

The reliance on historic outcomes and a “steady state” outlook, lacking strategic foresight, will prevent the inclusion of triggers or reopeners and therefore inhibit the ability for the UR to respond to changing circumstances.

- Efficiency
  - *“policy interventions must be proportionate and cost-effective while decision making should be timely, and robust”*

As stated above, the lack of a roadmap vision will limit the ability to adequately deal with a changing market. This in turn will result in numerous short term price controls[3], and potentially inefficient ad-hoc decision making. This does not represent proportionate intervention nor is it cost reflective.

Opex

As communicated throughout the previous price control process; a ‘line by line’ approach while representing a reasonably transparent approach is subject to significant error. Such an approach does not take a holistic view but rather subjectively disallows certain opex lines, using the lower of Power NI’s submitted figure or the UR’s view of an external benchmark.

This approach gives no consideration to comparative overall efficiency levels or inherent allocation differences and should be replaced with a top down competitive new entrant approach. This reflects the broader business costs that Power NI should be allowed (including marketing), and is reflective of the costs that a new entrant would need to invest in a sustainable business model. Other models including those used by IPART in Australia to price regulate suppliers in competitive markets which have not reached full price deregulation, are also more relevant to the Northern Ireland electricity market than the ‘line by line’ proposal.

[3] Power NI has had 4 price controls in the last 7 years

CEPA have explored the methodology question in more detail and the paper 'Framework for setting retail operating costs in a liberalised market' accompanies this Power NI submission, see Appendix B.

Any assessment methodology used must recognise that Power NI has and will continue to be faced with an unavoidable cost of competition. This has been seen in other markets and should be acknowledged within Power NI's cost allowances.

The current Et term element that covers unavoidable costs of competition does not appear to be functioning as it should, indeed frustratingly the UR appear to reject valid submissions for such claims[4].

Margin

Power NI welcomes the UR's stated intention in Section 5.3 of the Consultation Paper to look afresh at the margin assessment. Previous assessments were flawed and made no attempt to consider the financing requirements of a supplier competing in the retail market, and how it should be rewarded for the capital at risk. Nor did they adequately recognise the asset light, non vertically integrated nature of Power NI.

A "triangulation" approach to determining margin has merit however there needs to be clear agreement on which evidence is given greatest weight, given the difficulties of finding perfect comparisons with other benchmarks.

In terms of 'Regulatory precedent' the UR has once again quoted significantly outdated and inappropriate comparisons. To characterise Power NI as being in a similar position, in a comparable market or exposed to the same level of risk as those quoted is clearly incorrect. Power NI would urge the UR to look to appropriate comparators when considering regulatory precedent.

Margins earned in other sectors do provide more relevant comparisons. The UR has highlighted the work undertaken by Ofgem in this area. When making the comparisons it is important to recognise that Power NI faces significant underlying risk due to its lack of vertical integration, exposure to volatile wholesale prices and the development of retail competition has added significant additional risk.

[4] Submission made 28th May 2012

A capital base x cost of capital approach does have merit as it focusses the assessment on the UR's obligation not to set a margin per se, but to ensure licensees are able to finance their authorised activities.

CEPA have explored the question of margin in more detail and this paper will be submitted shortly after the BEQ submission.

4 Response to Consultation Questions

Structure and Form

Q3. Do respondents feel the existing structure and form remains appropriate for the next price control? If not, please explain what you believe the structure and form should be.

Power NI considers the current structure and form of the price control as generally appropriate.

In relation to the Et term the UR has stated a intention to review "*as part of this price control as the Enduring Solution project is complete*[5]". It is unclear as to what the UR is referring, is the UR suggesting that Enduring Solution cost (capex and opex related) will be transferred to St? Power NI would welcome clarification on this issue, especially as it pertinent to on-going interactions between Power NI and the UR in relation to costs associated with Phase 3 of the Enduring Solution Project.

Coverage and Non-Domestic Sector Bandings

Q4. In the Non-Domestic sector that is currently subject to price control regulation, do respondents agree that it is reasonable to assess Power NI supplier dominance in the 3 sections the UR has detailed: 0-50 MWh; 50-100 MWh and; 100-150 MWh per annum? If not, please explain your rationale.

For some considerable time, Power NI has presented the argument that if a market is demonstrably competitive, the prolonged application of a price control will compromise the proper operation of that market and is counterproductive. A regulated tariff that acts as a market reference price but is based on an unrepresentative set of cost drivers will distort the market and lead to poor customer outcomes. These outcomes are clearly not in the best interests of customers generally, or those customers who are taking supply from a competing supplier which is distorted upwards in line with the unrepresentative reference.

The removal of the retail price control will allow consumers to engage with suppliers who are able to tailor products, participate in tendering processes, provide quotations and compete

[5] Approach to the 2014 Power NI supply price control, Consultation Paper; page 14

for their business on a level playing field. This is a requirement which has been clearly communicated by consumer associations and customers alike as it provides increased ‘real’ competition whilst having the comfort of consumer protection through normal regulatory arrangements.

Over this considerable time period, Power NI has presented evolutionary suggestions to the UR, reflective of the changing market. These proposals included thresholds of consumption in excess of 50MWh[6], connection of 70kVA[7] and the full non domestic sector[8].

Power NI believes that the UR’s monitoring and decision making in relation to coverage has not kept pace with the Northern Ireland electricity supply market. While Power NI does currently retain a significant market share in the domestic sector (ie 75%), this price control will potentially extend to 2017. By not adequately describing the regulatory view to 2017, the UR fails to provide transparency of expected market developments, does not support the further development of competition, is unable to move away from repeated short term price controls and prevents Power NI undertaking normal business planning activities.

The UR needs to develop and articulate to stakeholders a clear regulatory roadmap for the development of the retail electricity market after April 2014 which will protect the interests of consumers in the medium to long-term. Without doing so, the UR risks failing to reach an appropriate price control decision in 2014.

The key element to address in developing a clear regulatory roadmap is how the plan promotes a competitive supply market in Northern Ireland.

The regulator, in carrying out its statutory duties, is required to promote competition unless it considers that is inconsistent with these duties.

While the statutory duties do afford the UR with some discretion it is also bound by EU law, and in particular Internal Energy Market legislation. Here the primacy of competition as the methodology to protect consumers is reflected in the European Commission’s insistence on timetables for phasing-out regulated energy prices.

The domestic retail market has changed significantly in the past year, driven largely by UR’s approval of >£50m[9] of IT investment to support unconstrained customer switching. The UR needs to consider both the actual market changes that have already occurred and the potential future changes if it is to decide an appropriate 2014 Price Control. This will require

[6] In July 2011
[7] In September 2011
[8] In January 2013
[9] NIE’s Enduring Solutions Programme

an assessment of the state of competition in each market segment, involving a clear definition of each market segment and a dynamic analysis of the numerous factors that, when combined, contribute to reaching a view on whether effective competition exists or how it should be promoted to protect consumer's interests. While this should include a review of structural characteristics, such as market concentration and entry and exit, an assessment of market conduct, perception and performance is also necessary before establishing the appropriate approach to future regulation.

Power NI's economic consultants, CEPA, have provided a short summary of how Ofgem approached this process. The information is summarised in Appendix A. CER also provided a clear strategy to the market in their paper, 'Roadmap for Deregulation of the Electricity retail Market' published in April 2010.

The regulatory review of the domestic market should provide a transparent basis for scope and coverage assessment. Regulatory market monitoring is essential to ensure the effective operation of the market. Market shares, switching rates and the number of competing suppliers are inputs of standard reporting. Power NI considers that in a rapidly evolving market, such as in Northern Ireland; quarterly reporting in insufficient and potentially hampers the UR's responsiveness. Pricing and tariffs will require the UR to be more active in monitoring and accurately reflect differentials between introductory and standard offers as well as aspects such as terms and conditions.

Within the consultation paper the UR makes extensive reference the concepts of dominance and market power. Any framework for the assessment of market power and dominance must include consideration of any or the lack of competitive constraints. The Northern Ireland electricity market already has price competition between suppliers, low barriers to entry, consumer service level protection and a commonly accessible wholesale market. In addition, Power NI unlike many of its competitors does not have supply chain power.

The non-domestic retail electricity market in Northern Ireland already has more active competition than at the time those markets were deregulated in the Republic of Ireland and Great Britain. Contestability is a goal of the ideal market and Power NI is disappointed that it continues to be effectively excluded from areas of the business market due to the current regulatory regime.

To this end, Power NI believes the <u>full non-domestic</u> market sector should be removed from the coverage of this control.

In the recently published UR Quarterly Transparency Report[10], figures show that Power NI supplies only 16.7% of commercial consumption. This means that in sectors in which price controlled regulation still exists, 83.3% of demand is supplied by non-price controlled suppliers. By customer numbers, Power NI supplies 48.5% of commercial customers; of the majority (51.5%) 3 non price controlled suppliers have a market share greater than the generally accepted marker of 10%.

The UR reports against a connection voltage level of 70kVA. The metric of connection voltage limits the ambiguity created by a consumption figure and is why Power NI previously proposed connection voltage as an appropriate threshold.

Power NI is price controlled in the less than 70kVA sector and to a smaller extent in the greater than 70kVA sector. The figures presented show that by consumption, Power NI supplies only 31.5% and 15.3% respectively. Power NI is therefore not the largest supplier in either sector. Indeed Power NI is the 2nd largest supplier in the less than 70kVa sector and 4th largest supplier in the greater than 70kVa sector behind non price controlled suppliers.

The retention of price controls in the non-domestic market is therefore no longer appropriate. Power NI believes any retention of a control would infringe the UR's obligation not to discriminate as between suppliers.

Power NI acknowledges the recent UR decision to remove non-domestic groups from the scope of price controlled regulation. It is however incorrect to characterise the frustration felt by group customers as an "anomaly"; it was in fact a failure in the retail electricity regulatory framework.

The removal of the retail price control for groups will allow consumers to engage with a greater number of suppliers who are able to tailor products, participate in the tendering process, provide quotations and compete for their business on a level playing field. This provides increased 'real' competition whilst having the comfort of consumer protection through normal regulatory arrangements. This outcome should be extended to all non-domestic consumers.

It is fundamentally nonsensical to have a supplier price controlled in a sector (ie SME <70kVA) with a market share of 31%, when the largest supplier in that sector has a market share of 41% and is growing by 2% per quarter. It is therefore likely, given the competitive market trends, that within months the largest supplier's market share will increase beyond the combined share of Power NI and Energia.

[10] Retail Market monitoring, Quarterly Transparency report FEB 2013

The UR has proposed broad bandings of non domestic market assessment. While Power NI believes these bandings may provide greater levels of monitoring detail, as stated above the entire non-domestic sector should be deregulated without further delay.

Duration

Q5. How long do respondents feel the next price control should last?

The question of duration is inextricably linked to the development of the UR's strategic roadmap. The UR has acknowledged that the series of short term controls has been "*due to the changing environment in terms of retail competition*". This creates a significant burden of regulation and removes efficiency incentives. To consider duration in isolation further compounds the cycle which Power NI has been exposed to i.e. 4 controls in 7 years.

Power NI believes that there is a clear need for a process that leads to a progressive removal of price controls and a properly functioning domestic retail market. A feature of this model would be clear trigger points or undemanding re-openers which align the price control process with the roadmap. This would provide clarity for the market, reduce the regulatory burden, facilitate appropriate business planning and restore the basic premise of incentive regulation.

Fixed: Variable Apportionment

Q6. Do respondents feel the 67:33 fixed: variable apportionment of Power NI's own allowed revenue (operating costs plus margin) is an appropriate method for reducing the opex and margin allowance in line with customer losses?

The 67:33 fixed variable apportionments operate effectively in markets with emerging competition. As this price control could extend to 2017 or beyond, it is important to recognise that should further entrenched competition result in significant customer number reductions in the domestic sector this may adversely affect its effectiveness. Indeed a more significant movement in customers is likely to shift the ratio towards a higher fixed element.

A fully targeted control with triggers and reopeners would deal with this issue.

Opex Assessment

Q7. Do respondents believe the approach outlined to assessing opex is appropriate at this price review following the 'line by line' approach at the last review? If not, please explain what approach you believe the UR should take to assessing opex and the reasons why.

As communicated throughout the previous price control process a 'line by line' approach while representing a reasonably transparent approach, is subject to significant error. Such an approach does not take a holistic view but rather subjectively disallows certain opex lines, using the lower of our submitted figure or the UR's view of an external benchmark.

Assessing individual opex categories and taking the lower of Power NI's own costs and an external best practice benchmark is particularly flawed for two reasons:

- There is a likelihood of variation in reported individual cost categories and cost allocation methods when considering the micro level.
- Even if there were no variations the method would imply a need for Power NI average efficiency to exceed best practice in order to achieve the baseline target.

Choosing therefore, from either the efficient Power NI current level or an industry best practice at a micro level, places an unreasonable expectation on Power NI. The methodology employed also does not reflect good practice as it gives no consideration to the comparative overall efficiency levels or inherent allocation differences. Power NI has little confidence in the overall opex approach used in recent controls. Consideration should be given to a top down approach as it would have stronger regulatory precedent, offers more credible results, suffers less from errors, passes empirical tests and allows a wider and more robust view of overall efficiency levels.

The reference to NI Water is illustrative of the dangers of using flawed benchmarks. NI Water is a monopoly network company making the first steps towards a semi-private state. It is widely recognised that NI Water has scope to make significant efficiencies over the next five years. Power NI by contrast is an asset light retail company which has, over the preceding 15 years, made significant efficiency strides and is considered to be at the efficiency frontier. To suggest applying the methodology developed to determine productivity growth assessments for NI Water to Power NI is fundamentally flawed.

The benchmarking analysis of comparable supply companies undertaken by NERA[11] illustrates that the Power NI cost to serve is more than 50% lower than key comparators. Power NI therefore is already an extremely efficient business and believes that the detailed information provided through the data submission process represents a reasonable assessment of forecast cost items. Power NI will provide further supporting narrative with the BEQ submission.

The business as usual approach which dates back to pre competition should be replaced with a top down best new entrant approach. This reflects the broader business costs that Power NI should be allowed (including marketing), and is reflective of the costs that a new entrant would need to invest in a sustainable business model. Other models including those used by IPART in Australia to price regulate suppliers in competitive markets which have not reached full price deregulation, are also more relevant to the Northern Ireland electricity market than the 'line by line' proposal.

CEPA have explored the methodology question in more detail and the paper 'Framework for setting retail operating costs in a liberalised market' is included in Appendix B.

Any assessment methodology used must recognise that Power NI has and will continue to be faced with an unavoidable cost of competition. This has been seen in other markets and should be acknowledged within Power NI's cost allowances.

During the last price control Power NI highlighted the likely prospect of customer service cost escalating, however UR choose to disregard this analysis without providing any justification for their decision. Additional service costs are now a reality of Power NI, for example customer call hours are up by 28% relative to the period just prior to domestic competition entering the market.

Other important factors also impacting customer service costs relate to the downturn in the economy and new market processes, which place increased pressure on credit control processes and contacts.

[11] As submitted during the previous price control assessment

Margin Assessment

Q8. What are respondents' views on the three methods of calculating margin that are discussed in Section 5?

Power NI welcomes the UR's stated intention in Section 5.3 of the Consultation Paper to look afresh at the margin assessment. Previous assessments were flawed and have resulted in Power NI leveraging Viridian Group assets in order to finance its activities.

A "triangulation" approach to determining margin has merit however there needs to be clear agreement on which evidence is given greatest weight given the difficulties of finding perfect comparisons with other benchmarks.

In terms of 'Regulatory precedent' the UR has once again quoted significantly outdated and inappropriate comparisons. In relation to the precedent included in the paper and as previously highlighted by Power NI, it is worth noting that –

- The MMC decision in 1995 to allow Scottish Hydro a 0.5% level was justified as a 7% regulated return on normal working capital, there was no competition and full vertical integration so no risk capital requirements.
- The 1998 Offer decision to allow a 1.5% margin was set in a context of high supplier opex costs and therefore incentivised further efficiencies which in part facilitated an out-turn margin of around 4%. The Offer decisions also assumed that suppliers could fully hedge, thus minimising risk capital requirements, and in many cases could take advantage of vertical integration (thus reducing collateral requirements).
- The CER decision of 1.3% was also set against high opex to incentivise efficiency gains. ESB Customer Supply (ESBCS) is also state owned which therefore largely removes the risk of insolvency. It is also important to note that CER were poised ready to implement a higher regulated margin of in effect up to 4.3%, during the second year of domestic competition but chose to fully deregulate the market at a stage when the incumbent's market share was not a great deal lower than Power NI's current level.

To characterise Power NI as being in a similar position, in a comparable market or exposed to the same level of risk as those quoted above (ignoring the evolution of CER to a higher regulated margin) is clearly incorrect. The reference markets do not have similar levels of competition, are set pre the evolution of permanent collateral requirements and are absent the levels of wholesale volatility currently experienced. The UR should look to appropriate comparators when considering regulatory precedent.

Margins earned in other sectors do provide more relevant comparisons. The UR has highlighted the work undertaken by Ofgem in this area. When making the comparisons it is important to recognise that Power NI faces significant underlying risk due to its lack of vertical integration and exposure to volatile wholesale prices, and in addition the arrival of retail competition has added significant additional risk.

Recent evidence from Ofgem's RMR profitability analysis for example, indicates that electricity supply companies in GB target much higher expected profit margins through the business cycle. Evidence from Australia also places comparable benchmarks closer to the 5% level.

Retail competition increases the risks to which an incumbent is exposed. Monopoly electricity suppliers are able to operate with lower margins because a correction (k) factor will guarantee their ability to correct any under-recovery of costs in future years. Where market entry is possible, on the other hand:

- Any fall in generation costs after the incumbent has contracted to supply its customers may result in both a loss of customers and a price level that does not enable cost recovery from the remaining customers;
- Any significant under-recovery is unlikely to be made good in future years as it would further reduce the competitiveness of the business;
- Any contracting gain, on the other hand, where electricity prices rise after the contracting round must be returned to customers.

In essence competition means that "k" is no longer a safeguard of business value

The price controlled supplier who faces competition is therefore exposed to an asymmetric risk which is potentially of a very large size. This is illustrated by the experience of ESB Customer Supply. When high cost contracts were secured by that business, competition was able to significantly undercut its prices. The resultant customer losses created such an under recovery that it was both reputationally and financially impossible to recover.

Power NI is exposed to significant risks on generation costs. These include:

- Pool price: An efficient hedging portfolio is likely to have around 80% cover and so a modest degree of exposure to pool prices. The shortage of liquidity in the SEM contract market actually means that pool price exposure is substantial, particularly at times of peak demand.

- Volume: The volume of sales may differ from what is expected through factors such as customer migration, economic activity or weather. These will affect both the degree of cover and the average cost.
- Hedging Options: There is significant contract scarcity with the real prospect of volumes being further reduced and price premiums applied to the NDCs in particular. The general operation of the hedging market forces Power NI to contract at specific and limited times. This exposes Power NI to both an inability to gain sufficient hedges and critically point in time strike prices. This inflexible system of locking into hedges can result in significantly higher prices offered to customers should fuel prices reduce.

The lack of contract volume availability disproportionally impacts Power NI. Vertically integrated deregulated businesses use the contract market to balance their overall position, whereas non-vertically integrated organisations have to rely upon the hedging market to manage risk.

Scarcity therefore creates a price premium which is applied to an entire volume potentially facilitating the manipulation of retail prices to artificially high levels. This is passed on to Power NI consumers in a disproportionate manner.

These asymmetric risks expose Power NI to only an expected cost or loss. Retail competition means that under-recoveries are increasingly unlikely to be recouped in later years while the operation of the price control means that over-recoveries must be returned. Notwithstanding some flexibility existing to adjust customer tariffs during the tariff year, substantial and practicably irrecoverable under-recoveries are not a remote possibility.

The SEM contracting round is compressed into a short period, the fuel prices that determine pool prices (and so future contract prices) are volatile and an electricity supplier can easily find itself with a portfolio that is substantially out of the market. Power NI did so two years ago. This only failed to result in severe losses because significant competitor entry into the NI market was not then practicable.

In RoI competitors to ESBCS were able to offer tariffs at a 10-15% discount over a sustained period. This margin contained such a significant headroom that it facilitated an unprecedented estimated €5.5 million p.a. spend on sales and marketing. This very quickly moved the RoI market to such a level that full deregulation has occurred.

It is worth noting that this took place in a two year period. The projected accumulated under-recovery on allowed revenue for ESBCS by September 2010 was circa £150 million and it made a loss of £65 million in 2008 and £37 million in 2009. In addition to the significant financial losses ESBCS experienced a huge reduction in their customer base and therefore in their overall business value.

A K factor therefore at best corrects for under and over recoveries relative to regulated allowances; it does not insulate Power NI from market risk. It is plausible that a retailer, not subject to price controls, would set their tariffs using a mechanism that mirrors the regulatory K factor with appropriate margin for risk mitigation and capital requirements.

Failure to acknowledge and allow for these risks exposes Power NI to potentially incurring the type of financial losses, customer reduction and capital devaluation as seen by ESBCS. Unlike ESBCS however Power NI is a privately owned non-vertically integrated organisation which simply could not survive such a scenario. This is clearly a foreseeable risk with precedent within the same wholesale market and can only be expected to increase as churn rates increase and as competition continues to develop in the Northern Ireland market.

Power NI therefore does not accept the UR's assertion that "k" correction acts to insulate the business from market risk. At best the "k" factor potentially corrects for under and over recoveries relative to Power NI's regulated allowances. It does not protect the business from market risk compared to the market risk that would be borne by an unregulated competitor, and it certainly does not safeguard business value.

A capital base x cost of capital approach does have merit as it focusses the assessment on the UR's obligation not to set a margin per se, but to ensure licensees are able to finance their authorised activities.

During the previous price control interaction, Power NI commissioned NERA Economic Consulting (NERA) to undertake an assessment of the required net margin going forward. The UR did not accept the NERA conclusion and reverted to using historical benchmarks rather than current empirical analysis.

The UR has a duty under Power NI's licence to ensure that where price controls are applied to its licensed activities, that the company is able to finance those price controlled activities.

In this Approach consultation, the UR has suggested that it can best discharge this duty by demonstrating that it has a robust, evidence based methodology for calculating allowed opex and margins including by showing that the return on offer:

- compares favourably with the returns that investors can get by investing in efficient businesses with similar risk profiles; and

- is capable of supporting and sustaining the investor capital that an efficient company would need for fixed assets and working capital plus access to a reasonable buffer to accommodate unanticipated financial shocks.

Power NI has asked CEPA to consider the question of financeability in the context of its 2014 price review and the implications this has for determining an allowed profit margin.

CEPA are currently finalising a paper which covers financeability and margin considerations. Power NI intends to submit this discussion paper to UR during the week beginning 25 March 2013.

Q9. As detailed in Section 5, do respondents' believe the UR should look across the range of methods or choose one method over the others when assessing margin? Please explain your reasons why.

As stated above, Power NI believes that there is merit in adopting a range of approaches. In addition to contemporary benchmarks and financeability assessments based on capital requirements[12] the UR could look at more fundamental assessments e.g. a return on an assumed investment base, similar to the method considered by IPART in recent margin assessments.

The UR could also consider the approaches used by the rating agencies.

Financeability

Q10. Do respondents agree that the appropriate financeability test is ensuring that Power NI can finance their price controlled licence activities by the UR demonstrating that it has a robust evidence-based methodology for calculating opex and margins? If not, please explain your reasons and advise what form of financeability test the UR should undertake.

Power NI welcomes the UR's commitment to adopt a robust evidence based approach to determining margin. As stated previously the margin assessment should determine a level appropriate to a business operating in an increasingly competitive market that remunerates

[12] The basis of the work currently being undertaken by CEPA on behalf of Power NI

the real risks Power NI faces as a business and replicates the outturns which would be expected by a notional business in an unregulated, efficiently competitive market.

As mentioned within our response to Q8, Power NI has asked CEPA to consider the question of financeability in the context of its 2014 price review and the implications this has for determining an allowed profit margin.

CEPA are currently finalising a paper which covers financeability and margin considerations. Power NI intends to submit this discussion paper to UR during the week beginning 25 March 2013.

5 Appendix A: Regulatory precedence on removal of price controls

Approach

Ofgem reviewed the development of competition in UK gas and electricity supply markets in detail on an annual basis. The purpose of these reviews was to provide evidence based market analysis to inform the regulator as to which customers needed protection by means of price controls and the appropriate scope and duration of supply price regulation going forward. The market reviews were also used to identify remaining barriers to entry and to competition developing further. Quantitative information regarding tariffs, related incentives, customer numbers, volumes shipped/ supplied and customers in debt was sought for each PES area. Gas market surveys requested information on suppliers ownership structure; tariffs and related products, split by volume bands; customers supplied, split by volume bands; customers who are also supplied with electricity; and customer movements between tariffs. This was supplemented by consumer surveys carried out by MORI and information on switching levels provided by Transco.

In the domestic sectors, the detailed and quantitative analysis of all customer groups in the gas and electricity sectors helped Ofgem assess the need for regulation of BGT and electricity suppliers' domestic tariffs. Ofgem's analysis covered the following areas:

- Customer awareness of the opportunity to choose an alternative supplier and the range of competing offers.
- Suppliers' behaviour, including entry and exit from the market.
- Suppliers' performance, in particular suppliers' market shares.
- Customers' behaviour, including switching suppliers and payment methods.
- The range of price and related offers available from new entrants, including 'duel fuel' offers.
- Potential barriers to the development of competition.

During the phased removal of price controls in the UK domestic gas and electricity supply markets, Ofgem provided a number of conditions it would expect to prevail in markets where there was effective competition. These included a market where:

- All customers can attract, and are aware of, a range of competitive offers.
- The abuse of market power is prevented.
- The operation of competition promotes innovation and improved economic efficiency.

Ofgem's market analysis was used to inform the regulator whether these conditions of effective competition had been achieved and if price controls could and should be removed. We have drawn out a number of specific points about Ofgem's approach that we believe are particularly relevant.

Market Definition

Ofgem's analysis did not seek to establish formal market definitions for the gas and electricity supply markets. When reviewing BGT's price controls, Ofgem paid particular attention to whether competition was developing at different speeds for different groups of customers. This was:

> "To inform Ofgem better as to whether, and for which groups of customers, price regulation on BGT may remain relevant"[13]

Ofgem's analysis was concerned with groupings of customers and therefore largely considered whether to de-regulate each of BGT's four categories of customers separately.[14] The way in which customers were categorised and the approach to assessing the development of competition was also to take into account how the scope of price control regulation could in practice be reduced. This reflected the relatively pro-active approach Ofgem took to removing price controls in the domestic gas supply sector.

[13] Ofgem: 'A Review of the Development of Competition in Domestic Gas and Electricity Supply', December 2000, p. 15.
[14] Ofgem: 'Review of British Gas Trading's price regulation – Final proposals', February 2001. Ofgem classifies price controlled customers as Direct Debit, PromptPay, LatePay, and PrePayment.

Assessing the development of competition

Ofgem interpreted the development of competition as a dynamic process characterised by constantly changing structures, behaviour and performance, and consequently the development and conditions for effective competition were not considered to be clearly measurable against a simple set of indicators (e.g. market shares). It did however, as outlined above, discuss the types of conditions it would expect to prevail in markets where there is effective competition. The regulator also considered it important to examine:

> "the functioning of the domestic gas market in its entirety. The functioning of the market depends upon the combined effects of the actions of the incumbent, competitors and customers, as well as upon the structural conditions in which they all operate."

Although essentially qualitative, Ofgem did provide a reasonably transparent proposal of how it intended to examine and benchmark the development of competition in domestic gas and electricity markets. Given price controls for BGT's domestic gas direct debit customers were only removed in April 2000, after the phased introduction of competition in this sector, the regulator seems to have required evidence of actual competition before it considered the removal of price controls.

6 Appendix B: Framework for setting retail operating costs in a liberalised market

Framework for setting retail operating costs in a liberalised market

1. Introduction

Northern Ireland's domestic and non-domestic retail electricity market has been open to competition since 2007. Both non-domestic and domestic sectors have seen active competition develop through market entry from new entrant retailers.

The continued application of price controls to Power NI's regulated business, within both the non-domestic and domestic retail sectors, has implications for Power NI and new entrant retailers' businesses looking forward.

For example, Power NI's regulated tariffs may act as a benchmark for the market (the price which competing retailers must price against when seeking to acquire customers) and the allowed operating costs which Power NI can recover from its customer base, are likely to impact on the sustainability of its business if costs are incurred but cannot be recovered.

With the advent of competition in Northern Ireland, the operating costs and supply risks which a retailer is likely to face, will be different to those faced by a monopoly service provider. For example, the company might be expected to incur:

- customer acquisition and retention costs associated with acquiring new customers and retaining existing customers (primarily marketing activities but also branding and enhancement of retail customer services); and
- greater costs from customer switching[15], bad debt and revenue collection management, linked to greater customer churn and retailers' supporting business models (this may be a volume rather than new type of cost issue).

The approach to allowed retail operating costs, and indeed retail margins, that has been adopted by the Utility Regulator (UR) for recent Power NI price control reviews, has instead tended to focus on the company's actual historical cost base and is organised around the principle of a retail

[15] For example, call centre and customer information costs.

business that faces none or at least limited competition. Power NI has identified this approach as a potential risk for the 2014 Price Control Review because:

- failure to recognise efficient operating costs within the regulated prices of its retail business may impact detrimentally on the economic sustainability of its business given the need to compete within a liberalized market; and

- failure to recognise certain retail operating expenses, such as customer acquisition and retention costs, may mean that Power NI's regulated retail prices are set at a level that discourages competition, which is a regulatory objective for the market.

Power NI has asked CEPA to consider the options for an analytical framework to assess the types of retail operating costs that should be accommodated within the regulated retail tariffs of an efficient retail business operating within a competitive retail electricity market.

This note sets out our initial analysis and a suggested way forward to support Power NI's March 2013 Business Efficiency Questionnaire (BEQ) submission. The implications for the retail margin of these different approaches is addressed elsewhere.

2. Objectives and principles

The purpose of 'incentive regulation' through periodic controls of maximum prices or allowed revenue is to control the potential abuse of monopoly power, or a dominant position within a market, and give incentives to improve efficiency and performance. Effectively replicating the working of a competitive market where pressure to reduce costs will exist.[16]

While actual regulated business costs (both historic and projected) are often an important input to the price determination, incentive based regulation is typically organised around establishing an allowed cost base for a 'notionally' efficient business. This reflects the principle that customers should be protected and only pay for efficient costs.

For monopoly businesses, regulators have tended to utilise benchmarking analysis as well as a variety of "bottom-up" methodologies (which utilise evidence of actual costs of the regulated business) to establish an efficient cost base. This approach also utilises information on expected "outputs" from the monopoly business so as to determine if the required "inputs" are efficient.

[16] The classic academic exposition of the theory of incentive regulation is provided in Laffont and Tirole (1993): 'A Theory of Incentives in Procurement and Regulation'

In theory similar principles should also apply to a price regulated business in a liberalised market. Prices should reflect the efficient costs of supply of the business as would be the case if competition was deemed to be fully effectively. However, the types of operating expenditure that the business might efficiently incur may change if the company is operating in a contestable rather than non-constestable sector (as discussed in the introduction).

Furthermore, if the costs of efficiently operating within a competitive market (as opposed to a monopoly market) are not accommodated within the regulated tariff, the price control itself may potentially act as a barrier to entry to the market, as the benchmark regulated retail tariff would be set at too low a level to encourage competition, where new entrant retailers do have to incur additional operating costs such as those related to acquiring and retaining customers.

Given the change, investment and development affecting Northern Ireland's retail market and Power NI's regulated business, and the discussion set out above, we have developed a set of principles that the framework for establishing an efficient retail cost base needs to achieve going forward. These are summarised in the text box below.

x 2.1: Principles and objectives

- **Economic sustainability**: retail operating costs and other components of Power NI's price control should allow an efficient company to finance and sustain its business.
- **Protection of consumers**: allowed retail costs should only be set at an efficient level given the activities and outputs of the regulated business.
- **Promotion of competition**: wherever appropriate the approach to allowed retail operating costs should promote effective competition.
- **Simplicity**: the approach which is used to determine allowed retail operating costs should be as simple as possible to implement.

3. Options and their assessment

In light of these principles and objectives, we have developed three possible models for assessing the types of retail operating costs that an efficient retail electricity business would be expected to accommodate within its retail tariffs, if operating within Northern Ireland's competitive retail electricity market.

The three approaches are as follows:

- **A business as usual approach**: this would involve an analytical framework similar to that applied by UR at previous price controls. This would involve setting an efficient operating cost base primarily with reference to Power NI's actual historic costs.

- **Hypothetical new entrant approach**: where an operating cost base for a hypothetical new entrant retailer (with the scale and scope of the retailer needing to be determined) would be used to set the allowed efficient operating costs for the regulated tariff.

- **Competing incumbent retailer approach**: a hybrid of the above approaches, whereby efficient operating costs would take account of evidence of actual/historic Power NI costs, but would also recognise the new types of cost and cost drivers of a competitive business and how these would be recovered by an efficient retailer.

Table 1 sets out in a little more detail how each of these different approaches might be expected to work in practice.

Table 1: Assessment of models for setting retail operating costs

Element	Business as usual	Hypothetical new entrant	Competing incumbent
Key regulatory principles	Actual historical efficient costs; Lack of competition / low risk of loss of market share	Prices set with reference to efficient new entrant retailer costs	Prices set with reference to efficient costs of competing incumbent retailer recognise customer retention costs etc
Description	Bottom-up / line by line review of Power NI's historic costs and cost drivers; some account taken of efficiency and input price changes	A hypothetical costing of a notional new entrant retail business with different supply characteristics to Power NI	Cost base for an efficient incumbent retailer that faces new types of cost and cost drivers related to competing in a liberalised and increasing contestable market
Implementation	Review of Power NI costs and evidence of input price changes	Will require assumptions to be made of the scale and scope of the hypothetical new entrant business (e.g. customer base)	Some assumptions needed but much more firmly grounded in the cost drivers of Power NI's business; may need some supporting benchmarks
Regulatory precedence	Power NI ; Phoenix Supply	IPART (2007); LRIC	IPART (2010); other Australian retailers
Economic sustainability	◔	◕	●
Protection of consumers	◑	◕	●
Promotion of competition	◑	●	◕
Simplicity	●	◔	◑

Source: CEPA

Key: ● *best;* ◔ *worst.*

We have also provided an initial assessment of how each of the options performs against the principles set out in Section 2 and where relevant made comparisons to regulatory precedence of the different approaches having been implemented.

Our initial assessment suggests that a Business as usual approach may not be appropriate for the 2014 Price Control Review. Given the changes affecting Northern Ireland's retail sector, this approach performs relatively poorly against two of the core objectives; allowing Power NI to finance its activities (i.e. economic sustainability) and promotion of competition.

A hypothetical new entrant approach is likely to be the most conducive to competition but would be the most difficult to implement as it is highly assumptions driven. There is however, at least some precedent of similar approaches having been applied in other contexts. For example, IPART (the New South Wales utility regulator in Australia) has previously set regulated retail electricity prices according to the operating costs of a "Mass Market New Entrant" (2007-2010 price review). In other contexts, regulators (and indeed the Competition Commission) have considered setting regulated prices on the basis of forward looking Long Run Incremental Costs (LRIC) where active competition within a market is expected to develop.[17]

In contrast, the competitive incumbent approach potentially provides a more pragmatic way forward than the hypothetical new entrant approach and which might balance the trade-offs between the different relevant objectives more effectively. As set out in Annex A, regulated prices in Australia also provide some regulatory precedence of this approach being applied where "Standard Retailer" costs are used to set regulated prices and which generally include an allowance for customer acquisition and retention expenditure.

This approach would allow for the costs of Power NI competing within a regulated market to be explicitly recognised in the efficient cost base, without appearing overly hypothetical and in conflict with the consumer protection principle. While some assumptions will need to be applied to develop those costs (for example, if there is a retention or acquisition cost per customer, how is this spread over the expected life of the customer?) it is less open to challenge from UR.

4. Conclusions

Our conclusions are as follows:

[17] The basis for applying LRIC to set prices is that this proxies the marginal cost based principle that company's would be expected to incur and price at if operating in a competitive market. LRIC recognises the impact of fixed short run costs but long term variable costs from supply.

- Given the new competitive landscape in the retail electricity sector, we think the competitive incumbent approach of establishing a required operating cost base has merit.

- We suggest that Power NI should seek to incorporate this approach in developing its BEQ submission to the UR.

- However, as part of the ongoing review process, Power NI and the UR will need to consider further the implications of how to implement this approach.

Annex A: Australian retail regulation

This short annex considers how Australian regulators have approached aspects of retail electricity price regulation in recent determinations.

Customer acquisition costs

A recent report for the Economic Regulation Authority of Western Australia noted that in the past, customer acquisition costs were not explicitly included in regulatory allowances for retail operating costs (although some allowance was typically made for general marketing costs). This has changed, with IPART including an allowance for customer acquisition costs in its recent determinations, and the QCA and ESCOSA following suite in allowing for customer acquisition costs.

We describe below the approach applied by IPART in recent completed reviews and the approach it proposes to apply for the 2013-16 review. 2007-2010 review

The terms of reference for the 2007 review required IPART to consider new entrant retail operating costs in the mass market. This represented a significant change from the approach IPART had taken in its previous determination.

At this review, IPART accepted that the allowance for mass market new entrant (MMNE) retail costs included both retail operating costs and the costs to acquire new customers. In determining the allowed retail costs, IPART's consultants concluded:

"*We interpret the MMNE to be an entrant that has achieved economies of scale. The evidence suggests that this occurs at a modest scale. However, our interpretation of the MMNE as a stand-alone new entrant implies that the MMNE may not achieve all economies of scope, particularly those available through vertical integration. Because we have used the costs of integrated retailers/distributors as a proxy for the costs of a MMNE, potentially the cost estimate may understate the costs of a stand-alone MMNE.*"

2010-2013 review

The terms of reference for the 2010 review specified that IPART should determine the retail operating cost allowance taking into account NSW Standard Retailers' efficient costs and other available information on efficient operating costs for retailers. The terms of reference also noted that to ensure regulated retail tariffs are set at a level which encourages competition in the retail electricity market, IPART should include customer acquisition costs in this allowance.

A key difference in the terms of reference for the 2010 review was the requirement for IPART to review the retail operating costs, including the customer acquisition costs, of an efficient Standard Retailer, as opposed to a mass market new entrant. IPART noted that "*while a mass market new entrant retailer must acquire all is customers, a Standard Retailer has an existing customer base.*"

2013-2016 review

IPART has recently published is approach paper for the 2013-2016 price review.[18] In estimating an efficient retail operating cost allowance, IPART's terms of reference for the review requires it to:

- take account of information from the NSW Standard Retailers and other available information on retailer's efficient operating costs;
- include customer acquisition and retention costs to ensure that regulated retail prices are set at a level that encourages competition.

IPART therefore propose to estimate 2 categories of retail operating cost:

- "*Retail operating costs (ROC), which are the operating costs an efficient Standard Retailer would incur in performing the retail functions required to serve its small customer base. They include, among other things, the costs of billing and revenue collection, call centres, IT systems and regulatory compliance, as well as an appropriate proportion of corporate costs.*"
- "*Customer acquisition and retention costs (CARC), which are primarily marketing costs associated with acquiring new customers and retaining existing customers, and transferring customers.*"

To apply the above approach, IPART consider the characteristics of the Standard Retailer.

18 http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Review_of_regulated_electricity_retail_tariffs_and_charges_2013_to_2016

"This characterisation will affect the specific cost items that should be included in the estimates of ROC and CARC, and the appropriate levels for these costs. Ultimately, this will reflect the balancing of the objectives for the review … this includes:

- *a standalone retailer in NSW that is not vertically integrated into electricity distribution in NSW*
- *serves retail customers, including small retail customers, in NSW and potentially other jurisdictions across the NEM, and in doing so has achieved economies of scale in retailing (ie, has efficient costs)*
- *can offer retail customers standard form and/or market customer supply contracts*
- *has an existing customer base to defend and seeks to acquire new customers.*

We consider that these characteristics are consistent with the terms of reference for this determination, including the requirement that the cost allowances we determine reflect the efficient costs incurred in supplying small retail customers. They are also consistent with the requirement that the prices resulting from the determination encourage competition in the retail market by including customer acquisition and retention costs in the retail cost allowance."