11th September 2009

Fergus O'Toole
The Commission for Energy Regulation
The Exchange
Belgard Square North
Tallaght
Dublin 22

Barbara Cantley
The Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ER

Dear Fergus, Barbara

RE: A Review of K Factors and Supply Margins

Bord Gáis Energy (BG Energy) welcomes the Regulatory Authority's (RA's) review of K-factors and supply margins in the context of enhancing the development of competition in the Irish and Northern Irish retail markets. BG Energy makes the following comments from the unique position as an incumbent to whom k-factors are applied in the retail gas market and as an independent supplier competing against a regulated entity applying k-factors in the retail electricity market.

Traditionally, retail prices in the energy market have been regulated to prevent abuse of monopoly power by incumbent energy suppliers. This essentially imposed a regulatory discipline on the incumbent as a proxy for a market discipline in the absence of real competition. As market disciplines emerge in the form of wholesale and retail market competition, consideration should be given to amending regulatory practices to better meet the needs of the changing market and to further facilitate the development of competition.

The current ex-ante regulatory formula, which uses price controls and k-factors, affords a regulated entity a level of protection from market uncertainty and volatility. However, as is evident from the current year's ESB PES retail tariff review process in Ireland, this formula is not appropriate in an increasingly competitive and volatile market. It can render the incumbent uncompetitive in a declining market and can make it difficult for independent suppliers to compete against in an increasing market.

When the market is developing rapidly, with significant levels of customer churn, it is important that regulations are not out of step with the competitive environment. As k-factors are only a by-product of ex-ante regulation, BG Energy is of the view that it would be more appropriate at this time for the RAs to examine the overall market and competitive environment and determine the appropriate role of regulation in an increasingly competitive retail market. This includes a review of the market, an examination of the market barriers, and the provision of a framework outlining how these barriers can be addressed to better promote and accelerate the competitive process.

The remainder of this response comments specifically on the proposals outlined by Skyplex in their report to the RAs. The k-factor proposals are designed to 'promote the development of supply competition in Ireland and Northern Ireland'. To this end, they must try to reduce the level of uncertainty and volatility that can be associated with k-factors which inhibit competition. If the RAs are seriously considering each of these proposals, a firm commitment from the RAs is required to ensure the market that they will be applied in each tariff year. Uncertainty will prevail in the absence of such a commitment, thereby negating the stated objectives of this review.

Proposal 1 as outlined by Skyplex outlines essentially what should be considered as the minimum standard for an ex-ante regulatory environment where k-factors are applied. In their previous consultation paper in February 2007, the RAs recognised that further information was required and suggested that the following be approved and provided to the market;

- High level principles;
- An approved hedging policy statement;
- Contract procurement guidelines; and
- Routine periodic reporting to demonstrate compliance.

The RAs have recently begun to implement this proposal by publishing the hedged purchases of the two incumbents. In addition to this information, greater detail with respect to the distribution of the k-factor across the different customer bands should be provided. BG Energy has previously advised in its previous responses to ESB Customer Supply's tariff reviews that it was unable to accurately reflect the cost of the k-factor across the different customer bands. As there are a number of bands against which other suppliers are trying to compete, the breakdown of the costs across the different bands should be provided to the market in a transparent structure.

With respect to **Proposal 2**, BG Energy does not agree with the first assumption which claims that incumbents are indifferent to k-factors. In increasingly competitive and transition markets, incumbents can become more uncompetitive as a result of the application of k-factors and therefore lose market share. As stated previously, k-factors are a product of ex-ante regulation which relies on reasonable forecasts to set tariffs for a future time period. According to the RAs February 2007 consultation paper, k-factors are only applied to those costs which are unavoidable and therefore out of the control of the incumbent. For these reasons, BG Energy does not believe that it is reasonable to levy a penalty on the incumbent for accumulated over or under recoveries.

Similarly, BG Energy does not believe that the suggestion to redistribute k-factors across all customers in the market is appropriate or in keeping with a competitive ethos. It should be the prerogative of competing suppliers to choose how and whether they account for under or over recoveries from previous years. It does not seem logical that independent suppliers would collect or charge monies for over or under recoveries accrued by the market incumbent in a previous year(s).

In general, proposal 2 seems overly complex for the purpose of removing the negative impact of k-factors and would not be a proportionate regulatory framework in the current market environment where competition is in its infancy but growing rapidly. Although proposal 2 would allow the incumbent to better control the level of k-factors within a tariff period, it would mimic the current issue of asymmetric information whereby the incumbent is at an advantage to other suppliers in the market. The incumbent would also have an advantage in determining when price changes would occur and be levied onto customers.

Combined, the outturns of this proposal would not decrease and may increase the level of uncertainty in the market for independent suppliers. BG Energy *does* support greater freedom in the setting of tariffs such they more accurately reflect the true market costs at the time. However, this should not be applied until such time as the competitive environment is deemed sufficient to control the behaviour of market participants more effectively than regulation. This is not to say that regulation would become redundant but would migrate to a monitoring role, similar to that suggested in proposal 3.

Proposal 3 is effectively an ex-post regulatory mechanism, which gives incumbents the freedom to set tariffs but subject to regulatory scrutiny and cost reflectivity. This is a common regulatory practice in transitionary markets, where competition is becoming more effective and the risk that regulated prices will distort competition increases[1].

The main benefit of ex-post regulatory regimes is that it allows the regulated company greater commercial freedom and provides a stepping stone in the transition towards full liberalisation. In markets where competition is established in the sense that there is significant and sustainable new entry but not yet deemed to be effective, ex post price monitoring can enable a smooth transition to full market liberalisation. This can enable RAs to monitor market and product developments before removing regulation from the market fully.

BG Energy does not believe that the current market environment is sufficiently robust, transparent and liquid to support the implementation of proposal 3 at this time. Before transitioning to this phase of regulation, the RAs should firstly conduct an assessment of competition in the market, examining the remaining barriers to entry and outlining a framework to remove these barriers in the future. Only when these barriers are removed such that competition is more influential than regulation should proposal 3 be considered for implementation.

In order to determine the appropriate **supply margin** for a given market, a market risk assessment should be conducted to determine a reasonable rate of return for investing in the market. Given that margins are designed to reward market risk, it is reasonable to expect that the margins of a regulated entity

[1] Regulatory authorities in Texas, Victoria and the Netherlands implemented ex-post regulation for a period of time after removing ex-ante revenue controls. This approach was adopted until competition was deemed effective and regulation was removed.

with k-factors should be less than an entity which is exposed to the full risks of the market. The Commission for Energy Regulation has previously conducted an analysis on suitable margins relevant to the market risk exposure in the retail gas market. This analysis could be used as a benchmark for the electricity market and to better understand the risk/return relationship in competitive retail markets.

On a separate point, it is suggested by Skyplex that the implementation of proposal 2 or 3 will reduce the demand for CfD contracts by regulated suppliers thus reducing the problem of undersupply to the market. However, this is only one of the issues with the current hedging market. The principle problem is that of liquidity. Suppliers cannot hedge outside of the CfD auction window, which essentially prevents competitors from changing their position throughout the year or differentiating their purchasing strategy from other suppliers in the market.

Summary

Although the existences of k-factors have been identified as a market barrier, a review of k-factors in isolation will do little to improve the market environment and thus competition. This would be better facilitated by a review of the market and the role of regulation in an increasingly competitive market.

BG Energy does not believe that there is sufficient transparency, liquidity or stability in the wholesale and retail electricity markets to support the relaxation of the current ex-ante regulatory framework. Proposal 2 is overly complex and penal in its application and would not deliver competitive benefits to the market. Proposal 3 as it is currently understood is a viable option however only in the context of an overall change in the competitive environment and the regulatory framework.

Therefore at this stage of the markets development, BG Energy would support the roll-out of proposal 1 as an interim measure until such time as a regulatory framework to manage the transition towards full market liberalisation is finalised and approved.

Bord Gáis Energy
think beyond

I hope the above comments are helpful in your review and would welcome an opportunity to discuss the content further with you and your consultants should you think it would be useful.

Yours sincerely,

Jill Murray
Commercial Regulation
Bord Gáis Energy

{by e-mail}