The Consumer Council

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Barbara Cantley
NIAUR
Queens House
14 Queen Street
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Dear Barbara,

Re: Consultation on 'A Review of K-Factors and Supply Margins in the Single Electricity Market

The Consumer Council is a Non-Departmental Public Body set up in legislation to safeguard the interests of all consumers, and particularly the vulnerable and disadvantaged. The Consumer Council is an independent organisation which operates to promote and protect the consumer interest.

The Consumer Council welcomes the opportunity to respond to the consultation on 'A Review of K-factors and supply margins in the Single Electricity Market'.

The Consumer Council wishes to make a number of comments and does this in the context of welcoming and sharing the Regulator's desire to improve the energy retail markets in Northern Ireland in order to benefit consumers.

Key points

- Competition has the potential to bring benefits to consumers but should be pursued with a due regard to the cost to the consumer;
- The K-factor is incompatible with a fully competitive market;
- By removing the K- factor there is a risk for consumers of an increased price with no guarantee that competition will appear and prices will be driven down;

- The K-factor must be considered in tandem with other issues that impact on promoting competition;
- The Regulator and DETI need to explain their vision for how they want to see competition develop;
- As a neutral party and industry expert, the Regulator must provide a lead in assessing in detail the benefit and risk of its proposals followed by a recommended course of action.
- If and when competition does appear in the domestic market it must be accompanied by regulatory requirements to safeguard the interests of vulnerable and disadvantaged customers.

Introduction

Unemployment in Northern Ireland is currently at its highest level since 1999, whilst those in work continue to earn less than their counterparts in Great Britain.

The Consumer Council believe therefore, that in the current economic downturn there is a great need to relieve the pressure on consumers by keeping electricity prices down. However, despite the recent 5 per cent decrease in the price of electricity customers in Northern Ireland are paying 12 per cent more for their electricity than their GB counterparts, and they are paying 29 per cent more than they did in April 2008.

This is against a backdrop of increasing fuel poverty in Northern Ireland. In 2006, official figures showed 34 per cent of Northern Ireland households were which DSD officials believe may have risen to as many as 50% by 2008[1].

Unfortunately, the long term future suggests that energy prices will continue to rise, regardless of whether Northern Ireland maintains its current energy infrastructure or chooses, as the Department of Trade and Investments' Strategic Energy Framework Consultation document sets out, one based on renewable energy.

The Consumer Council has therefore consistently called for all regulatory and policy avenues be explored to help drive down costs, so that the consumer pays the lowest price possible for their energy.

The Consumer Council agree that competition, if designed correctly, could be a key mechanism in delivering lower prices to consumers. The Consumer Council has undertaken its own independent research which shows that 86 per cent of consumers in Northern Ireland want to see a greater choice of energy suppliers, with 84 per cent seeing the main perceived benefit as being more competitive prices[2].

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[1] DSD spokesperson 2008
[2] The Consumer Council Fuel Usage Survey, September 2009. Appendix A

The Consumer Council recognises the potential benefits that competition can bring in Northern Ireland and believe that in order to be viable it must improve the customer experience for **all** consumers and that it will only do this by:

- Providing lower prices to all consumers;
- Providing better customer service to all consumers;
- Being available to all classes of consumers, and;
- Providing increased and targeted protection to vulnerable consumers.

Therefore, the Consumer Council believes that no customer should be worse off as a result of competition, and we would not want to see the price of energy increase due to measures taken to introduce competition.

Consultation questions

(A) Do customers prefer a single tariff change per year, and are any other matters that should be taken into account in considering the issues associated with reducing the effects of, or abolishing k-factors?

During August 2009, the Consumer Council commissioned an independent omnibus survey of consumer's views on energy issues. Almost half (47per cent) stated they would prefer their energy bills to be fixed for a defined period, rather than variable to reflect fluctuations in international fuel prices, a preference which was relatively consistent across all demographic groups. Over a third (35 per cent) preferred the idea of a variable energy bill.[3]

Other matters:

Competition and consumer protection

The Consumer Council recognise that the K- factor is incompatible with a fully competitive retail energy market. We agree that it distorts a competitive market and reduces the purchasing risk for NIEE relative to that of other suppliers.

However, the K-factor, if operated correctly, can provide some level of protection to the consumer. The stability it provides for the incumbent supply allows for a relatively low margin to be set, in addition it provides an element of risk-smoothing for consumers, and is compatible with annual tariff setting.

If the K-factor was removed, and any wholesale electricity purchases were not covered by hedges, this would expose the incumbent to variations in the wholesale generation price which more than likely will be passed directly through to the consumer. This could lead to more frequent and less predictable tariff revisions. The Consumer Council are concerned, that in the current climate of increasing energy costs, the potential impact of removing

[3] The Consumer Council Fuel Usage Survey, September 2009. Appendix A

the K-factor without some mechanism for suppliers to mitigate their risk, exposes consumers to potentially higher and less stable prices.

It is clear from this consultation, responses to previous consultations and from informal discussions that the Consumer Council have had with industry players that to remove the K-factor would mean the NIEE margin, and hence the final price to consumers, would have to increase. The argument is made that the increased margin will encourage new competitors into the market. Having achieved this, the cut and thrust of competition would eventually drive prices back down. However, the Consumer Council is concerned that there is no guarantee that competition will come, and even if it does that it will it work effectively enough to deliver lower prices than consumers are currently paying.

<u>A co-ordinated approach to achieving competition</u>

There are a number of policy issues that are currently being addressed by Government and the both Regulators that aim to promote, or remove the barriers to competition. These include:

- The Enduring Solution project which aims to remove barriers to switching and update market arrangements in agreement with suppliers;
- Increasing the range of products available on the contracts market and allowing more freedom in the purchasing of electricity;
- The re- branding of NIE Energy/ NIE to remove the perceived advantage for the incumbent;
- System harmonisation with the Republic of Ireland to encourage all Ireland operators.

The Consumer Council understands that no single initiative that aims to promote competition can be progressed in isolation. Each initiative must be progressed together to ensure that all the barriers are removed at the same time. For example, even if a potential competitor felt that an increase in the margin gave them sufficient incentive to enter the market if they know that customers cannot switch in sufficient numbers they will not enter the market. This outcome would present the worst possible scenario for consumers in terms of wasted costs.

<u>A vision of a competitive market</u>

The way that the K-factor is dealt with will ultimately depend on how the Regulator and DETI envisage a competitive market developing in Northern Ireland. In GB during gas privatisation Regulators required British Gas to absorb their K-factor which allowed competitors to attain significant market penetration relatively quickly. However, currently in ROI, the regulated incumbent ESB remains the dominant player despite vigorous competition being introduced and it has not been required to either absorb its K-factor under recovery into its margin or incorporate it into its tariff. The Consumer

Council are concerned that such an inconsistent approach by a regulator will not help to encourage competition.

A balanced view

We note that respondents to the NIAUR April 2008 consultation on retail market competition overwhelmingly favoured abolition of the K-factor. However, it is also true that the majority of those respondents are actual or potential competitors in the Northern Ireland electricity market and have a vested interest in a high margin competitive energy market.

The Consumer Council can understand the argument that an increased margin is required for competition to exist, but it is ultimately the consumer who will pay this and currently they have no guarantee that competition will follow, or if it does that it will deliver a lower price.

(B1) What additional information should the regulated suppliers be required to make available in relation to their contract cover and forecasts of over/under recovery, and in what timescales?

The Consumer Council believe a balance must be struck between providing sufficient and timely information to enable potential competitors to assess the market and ensuring that the incumbent is not placed at a disadvantage in a competitive environment.

(B2) Are there any reasons why it would not be appropriate for additional information on such issues to be made available?

The Consumer Council believe that in the current fully regulated monopoly system there should full and timely disclosure.

(B3) What proportion of any over recovery should be returned in the following year to customers in general rather than only to customers of the regulated supplier?

The Consumer Council would ask for further clarification of the rationale for this proposal.

In respect of Proposal 2:

(C1) What level of asymmetry should be introduced into the K-factors and how should this vary over time?

The Consumer Council believe that this is a matter for the Regulator to determine using their expertise of economic modeling and in consultation with stakeholders.

(C2) What level of additional margin should be afforded the regulated suppliers to give them a reasonable expectation of recovering their costs?

Quantitatively, how should this vary with the level of asymmetry and the expected frequency with which tariffs can be changed?

The current system provides the incumbent with a no risk business. The Consumer Council believes the margin should fairly reflect the risk to both the consumer and the supplier. Therefore, if the level of risk introduced remains low, the margin should remain low.

In respect of Proposal 3:

(D1) Is it feasible for regulated suppliers to apply ex-post tariff corrections in order to avoid an over recovery of revenues?

The Consumer Council believes that a consumer should pay a fair price for their energy. The Consumer Council would therefore support this correction if it provided consumers with a better deal.

(D2) What level of additional margin should be afforded the regulated suppliers to give them a reasonable expectation of recovering their costs? How should this vary with the frequency with which tariffs can be changed?

This is a matter to be determined by the Regulatory authorities, but the Consumer Council believe that it ultimately needs to be fair to the consumer, with the aim of reducing overall energy costs, and that it should reflect the level of risk that is introduced.

Finally,

(E) Which, if any, of the proposals put forward in this document should be adopted and why? What alternative proposals should also be considered?

<u>Proposal One</u>

The Consumer Council believe that if proposal one is to be taken forward that a greater degree of transparency and consistency would be helpful to encourage competitors into the market. Competition has started in the ROI market, with the K-factor retained. However, the inconsistent treatment of the K-factor in this year's ROI tariff review is unlikely to encourage competitors, and the Consumer Council will be interested to see how competitors will ultimately react.

<u>Proposal Two</u>

The Consumer Council believe that as the K-factor currently operates, it gives NIE Energy an unfair advantage over potential competitors. In passing through their costs to the consumer NIE Energy have virtually no risk on the regulated side of the business. The fact that the profit allowed is relatively small does not diminish this.

NIE Energy should be allowed to lose money, as well as make it. Thus the idea of a K-factor with an incentive and penalty built in appears to have merit whilst the transition to a fully de-regulated industry without any K-factor is made.

Such a system would at least start the process of moving the incumbent to a competitive environment by creating a ‘bottom line’ incentive to purchase, forecast and generally run the supply business in as efficient a way as possible. Whilst it could be argued that this introduces an element of risk into the business, the Consumer Council believe it is not high enough to justify an increased margin.

<u>Proposal Three</u>

The explanation behind this proposal is worded in such a way that seems to assume that there is already competition in the market. Cleary this is not the case in the domestic market, and the Consumer Council believe that there still is no clear view that competition will appear in the market soon - The Department of Enterprise, Trade and Investment’s Head of Energy, recently stated that DETI hoped to see competition within the next 12-18 months[4].

The Consumer Council believe that the short term impact of removing the K-factor could be a price increase for customers with no guarantee that competition will follow. The challenge for policy makers is to introduce competition, without incurring additional costs to consumers.
The Consumer Council believe that within the business sector, where competition currently exists, there is a stronger case for removing the K-factor where it still applies, as it will encourage competition and a more efficient market.

Conclusion

The consultation document states that none of the three proposals will create any material disadvantage. The matrix assessment states that only proposal three has the possibility of unintended consequences.

However, the Consumer Council believe that it is difficult to reconcile the widely held view that to remove the K-factor would require the incumbent’s margin (and hence the price across the board) to be increased.

A price increase for the end user would in our view represent an unintended and unacceptable consequence. The risk the consumer would face is that of a failure for competition to arrive, or for it to arrive but fail to lower prices.

If you require any clarification please contact me.

[4] Head of Energy for DETI at the Enterprise, Trade and Investment Committee hearing 24 September 2009

Yours Sincerely,

Richard Williams,
Senior Consumer Affairs Officer