



Electricity Supply Board

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Consultation Papers: CER/09/093

**Review of K factors & Supply Margins and
Tariff Structure Review**

Dear Fergus & Barbara,

ESB Customer Supply (ESBCS) is pleased to have this opportunity to respond to these two important consultation papers.

Our response is presented in 3 parts:

1. Overview & Summary
2. Skyplex: A Review of K-Factors and Supply Margins in SEM
3. Poyry: Retail Tariff Structure Review

Yours sincerely,

Tony Dunlea
Regulation Manager.

Part 1

Overview & Summary

It is over 2 years since the Regulatory Authorities (RAs) first proposed to undertake such reviews¹ and 12 months since the RAs sought consultants to assist them with this body of work. Meanwhile there has been a very significant change to the electricity retail market in the Republic of Ireland (ROI) with the emergence earlier this year of new competitive offerings in the domestic sector and renewed competition/customer switching in the non-domestic sector. This paper issued for public consultation 3 months ago, and in recent weeks the CER has announced that it is fully committed to delivering full price deregulation in the short to medium term and intends to consult in the autumn on a 'Roadmap' for deregulation². The 'Roadmap' consultation intends to explore the criteria for decision points in the removal of regulatory controls on ESB in a fully competitive environment.

ESB strongly supports the RAs' view regarding the benefits of retail competition, particularly in relation to customer choice and competitive pricing and service offerings.

Given these recent developments we believe it is not appropriate for the RAs to advance any of the proposals put forward by their consultants in these papers until after this most important 'Roadmap' consultation is concluded as they are intrinsically correlated.

The 'Roadmap' consultation will address the question of the most appropriate criteria for the removal of regulatory controls and what transitional mechanisms are suitable, whereas both these papers are addressing matters of what regulatory controls should be applied. We believe that there is an apparent conflict between the goals of both sets of consultations and the 'Roadmap' consultation needs to be concluded before any of the proposals in these papers should be considered for implementation by the RAs.

ERGEG³ in a recent report argued for customers' interests to be protected by the market rather than by regulatory intervention and it stated that end-user price regulation is not the right solution to protect or to empower consumers in the market⁴.

¹ AIP/SEM/07/304, 20th June 2007, 'Regulation of ESB and NIE in SEM'.

² CER/09/125, 6th August 2009, 'ESB PES Proposed Tariffs for the Period 1st Oct 2009 to 30th Sept 2010'.

³ ERGEG is an advisory body established by the European Commission to assist the Commission in consolidating a single EU market for electricity and gas. ERGEG's members are the heads of the national energy regulatory authorities in the EU's 27 Member States.

⁴ ERGEG Status Review of End-User Price Regulation as of 1 July 2008. Ref: E08-CPR-21-05 (11 March 2009)

In line with this report, and given that Bord Gais and Airtricity have actively entered the domestic retail electricity market, it is clear that ESB's current structure along with the regulatory controls hinders its ability to compete in the market and acts as a distortion to the development of a fully competitive market. This is not in customers' interests and may give rise to higher retail costs/prices and a lack of innovation in customer offerings i.e. products and services.

Therefore, in line with EU policy, ERGEG's objectives and the recent major changes that have taken place in the competitive landscape, we would propose that the RAs (and in particular CER) must set out the 'Roadmap' to deregulation as the next critical step in the development of a fully competitive electricity market.

Regulation of ESBCS:

As a regulated supply business ESBCS is subject to a number of unique Licence and market conditions that do not apply to other suppliers, and the inclusion of a revenue correction mechanism (k-factor) as an integral part of the regulatory regime is essential to the viability of the business as long as these unique attributes pertain.

The k-factor is used to adjust from one year to the next for any over-recovery or under-recovery based on the differences between expected and prudently incurred outturn costs and revenues. Independent suppliers are of the view that it is a distortion of competition. This is a view that has some limited veracity when only taken in the context of one tariff period. The K-factor ensures ESBCS (eventually) recovers all prudently incurred costs that it may otherwise have recouped if the regulatory mechanism didn't restrict it from acting in a fully commercial manner. It is the regulatory lag that gives rise to contentions of distortion of competition.

There are many things that can influence the differences between expected and outturn values [e.g. sales, customer numbers, SEM pool energy costs, Networks charges, etc] and although some of these can be common to all suppliers in a competitive market, ESBCS faces some unique factors arising from the regulatory regime in which it operates and these broadly fall into 4 areas as follows:

1. Regulated Fixed tariffs

- Tariff structures/prices must be approved by CER in line with agreed principles of satisfying Economic Purchase Obligation (EPO), achieving cost reflectivity and transparency.
- changes to the tariff structures/prices are onerous because of the regulatory burden on the business & are usually implemented once a year.
- the customer base is primarily residential with a volatile/peaky load profile.
- extent & timing of customer movements exposes the business to risk over the tariff period.

2. Ringfencing & Limited Hedging

- ESBCS must operate as a stand-alone business independently of other businesses within the ESB Group (with no offset or affiliated generation as is the normal corporate structure for other market participants).
- ESBCS cannot develop commercial trading risk management strategies with generators/suppliers within the ESB Group.
- The degree of wholesale market liquidity results in significant residual exposure to unpredictable pool price volatility for ESBCS.
- ESBCS has few assets and limited ability to cope with financial risk.

3. Licence obligations

ESBCS has specific and unique licence obligations not faced by other suppliers such as:

- Economic Purchase Obligation (EPO). This requires ESBCS to purchase wholesale electricity (& financial hedging of associated price and volume risks) in a fair, open & transparent way that demonstrate best value for the customers.
- Universal Service Obligation (USO) whereby ESBCS must enter into a supply contract with all reasonable applicants, and cannot be selective about customers and/or special terms to apply.
- Furthermore the business is unable to make independent commercially based decisions on the terms & conditions it may set for different categories of customers (existing & potential) without prior CER approval.

4. No Global Aggregation

- All market participants, except ESBCS, settle their energy purchases on the basis of verified meter data. ESBCS is assigned the balance/difference between loss adjusted metered generation outputs and metered supplier demands plus a net inter-jurisdictional import adjustment. This exposes ESBCS to the volatility & errors of the metering of the whole market.
- Global Aggregation is a methodology whereby all participants would settle on the same basis of verified meter data, but it is not yet implemented in Ireland. In the event of an error arising under global aggregation settlement can be recalculated and/or the error can be shared by all participants.

ESB strongly supports the RAs' view regarding the benefits of retail competition, particularly in relation to customer choice and competitive pricing and service offerings. We are fully committed to engaging with and helping the RAs to develop the 'Roadmap' towards development of a competitive market and the removal of end-user price regulation. It is essential to the viability of the ESBCS business that any consideration of removal or amendment of k-factor is considered simultaneously with a review of the above regulatory restrictions, and in the full context of the 'Roadmap' consultation process. It is critical to the orderly development of retail competition and to customers benefit that the 'Roadmap' consultation is commenced immediately and concluded within a short timeframe (no more than a couple of months) so that the structure and nature of

the regulatory regime is known in advance in the lead up to the 2010/2011 Retail Tariff Timetable.

Skyplex report – Review of K-factors & Supply Margins:

As a regulated supply business ESBCS is subject to a number of unique Licence and market conditions that do not apply to other suppliers, and the inclusion of a revenue correction mechanism (k-factor) as an integral part of the regulatory regime is essential to the viability of the business as long as these unique attributes pertain.

The Skyplex proposal as presented means shortfalls are never fully recoverable, and over recoveries are penalised through financial penalties. The issues that influence the formation of an over/under recovery position are outside the direct control of the PES and yet the business will suffer a loss no matter which outcome is achieved.

We would expect that any assessment of the impact of regulation on the development of retail competition should consider the regulatory package as a whole, rather than concentrate on a particular aspect of the regime – such as the K-factor and Margin as is the case here.

Poyry report – Tariff Structure Review:

The Poyry report could have been more robust if it had more adequately considered the likely benefits & costs of the various proposals presented. We believe it would have been useful if the consultant could reference some regulatory precedent (from other markets) to support their views that their proposals actually promote competition through the development of increased customer choice. The application of such evidence-based approaches to policy decisions is well recognised as being a very effective results-orientated approach to improving customer services and achieving value for money.

We are also of the view that the evaluation criteria would have benefitted from a high level assessment of regulatory impact and in particular the concept of 'necessity' (i.e. that the regulatory policies and instruments proposed are justified in order to promote retail competition). While the proposals appear worthy, for many there is a distinct absence of demonstrable benefits that can be gained from regulatory intervention (that would not otherwise accrue). Ultimately the development of effective competition will ensure that competitive pressures will drive all suppliers to innovate and develop price and service offerings that are based on customers' preferences. Imposed regulatory solutions do not appear in this case, and at this juncture, to be warranted.

The absence of any evaluation from the customers' perspective is notable. We believe this is a very significant gap in the report given that a primary objective of the regulatory process is to promote competition so that customers can benefit from price and service offerings.

In the following sections we outline our observations on the two detailed consultants' reports and have answered the specific questions raised in each paper.

In summary we believe it is not appropriate for the RAs to advance any of the proposals put forward by their consultants in these papers until after the 'Roadmap' consultation is concluded as they are intrinsically correlated.

Part 2

Skyplex: A review of K-Factors and Supply Margins in SEM

We would expect that any assessment of the impact of regulation on the development of retail competition should consider the regulatory package as a whole, rather than concentrate on a particular aspect of the regime – such as the K-factor and Margin as is the case here.

As a regulated supply business ESBCS is subject to a number of unique Licence and market conditions that do not apply to other suppliers, and the inclusion of a revenue correction mechanism (k-factor) as an integral part of the regulatory regime is essential to the viability of the business as long as these unique attributes pertain. There are 4 broad areas of the regulatory regime that are unique to ESBCS:

Regulated Fixed Tariffs	Tariff structure/prices must be approved by CER and changes are difficult to process because of the regulatory burden imposed and the extensive lead-times involved.
Ringfencing	ESBCS is required to operate as a standalone business with no offset or affiliated generation, and cannot develop commercial trading strategies with other generators and suppliers within the corporate group as other market participants are capable of doing. The degree of wholesale market liquidity combined with this ringfence requirement results in ESBCS having a significant residual exposure to unpredictable pool price volatility.
Licence obligations	The EPO & USO licence requirements places very particular and specific obligations on ESBCS. The EPO requirement imposes a procurement regime on the business that must demonstrate openness, transparency and fairness in wholesale electricity purchases (including financial hedges), and equally exhibit price stability, price certainty and best value for the final customer. The terms must be approved or directed by the CER. The USO requirement requires ESBCS to enter into a contract to supply electricity to all persons that make a reasonable request for same. Furthermore the business is not permitted to make independent commercially based decisions on the terms & conditions it may set for different categories of customers (existing and potential) without prior CER approval.
Global Aggregation	All market participants other than ESBCS settle their energy purchases on the basis of verified meter data, and the absence of Global Aggregation exposes ESBCS to the volatility & errors of the metering of the whole market.

Responses & observations on specific Questions:

Question 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?

Response A: ESBCS, as the PES (Public Electricity Supplier), is predominantly concerned with serving the mass market and a particular feature of the customer base is that they have a desire for simplicity in tariff structures and they also place a high degree of importance on stability and budget certainty for electricity costs. Recent customer research undertaken by ESBCS reaffirms this opinion.

It is also likely that customers on regulated tariffs are presently conditioned to a regime of annual price changes and may therefore be reluctant to adopt other forms without understanding the associated risks and costs. The entire regulatory process, as applied to the PES, operates on an annual retail tariff year basis. ESBCS has conducted annual tariff changes for well over a decade, and it is only the unprecedented changes in international fuel markets coinciding with transition to the SEM that necessitated within-year tariff adjustments in the most recent past.

No evidence has been presented by Poyry in their paper to demonstrate that customers have a preference for more or less frequent tariff changes. We would encourage the RAs to develop a policy for undertaking regular customer research which could be used to better inform issues such as customers' attitudes to more/less frequent tariff changes, and their degree of understanding of the associated risks and costs. In Great Britain part of Ofgem's 'Consumer First' programme involves consumer research to inform their key policy decisions.

Although a change in wholesale energy costs may be the biggest contributor to a revenue correction from one tariff period to the next it is not the only one. Any consideration of reducing or abolishing k-factors together with a process of more frequent tariff adjustments must take account of the removal of the other competitive restrictions which necessitate the requirement for a K-factor as outlined in the previous section.

The paper did not address the issue of the costs of implementing and administering a shorter tariff period, or some process of mid-year tariff adjustment. Ultimately effective competition will ensure that competitive pressures will drive suppliers to innovate and develop price and service

offerings that are based on customers' preferences. An imposed regulatory solution is not the most appropriate remedy.

Question 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?

Response B1: Since the drafting of this paper the RAs have agreed a format with both PES businesses for enhanced disclosure of hedge positions during and on completion of the annual auction process. This has been broadly welcomed by independent suppliers.

There is a need to carefully balance the transparency requirements for publication of PES specific data with the potential opportunity for independents to exploit to their immediate advantage the arbitrage⁵ position that may become evident to the market. As there is now very robust competition for customers of all categories in the ROI market the need for such disclosure needs to be re-examined in that context.

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

Response B2: The recent development of robust competition in all sectors of the ROI market has diluted the need for a regulatory requirement to have the PES divulge even more information to the market. There is some risk that such disclosures could result in short term exploitation of arbitrage possibilities by other market participants. If such an eventuality were to happen then the best efforts of the PES to minimise forecast over/under recoveries would be undermined with resultant financial loss to the PES and/or unwelcome impacts on PES customers (assuming the standalone implementation of one of the proposed options in this paper).

⁵ Arbitrage is the practice of striking a combination of matching deals that capitalise upon the imbalance of a price differential between two or more markets; in this case the difference between spot wholesale prices and that of regulated retail tariffs (underpinned by a hedged wholesale position).

Question 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?

Response B3: If the present strategy of independent suppliers to mimic PES tariffs prevails then it is reasonable to assume that, if their hedging strategies are not too dissimilar to that adopted by PES, they too will have an over/under recovery outcome for an equivalent time period. Some observers believe that sharing a PES over recovery with all the market (customers) is a neutral solution in competitive terms. However this simplistic view fails to recognise that independent suppliers are most likely to also have over recovered and banked unexpected surpluses. Such gains can be used to fund pricing strategies aimed at maintaining or growing customer acquisition or market share growth at other times when a supplier may in fact be under recovering.

To adopt an approach of returning over-recoveries to ALL customers rather than only to customers of the regulated supplier on whom the past over-recovery had been charged, would amount to a subsidy of some customers/suppliers who did not fund the over-recovery and would act as a market distortion. CER has previously declared a very strong position on such proposals when it stated:

“....the Commission does not support the Respondent’s proposal to return any over recovery (or under recovery presumably) incurred by PES to all customers either through a reduction in PSO charges or invested in the Transmission and Distribution networks, as this involves a direct cross-subsidy from one separated business to another. The transfer of monies in this way is in breach of legislation relating to unbundling of accounts and the calculation of the PSO”.⁶

Customers can legitimately have an expectation that competitive pressures (or regulatory controls in the absence of competitive pressures) will bring the prices into line with costs faced by the supplier, and over the long run average the price is fair and reasonable. The present regulatory control of k-factor adjustments has served the market well over the long run. The necessity for moving to an alternative needs to be considered in the context of increased competition and a commitment to de-regulation (i.e. the ‘Roadmap’).

⁶ See section 6.3.2 of CER/05/164, 9th Sept 2005, Direction to ESB PES (Public Electricity Supplier) on Allowable Costs 2006 – 2010.

Question C1: What level of asymmetry should be introduced into the k-factors and how should this vary over time?

Response C1: The functions of CER, as set out in the Electricity Regulation Act (1999) and subsequent amendments, requires, among other things, that it “*does not discriminate unfairly between holders of licences*”, and furthermore it must “*secure that licence holders are capable of financing the undertakings of the activities which they are licensed to undertake*”. The asymmetrical proposals outlined by Skyplex in this paper have not been considered in the context of these statutory duties and may therefore be inherently flawed.

Asymmetry is presented as a means to introduce a ‘cost’ for the regulated PES in having the k-factor. There is already a ‘cost’ imposed on the business through a very low margin on sales and the unique and restrictive licence and regulatory conditions that do not apply to other suppliers as outlined previously. Any adjustment to the ability of the regulated business to recover reasonably incurred costs must be considered and evaluated in the fuller context of the regulatory regime in which it is required to function.

The proposal as presented means shortfalls are never fully recoverable, and over recoveries are penalised through financial penalties. The issues that influence the formation of an over/under recovery position are outside the direct control of the PES and yet the business will suffer a loss no matter which outcome is achieved.

Furthermore it should be noted that the adoption of asymmetrical adjustments could give rise to perverse incentives for the PES to achieve a particular outcome. (i.e. situations where over recovery is more favourable than under recovery or vice versa).

Question 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?

Response C2: At present the PES is restricted to a very low margin on sales and unique and restrictive licence and regulatory conditions that do not apply to other suppliers. This situation, which has prevailed since market opening in

2000, was deemed to be appropriate in an environment of almost being the only supplier in the market and little or no competitive pressures on the business. With the advent of SEM in 2007, wholesale energy costs are fully competitive, and with all other tariff inputs being set by the regulator, the customers are in receipt of lowest possible regulated prices. A higher margin on a regulated tariff will only lead to increased prices for customers. There is no mechanism presented to demonstrate that lower consumer prices will be realised. As a regulated PES we do not believe that substituting margin for k-factor recovery is in the customers' best interest.

Based on our experience of SEM since its inception it is highly unlikely that ESBCS (under current market structures and licence obligations) can achieve a reduction in its unhedged volume below 15-20% for a full tariff year. In an environment of highly variable fuel prices any increase in pool price will result in an increase cost for the unhedged volume. Recent fuel price variability has resulted in up to 3-fold changes in SEM wholesale prices. The potential financial exposure faced by ESBCS in a tariff year is of the order of €100-€200m which is many multiples of the quantum of the margin.

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

Response D1: It is not practical for the PES to apply this in a manner that is fair and transparent to all customers, and not just those that are with the PES for the full period of the tariff. It is far more practical to implement the approach whereby if forecast variances between costs included in tariffs and revised forecast costs during the year exceed a threshold value the tariff will be subject to review.

Given customers' current known preference for fixed tariffs and the absence of Time of Use metering and tariffs, the introduction of ex-post adjustments for outturn SEM pool prices and outturn customer demand without adjustment for contract costs would create an unacceptable level of risk (i.e. fixed tariffs and variable pool energy costs).

Even if limited, the application of an ex-post tariff reduction just to existing customers, in order to avoid or reduce an over recovery outcome, is in practical terms very difficult to apply. It is the experience of ESBCS that any changes to tariffs that aren't very clearly understood by all customers leads to customer confusion as exemplified by increased call traffic to our

National Customer Contact Centre (NCCC) in the immediate aftermath of announcements and the release of the first bills with revised complex tariff rate changes involving PSO Related Rebates, etc.

If one is to accept that such adjustments can be made on an ad hoc or annual basis then they could, in theory, also be made at each billing cycle e.g. some form of fuel variation tariff adjustment. However this would be an important change in concept and strategic direction without any guarantee of a positive impact on customer benefit and retail competition.

There is likely to be very significant costs to the PES business if it is required to implement such changes to its billing system for regulated tariffs, and there is no evidence that this would promote competition. Assuming independent suppliers continue to mimic regulated PES tariffs they too will be faced with significant costs to alter their billing systems.

Question 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?

Response D2: The theory put forward in the paper is that the amount of additional margin should be directly related to the amount of K-factor being put at risk. This is particularly important if the other regulatory constraints are remaining unchanged. As set out above in Response C2 we believe that a higher margin on a regulated tariff will only lead to increased prices for customers and the paper fails to demonstrate through what mechanism lower consumer prices will be realised. As a regulated PES we do not believe that substituting margin for k-factor recovery is in the customers' best interest.

Based on our experience of SEM since its inception it is highly unlikely that ESBCS can achieve a reduction in its unhedged volume below 15-20% for a full tariff year. In an environment of highly variable fuel prices any increase in pool price will result in an increase cost for the unhedged volume. Recent fuel price variability has resulted in up to 3-fold changes in SEM wholesale prices. The potential financial exposure faced by ESBCS is of the order of €100-€200m which is many multiples of the quantum of the margin.

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

Response E: In Section 5.1 of their report, Skyplex state:

“Recent developments in competition for domestic customers in Ireland suggest that it may be possible for a competitive electricity supply market to evolve even with the existing k-factor and associated arrangements in place”.

We do not believe that it is appropriate at this point of evolution of the competitive retail market to introduce such radical changes in isolation of a review of the full scope of regulatory controls of the PES businesses.

Part 3

Poyry: Retail Tariff Structure Review

As stated in Part 1 this paper has been overtaken by the recent emergence of considerable competitive developments in the ROI retail electricity market, and more recently by CER's announced intention to conduct a 'Roadmap' consultation in the autumn.

Given these recent developments we believe it is not appropriate for the RAs to advance any of the proposals put forward by their consultants in these papers until after this most important 'Roadmap' consultation is concluded as they are intrinsically correlated.

Nevertheless the following observations and responses to the specific questions are provided to assist the RAs with understanding our views of the papers as presented by the consultants.

The Poyry report does not adequately give consideration to the likely costs, benefits & impacts of the various proposals presented. We believe it would have been useful if the consultant could reference some regulatory precedent (from other markets) to support their views that their proposals actually promote competition through the development of increased customer choice. The application of such evidence-based approaches to policy decisions is well recognised as being a very effective results-orientated approach to improving customer services and achieving value for money.

We are also of the view that the evaluation criteria would have benefitted from a high level assessment of regulatory impact and in particular the concept of 'necessity' (i.e. that the regulatory policies and instruments proposed are justified in order to promote retail competition) in line with the principles of the Government's 2004 White Paper "Regulating Better"⁷. For many of the proposals made there is a distinct absence of demonstrable benefits to be gained from regulatory intervention that would not otherwise accrue. Ultimately the development of effective competition will ensure that competitive pressures will drive all suppliers to innovate and develop price and service offerings that are based on customers' preferences. Imposed regulatory solutions do not appear in this case, and at this juncture, to be warranted.

The absence of any evaluation from the customers' perspective is notable. We believe this is a very significant gap in the report given that a primary objective of the regulatory process is to promote competition so that customers can benefit from price and service offerings. This paper does not provide supporting information to underpin the proposal that disaggregation of charges would be welcomed by customers on regulated tariffs,

⁷ See www.regulatingbetter.ie

and that it would nurture the development of more competitive offerings. PES is predominantly concerned with serving the mass market and a particular feature of the customer base is a desire to have simplicity in tariff structures. We would encourage the RAs to develop a policy for undertaking regular customer research which could be used to better inform issues such as customers' attitudes to more/less frequent tariff changes, and their degree of understanding of the associated risks and costs.

Global Aggregation is important to ESBCS not only because of the additional risk the business bears in its absence but also our capability to understand the make up of demand so that we can better validate pool invoices, forecast more accurately, set out tariffs more equitably, and improve processes in Billing and reconciliation between the retail demand and wholesale demand. In the absence of Global Aggregation and/or an alternative adjustment mechanism we consider the ability to address such issues through the revenue correction mechanism as imperative to the regulatory role of ESBCS as presently constituted.

Decisions to adopt more Time of Use (TOU) type tariffs should not be taken in isolation ahead of the outcome of Smart Metering trials. Any proposals to have increased TOU pricing (e.g. STOD tariffs) are likely to involve very substantial developments and/or revisions to settlement and customer billing arrangements. This would place significant costs on the PES business and assuming independent suppliers continue to mimic regulated PES tariffs they too will be faced with significant costs to alter their systems. There is no concrete evidence that this would be to the overall benefit of customers or advance the promotion of competition.

Responses & observations on specific Questions:

Question 1: Has this review appropriately described the various features of the structures of retail tariffs and their underlying cost allocation methodologies?

Response 1: The review has been limited to the incumbent supplier in each jurisdiction despite the original Terms of Reference that specifically sought not to do so.

It was noted at the outset that this project aimed to undertake a

“detailed review of existing electricity tariff structures and cost allocation methodologies in Northern Ireland and in the Republic of Ireland including (but not exclusively) Supply (NIE Energy Supply and ESB Customer Service)”⁸.

The RAs had indicated that the review may include reference to other suppliers (domestic or international) where tariff innovative or best practice structures have been implemented. It would have been helpful to document the tariff structures and cost allocation methodologies of at least the (domestic) independent suppliers, and their strategic approaches to managing these issues. It is our understanding that independent suppliers were fully engaged with during Poyry’s work.

It is also noted that the report does not explain how various licence obligations, specific to the PES business, can influence the way in which tariffs are structured and their underlying costs. In particular the EPO licence condition requires the PES to financially hedge the volume and price risk associated with wholesale electricity purchases, and to conduct this in a particular manner. It is ESBCS trading policy to hedge as much as possible (subject to suitability, availability & economic value) based on our view that customers have a preference for a fixed tariff.

Furthermore the ringfencing licence condition requires full operational and management independence including complete separation of energy trading activities. Other than the DC, NDC and PSO supported auctions the PES is constrained from freely entering bilateral contracts with its respective generation business.

⁸ Reference clarification to RFT, 25th September 2008.

Question 2: Are there other aspects that should be covered by this review to the extent that it impacts PES retail tariff structures?

Response 2: Please refer to Response 1.

The review does not present a customer perspective on the subject matter. This is a very significant gap in the report given that a primary objective of the regulatory process is to promote competition so that customers can benefit from price and service offerings. We would encourage the RAs to develop a policy for undertaking regular customer research which could be used to better inform issues such as the needs of the customer and his/her attitude to competition and specifically the role of tariffs.

Work on cost/benefit analysis should be undertaken before any of these proposals are considered further for implementation. This should include costs/benefits to parties other than the PES.

Question 3: Do you agree with the categories suggested for these proposals?

Response 3: The categorisation is reasonable.

It is noted that in section 2.2 [Tariff Methodology Statements] Poyry makes a statement about the absence of a published document that details the methodologies employed by the transmission and distribution companies in the formulation of their charges. This observation hasn't translated into a recommendation for consideration by the RAs [given that the recommendation in section 3.3.3 is addressing the development of a single cost allocation model for distribution charges rather than publication of existing methodologies].

Question 4: In the context of the all island market structure do you think the introduction of an EFA style CfD would assist in bringing liquidity to the CfD market? What other arrangements would help in this respect?

Response 4: In the current year the trading process, from an operational viewpoint, has successfully adapted to the Tullett Prebon electronic trading platform for

all auctions (DC, NDC & PSO). However it is observed that the use of the electronic platform has, so far, not delivered any significant improvements to market liquidity.

The degree of liquidity evident to-date in SEM is likely to be a function of a range of different factors and the interrelationships between these factors, including how the majority of market participants are structured and how others are prevented from similar corporate structures through regulation & ringfence provisions. Those that have both generation and supply activities can choose between relying on the market for the provision of wholesale energy or adopt alternative strategies such as creating their own internal CfDs/hedges to manage their opposite market risks.

However it must be noted that it is not simply a case of one way or the other. Other markets such as Germany exhibit high degrees of vertical integration and yet also have good degrees of liquidity. The extent of cross-border interconnection and the participation of financial organisations in that market appear to have supported liquidity.

The regulated supply entities are conditioned by licence obligations [ringfencing & EPO] that require a particular approach to hedging that is not replicated by commercially freer participants. Because of the relatively small size of SEM taken in conjunction with the organisational structure of its participants, lack of interconnection, etc., it is very unlikely that significant market liquidity will become established.

The burden of regulation is possibly a barrier in itself to the development of wholesale market liquidity that is normally brought about by the dynamics of a competitive environment.

Question 5: Would 'global aggregation' provide a level playing field for the PES to better allocate its costs within its tariff structures?

Response 5: As the Error Supplier Unit (ESU) in each jurisdiction the regulated supply businesses (ESBCS & NIEES) are exposed to the volatility and errors of the whole market metering and settlement processes. ESBCS faces significant issues that do not apply to other suppliers in the market and these create risk:

- For independent suppliers their NQH (Non-Quarter Hour) customers are profiled and thus their exact demand profile is

always known which enables the supplier to hedge with a reasonable degree of accuracy. All deviations of independent suppliers' customers demand from the standard profiles are absorbed by the ESU. Therefore the ESU in effect pays for and takes the pool risk on other suppliers' non-profiled residual demand. This is a demand that cannot be controlled by the ESU or determined in advance.

- The profiles used in determining the independent suppliers' demand don't vary with changes in temperature and thus any deviation in the suppliers' NQH customer demand from the standard profile is also absorbed by the ESU. On a cold winter's evening the additional demand on an independent supplier's customers will be allocated to the ESU, resulting in additional exposure to pool prices at a time when the prices are most likely to be highest. It is recognised that the mass market demand is the most sensitive in this regard. This too is a demand that cannot be controlled by the ESU or determined in advance.

Recently ESBCS has noted that its cost of pool energy purchases at Trading Point has increased as an inadvertent result of the methodology of calculating Generator Transmission Loss Adjustment Factors (TLAFs) on an All-Island basis (incorporating the Eirgrid locational incentive scheme for ROI based generators). It was the intention of the locational incentive scheme to affect generators only and the disproportionate cost impact on the ESU (ESBCS and NIEES) was not intended. ESBCS will remain at a relative disadvantage until the ESU calculations are modified or until Global Aggregation is introduced.

Global Aggregation is important to ESBCS not only because of the additional risk it bears in its absence but also its capability to understand the make up of its demand so that we can better validate pool invoices, forecast more accurately, set out tariffs more equitably, and improve processes in Billing and reconciliation between the retail demand and wholesale demand.

In the absence of Global Aggregation and/or an alternative adjustment mechanism we consider the ability to address such issues through the revenue correction mechanism as imperative to the regulatory role of ESBCS as presently constituted.

Question 6: Would the creation of a common code of metering practice across both regulatory jurisdictions help in providing a basis of measurement that would facilitate harmonising retail tariff structures?

Response 6: The paper recognises that a common Metering CoP would be a very useful mechanism to create significantly more opportunity for harmonisation by means of a platform for the deployment of Smart Metering technologies and TOU tariffs. To date the RAs have approached the topic of Smart Metering without sufficient consideration of the harmonisation question and any significant divergence in strategic intent for Smart Metering deployment could give rise to differences and consequences that would become enduring barriers to retail tariff harmonisation.

The paper also recognises the long period of time it would take to develop a common Metering CoP. Nevertheless we believe metering is a critical area that must be harmonised in the interests of ensuring that a supplier operating in both jurisdictions is facilitated in doing so at least cost through the avoidance of unnecessary uncoordinated protocols.

We would urge the RAs to work more closely together on the issue of Smart Metering and TOU tariffs.

Question 7: Do you agree that the use of common profiles for class demands in both jurisdictions would help ensure the same allocation of wholesale costs when deriving retail tariffs, and provide the same incentives for the structures offered?

Response 7: Yes, assuming the customer characteristics in both jurisdictions are similar enough not to require differentiation, we agree with the conclusions that a common programme of load research would be useful and allow for agreement on a common basis of wholesale cost allocation in tariff formulation.

This proposal needs to be considered in conjunction with decisions on Global Aggregation and Smart Metering. As previously outlined in response to Question 5 above in the absence of global aggregation independent suppliers are immune to the consequences of divergence from standard profiles displayed across the variety of customer types.

We do not consider the adoption of common profiles as leading to a basis for CfD forms. Generators are primarily classified as base-load, mid-merit or peak and would be unlikely to develop hybrid CfD products without adding a risk premium. It is more appropriate for a supplier to aggregate their demand requirements and purchase a basket of base-load, mid-merit and peak type CfD products to satisfy a particular hedging strategy.

Question 8: Would the further segmentation of the SME sector of the electricity market and the creation of class profiles for these segments make PES tariffs more reflective of the underlying costs and also encourage competition in supply to these customers?

Response 8: As pointed out in the paper one of the inevitable 'costs' of adopting a more segmented approach to the SME sector will be the creation of winners & losers, and any changes in profiles/tariffs must always be reviewed with due consideration for customer impact.

This proposal also needs to be considered in conjunction with decisions on Global Aggregation and Smart Metering. As previously outlined in the absence of global aggregation independent suppliers are immune to the consequences of divergence from standard profiles displayed across the variety of customer types.

This is a segment of the market that already has significant number of competing suppliers and it is not demonstrated within the paper that there is a need for regulatory intervention to further stimulate competition.

Question 9: Would the harmonisation of distribution use of system charges better facilitate competition in supply? Would the introduction of a pricing signal for higher distribution voltages provide a useful signal to encourage the appropriate location of distributed generation?

Response 9: This proposal is scored highly by Poyry because there are jurisdictional boundary issues for similar customers in each jurisdiction. It is not made clear how this is a barrier to competition or how its removal would encourage more competition.

We would recognise that a common Network charging methodology would make it easier for a supplier operating in both jurisdictions to align its retail tariff offerings if it so desired.

The introduction of geographic locational signals at higher distribution voltages would need to be examined further including a comprehensive cost/benefit analysis and a detailed consultation process before arriving at any decisions.

Question 10: Do you agree that the separation of charges for the provision of energy, and the use of the transmission and distribution networks would create an opportunity for customers to be offered more choice in the term of the energy component of its contract and the manner in which price levels could be revised? Should the PES simply pass on the network charges it incurs to its customers?

Response 10: The absence of a customer perspective from this paper is most acute when this proposal is considered. ESBCS's customer research would reflect a generally held view that mass market type customers (primarily domestic & SMEs on regulated tariffs) have a preference for simplicity in the presentation of billing information and do not want to be 'confused' by a variety of tariff components. Larger customers (like LEUs on unregulated tariffs) may have a load management capability and the competence to monitor and assess their energy usage and costs, and accordingly may have some preferences for somewhat more detailed billing information.

This paper does not provide supporting evidence to underpin the proposal that disaggregation of charges would be welcomed by customers on regulated tariffs, and that it would nurture the development of more competitive offerings.

CER has previously undertaken consultations on proposals for a fuel cost variation mechanism applicable to PES tariffs⁹ and concluded in both cases that customers, particularly industrial & commercial, attach a certain degree of importance to contract and budget certainty for electricity costs and a move to a variation mechanism would undermine that customer reliance on price certainty. It was also acknowledged that a

⁹ CER/04/270, 28th July 2004 & CER/06/144, 26th July 2006.

variation mechanism based on tracking a particular fuel cost (or wholesale costs) is not fully representative of the PES costs and therefore not the most appropriate approach.

As with our PPPT¹⁰ tariff some independent suppliers also provide multi-part billing information to their customers, particularly at the upper end of the market, and there is no evidence that this is a preferred option for these customers or that it promotes choice and competition.

There is likely to be very significant costs to the PES business if it is required to implement such changes its billing system for regulated tariffs, and there is no evidence that this would promote competition. Assuming independent suppliers continue to mimic regulated PES tariffs they too will be faced with significant costs to alter their billing systems.

The cost to serve model used by ESBCS provides for cost reflective assignment of networks charges to the various customer categories. It is important that the model recognises that there are differences between customer categories, and it may be the case that jurisdictional differences are real and require to be recognised in any proposals for harmonising of cost allocations.

Question 11: Should customers be permitted to choose from fixed price energy contract terms that could vary from 6 months to 2 years, and which could also include indexation provisions that would help align retail and wholesale energy price? Should the PES be encouraged to offer such a choice?

Response 11: There is no evidence presented by Poyry that customers have preferences for longer or shorter tariff periods. However as referenced in Response 10 above there is evidence that customers attach a degree of importance to stability and budget certainty. It is also likely that customers who are presently conditioned to a regime of annual price changes may be reluctant to adopt other forms without understanding the associated risks and costs.

¹⁰ A PPPT tariff is a variable tariff where the energy cost component of the tariff is related to the forecasted Day ahead System Market Price (SMP) of electricity in the All Island Electricity Pool Market. The forecasted SMP is variable on a half-hourly trading period.

The idea of adjusting tariffs to take account of movements in underlying fuel/wholesale prices has been widely used elsewhere, and indeed was used by ESB for almost a decade as a response to the 1973 oil crisis. However, as indicated in Response 10, CER's examinations of fuel variation type tariffs were not supportive of the adoption such arrangements in more recent times.

It should also be noted that in deciding the form of PPPT arrangement that should be applied to LEU customers supplied by PES, CER had regard for customers being aware of the price of electricity in advance of its purchase¹¹.

This proposal does not include details of the cost of implementing and administering a fuel/wholesale indexation mechanism or the vast logistical challenges of developing such a product for the mass market. The ability of any supplier to offer tariffs with indexation provisions must be considered in the context of the current arrangements of a 6 bill cycle that on average has 2 estimated bills. Moving to a shorter tariff period needs to be balanced with the costs of implementing changes & notifying customers of the changes, and administering such a system.

Ultimately the development of effective competition will ensure that competitive pressures will drive suppliers to innovate and develop price and service offerings that are based on customers' preferences. Imposed regulatory solutions do not appear in this case to be warranted.

Question 12: Would there be merit in adopting a common "cost to serve" model in both jurisdictions for allocating the regulated costs of supply between different customer classes?

Response 12: Irrespective of the format adopted by PES to allocate supply costs it must be borne in mind that it is possible to have jurisdictional differences between what outwardly appears to be similar customer categories. As a simple example prepay domestic customer categories are serviced in manifestly dissimilar ways in each jurisdiction and no doubt the cost to serve each is distinctly different.

On the basis that such differences, where material, are recognised we concur that a process to agree commonality in cost allocation methodologies to be adopted by PES could help advance the harmonisation objective.

¹¹ CER/07/149, 27th Sept 2007, 'PES restriction and charging arrangements for Large Energy Users under the SEM'.

Question 13: Should the PES be encouraged to offer tariff structures with more time of use rates that reflect the underlying movement in wholesale costs and thus provide the customer with the choice of when it would be most economic to take its supplies of electricity? Would you support the replacement of maximum demand charges and block kWh structures in existing tariffs by a time of use tariff structure?

Response 13: PES is predominantly concerned with serving the mass market and a particular feature of the customer base is a desire to have simplicity in tariff structures. Decisions to adopt more TOU type tariffs should not be taken in isolation ahead of the outcome of Smart Metering trials. Any proposals to have increased TOU pricing (e.g. STOD tariffs) are likely to involve very substantial developments and/or revisions to settlement and customer billing arrangements. This would place significant costs on the PES business and assuming independent suppliers continue to mimic regulated PES tariffs they too will be faced with significant costs to alter their systems.

There is no concrete evidence presented in this paper that this would be to the overall benefit of customers or advance the promotion of competition.

Under SEM there is no logical reason why the cost of electricity should decline with increased volume consumed by an individual customer since all kWh purchased from the pool in any settlement period are charged at the same price. Furthermore a tariff rate that is regressive with increased consumption is not conducive to encouraging the efficient use of energy. ESBCS has sought to discontinue the block rate structures in the GP tariff group since 2007, but CER has since directed that the change should be implemented on a phased basis out to 2011. The recently approved 2009/2010 ESBCS GP tariffs has implemented the first phase of this change.

The principle features of the MD tariff has not been given due consideration in this paper. To ensure a customer has sufficient capacity to operate its business it is required to have a contracted MIC [Maximum Import Capacity] with the network operator (ESB Networks Ltd.). This is a requirement for every business that has an electricity supply, irrespective of the electricity supplier. ESBCS customers face two charges related to the MIC: a fixed cost per KVA of MIC contracted and an excess charge in the event that the MIC is exceeded.

The total demand for electricity at any instant is the sum of the individual demands of all customers, and because electricity cannot be stored there

must be sufficient generation, transmission and distribution capacity to meet the highest demand. For these reasons most tariffs for larger users are designed to encourage customers to control electricity demand at peaks periods, and accordingly MD tariffs are structured to reflect not only the amount and rate of electricity use but also the time of day it is used. The LVMD tariff has in recent years been simplified to 3 time bands for energy: Summer Day, Winter Day & Night. This suits the customers and a reversal to more time bands might not be welcomed or better influence customer consumption patterns.

Question 14: Would the publication of a common Tariff Methodology Statement that would apply to each PES be helpful in bringing convergence in the practices and cost allocation methodologies used by each PES?

Response 14: We consider the TMS to be an important instrument to demonstrate to independent suppliers the cost basis of regulated tariffs against which they will compete, and in particular the transparency and consistence in PES tariff formulation. A common TMS can only emerge if and when there is convergence to a common framework for cost allocation methodologies to be deployed by the PES. We do not see the adoption of a common TMS being useful to the promotion of retail competition in the absence of development on alignments of cost allocation methodologies. Refer also to Response 12.

Question 15: Do you think the criteria chosen to evaluate the various proposals in Section 3 are appropriate? Are there other criteria that should have been considered?

Response 15: The absence of a customer perspective and consideration of the benefits & costs is notable. We believe it would also have been useful if the consultant could reference some precedent (from other markets) to support their views that their proposals actually promote competition through the development of increased customer choice. The application of such evidence-based approaches to policy decisions is well recognised

as being a very effective results–orientated approach to improving customer services and achieving value for money.

We are also of the view that the evaluation criteria would have benefitted from a high level assessment of regulatory impact and in particular the concept of ‘necessity’ (i.e. that the regulatory policies and instruments proposed are justified in order to promote retail competition). For many of the proposals made there is a distinct absence of demonstrable benefits flowing from regulation that would not otherwise accrue.

Question 16: Would you generally support the conclusions of the evaluation? If not how would your view differ from those expressed here?

Response 16: Please refer to individual Responses 1-15 above.

[end].