

# **Utility Regulator**

**Regulatory Approach to Energy  
Supply Competition in Northern  
Ireland**

**Submission of the Electricity  
Supply Board**



**23<sup>rd</sup> September 2011**

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## **EXECUTIVE SUMMARY**

### **1. Introduction**

The 3<sup>rd</sup> Package (IME3) requires member states to implement measures that facilitate retail market competition while ensuring the protection of vulnerable customers. The Utility Regulator's (UReg) proposals are designed to facilitate competition so long as it can develop efficiently and deliver lower prices than regulation would otherwise achieve. Overall, ESB is of the view that the UReg proposals are a pragmatic approach at this stage in the development of the retail market in Northern Ireland. However, ESB recognises that it will be challenging for UReg to define maximum tariffs each year that are neither too low to discourage market entry by suppliers nor too high to have a detrimental impact on customer welfare.

The completion of the Harmonisation project during 2012 will allow for a step change in the level of switching across the domestic and SSME sectors in Northern Ireland. Experience from other markets suggests that it is difficult for regulated tariffs to co-exist in markets once significant competition emerges, without distortion occurring. ESB suggests that arrangements to facilitate transition from maximum tariff regulation to full tariff freedom for all suppliers be also considered at this time.

ESB believes that in order for any supplier to be most innovative in terms of its tariff offerings to customers and most effective in terms of managing market risk positions and overall costs, that integration of that supplier's Supply and Generation businesses is required. Therefore, ESB calls for UReg, through the SEM Committee to make the necessary decisions to enable such integration by all suppliers across the industry.

### **2. Harmonisation Project will enable both Retail Markets to Co-exist**

The Harmonisation project, due for completion during 2012, has the objectives of promoting effective retail competition and equal treatment of participants and customers regardless of their location and of establishing a set of common switching systems, processes and supplier interfaces. Following its successful delivery, any remaining system or process barriers to large scale customer switching in the residential and small business sectors in Northern Ireland will have been removed. Delivery of these systems will be a significant step towards removal of barriers for further supplier entry in the domestic and small business sectors in Northern Ireland.

ESB Electric Ireland has recently announced its intention to enter the domestic market in Northern Ireland during 2012. ESB is of the view that those other suppliers in the market in RoI who are not already operating in the residential and small business sectors in Northern Ireland may follow suit.

### **3. Regulated Maximum Tariff and the K-factor**

Continued regulation of Power NI cost base can result in benefits for customers, albeit ESB considers that the level of any such efficiencies are likely to diminish over time in comparison to savings that may have been regulated from Power NI cost base in the past. In contrast, the cost of wholesale power will remain the main driver of end-user prices and the maximum tariff. The ability of a supplier to purchase fixed-price power at the optimum time, to align

these power purchases in combination with its own affiliate generation reflecting its changing customer demand profile is what distinguishes one supplier from another in the market and provides a basis for lower prices to customers. In ESB's view, the procurement of wholesale power is not something that lends itself to being readily regulated, in terms of its timing and volumes, while still allowing for differentiation between suppliers. As a result, ESB believes that it will prove challenging for UReg to structure maximum tariffs such that they aren't so low so as to discourage supplier entry, or too high so as to have negative consequences for customers.

It is anticipated that following delivery of the "Harmonisation" project, Power NI will experience significant customer losses. While regulatory tariff reviews outside the normal yearly cycle may limit to some degree any K-Factor under-recovery, upward pressure on incumbent's maximum tariff is still envisaged as customer demand and hedge positions misalign. .

#### **4. Risk Optimisation**

In ESB's view the ability of a supplier to purchase fixed-price power at the optimum time and to align these power purchases in combination with its own affiliate generation and in line with its changing customer demand profile provides the best means for it to optimise market risks and thereby lower costs and pass savings to customers.

Overtime, a stand-alone supplier without any generation capacity with which to integrate for risk management and tariff innovation purposes will be significantly disadvantaged as against its existing and prospective competitors who operate an integrated model. The substantially higher costs for market risk management, manifesting in comparatively higher end user prices, will result in a continued high level of market share loss, putting the viability of any stand-alone supply business at serious risk.

ESB is of the view that in the interest of sustainable retail competition that all stand-alone suppliers should be permitted to integrate with their affiliate generators in order to manage market risks in the most optimum manner on behalf of their customers.

#### **5. ESB's Progressive Deregulation Proposal**

ESB has previously provided its proposal for "Progressive Deregulation" to UReg, which it believes will lead to benefits for all suppliers in the market and as a consequence will be good for all customers. ESB's proposal involves a progressive sequence of modifications to the ring fencing provisions throughout its various generation and supply licences, in line with market events. This integration will allow cost inefficiencies, brought about by these very separation requirements such as those caused by duplication and sub-optimal market risk management practices, to be driven out of the business. Furthermore it will enable further contract market liquidity while all the time providing for greater transparency to the market and oversight by the Regulators.

ESB believes that the implementation of its proposals will provide the necessary market environment, within which the current regulatory mechanisms of maximum tariff with K-Factor recovery in Northern Ireland can be transitioned to one supporting full tariff freedom, without impacting on customer welfare.

## 6. Summary of ESB's Views

ESB is of the view that:

- The UReg proposals are a pragmatic approach at this stage in the development of the retail market in Northern Ireland;
- It will be challenging for UReg each year to set the maximum tariff so as to encourage supplier entry and at the same time to ensure customer welfare is not impacted;
- Completion of the "Harmonisation" project will remove any remaining system or process barriers to large scale customer switching in the residential and small business sectors in Northern Ireland;
- Should Power NI experience significant market share loss, the continuation of the regulated maximum tariff with K-Factor recovery may not prove to be a viable mechanism over time. As such consideration of transition mechanisms at this stage appears worthwhile;
- The ability of any supplier to purchase fixed-price power at the optimum time and to align these power purchases in combination with its own affiliate generation, reflecting its changing customer demand profile is what distinguishes it from other suppliers in the market;
- All suppliers should have the capability to integrate with their affiliate generation so as to most optimally manage market risks on behalf of their customers;
- Its progressive deregulation proposal will enable real benefits for all customers and therefore requests that UReg supports its approval as soon as possible, through the SEM Committee;

ESB is happy to meet with UReg to discuss any aspect of this submission.

## INTRODUCTION

ESB welcomes the opportunity to provide its views on the Regulatory Approach to Energy Supply Competition in Northern Ireland. This position paper comes at a very opportune time when cost pressures are increasing in fuel commodity markets and the retail market harmonisation project is progressing at pace. The drivers and enablers for competition in Northern Ireland are real and these now afford the opportunity for the advantages and disadvantages of the UReg proposals to be assessed from a concrete rather than abstract perspective.

### Harmonisation Project

In order to comply with EU Directives, retail market competition must be facilitated throughout each Member State over time. As such the policy decisions taken on foot of this consultation, i.e. the Regulatory Approach to Energy Supply Competition, need to maximise the competitive potential of the market through empowering customers to exercise choice.

The table below<sup>1</sup> shows the number of customers in each of the retail markets (RoI and Northern Ireland) and distinguishes whether tariff regulation exists or not.

	RoI	NI
<b>Customer Numbers</b>		
Total Customers	2,231,600	824,000
Domestic	2,000,000	765,000
SME	200,000	54,000
LEU	1,600	5,000
<b>Suppliers</b>		
Full Market Opening	Feb 2005	Nov 2007
Domestic Market	Deregulated April 2011	Regulated
Business Markets	Deregulated October 2010	Partially Regulated
Suppliers Domestic	5	2
Suppliers Business	9	7

**Table 1 - Customer Numbers and Regulatory Approach**

In the lead up to Full Market Opening in RoI, ESB Networks implemented a major project to accommodate customer switching and all associated industry-wide business processes. The effectiveness of this system and these processes has been evidenced through the high volume of customers that have switched supplier, particularly since early 2010 and the positive experience enjoyed by customers throughout this process.

In Northern Ireland delivery of the “Enduring Solution” project will provide similar central market capability. The retail “Harmonisation” project between both jurisdictions has the objectives of promoting effective retail competition and equal treatment of participants and customers regardless of their location and of establishing a set of common switching systems, processes and supplier interfaces. With the completion of the Enduring Solution and Harmonisation Projects during 2012, any remaining system or process barriers to large scale customer switching in the residential and small business sectors in Northern Ireland will have been removed. Delivery of these systems will be a significant step towards removal of barriers for further supplier entry in the domestic and SSME retail market sectors in Northern Ireland.

<sup>1</sup> Source CER presentation at CEER Workshop, Brussels, 10<sup>th</sup> February 2011.

ESB Electric Ireland has recently announced its intention to enter the domestic market in Northern Ireland during 2012. ESB is of the view that those other suppliers in the market in RoI who are not already operating in the residential and small business sectors in Northern Ireland may follow suit.

### Approach being followed across Europe to tariff regulation

ERGEG (the predecessor to ACER) issued a position paper<sup>2</sup> on end-user energy price regulation in July 2007. In this paper ERGEG commented on some Member States arguments that regulated tariffs were a tool to protect vulnerable customers. ERGEG view was that protecting vulnerable customers should not be confused with regulated tariffs for all (or certain categories) of customers. It was ERGEG's stated view that *"fully open markets with well functioning competition cannot in the long term coexist with regulated end-user energy prices"*.

ERGEG was of the view that end-user price regulation distorts the functioning of the market but nonetheless recognised that protecting "vulnerable customers" remains necessary in competitive markets provided the tools used to provide this protection work in line with the pre-requisites of open competitive markets. Furthermore, ERGEG was of the view that in some jurisdictions where the retail markets were technically open that in practice there may still have been only one supplier, with a consequent lack of choice for customers. Even in such situations, ERGEG was of the view that regulated tariffs should only continue for the shortest duration possible so as to enable effective competition to develop.

Article 3 of Chapter 2 of the 3rd Energy Package<sup>3</sup> which deals with public service obligations and customer protection, underpins the necessity for harmonisation between the two retail markets in Northern Ireland and RoI where it states that *"Member States shall ensure that all customers are entitled to have their electricity provided by a supplier, subject to the supplier's agreement, regardless of the Member State in which the supplier is registered, as long as the supplier follows the applicable trading and balancing rules. In this regard, Member States shall take all measures necessary to ensure that administrative procedures do not discriminate against supply undertakings already registered in another Member State"*.

ESB understands that UReg is seeking to establish a mechanism, through maximum tariff regulation, that will protect customers. However, continuation of this approach for any extended period appears not to be in line with the direction being followed across Europe and as such transition arrangements need also to be considered now. ESB is of the view that the most optimum manner for any supplier to manage market risks on behalf of its customers is through integration with its affiliate generation business and that such an approach provides the means for transition from the current regulatory approach to one that will enable full competition over time while still protecting customer welfare.

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<sup>2</sup> E07-CPR-10-03

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DIRECTIVE 2009/72/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL  
of 13 July 2009

## **Wholesale Market Prices and Risk Optimisation**

The recent regulatory decision to allow an 18.6% increase in Power NI Supply Tariff<sup>4</sup> from October 2011 was driven primarily by increased wholesale energy costs. Reliance by SEM generators on imported fossil fuels for electricity generation means that the consumer in either retail market can be exposed to tariff increases when wholesale gas prices increase on the international markets. In order for suppliers to offer fixed-price power to their consumers, sophisticated hedging strategies must be employed to manage these wholesale market risks.

### **Risk Management and Product Innovation**

Suppliers can mitigate wholesale market price risks in the SEM through either the procurement of fixed-price power using hedges or through optimising their risk positions across their generation and supply businesses. In practice most suppliers procure fixed-price power made available through the Directed Contracts, PSO-backed CfD and standard Non-Directed Contract auctions and use these hedges in combination with their internal generation capacity (an “internal hedge”) to manage their market positions. Using the certainty that these strategies provide over wholesale power costs enables suppliers to structure their tariff offerings to customers.

The exceptions to this approach are the two former Public Electricity Suppliers, ESB Electric Ireland and Power NI who operate as standalone suppliers and as such do not have the opportunity to internally hedge a portion of their risks. As such both of these standalone suppliers are disadvantaged in their capability to manage wholesale market risks on behalf of their customers and must rely wholly on purchases from the DC, NDC and PSO auctions. Due to the necessity to secure significant volume through these auctions, the ESB Electric Ireland and Power NI power purchases can at times necessitate a premium payment which ends up being passed on to customers.

In ESB’s view the ability of a supplier to purchase fixed-price power at the optimum time and to align these power purchases in combination with its own affiliate generation and in line with its changing customer demand profile provides the best means for it to optimise market risks on behalf of its customers. The maintenance of regulatory barriers to the optimal management of market risks, when the market mechanics are in place to allow retail competition develop will not be in customers’ best interests.

Those suppliers operating an integrated business model in Northern Ireland have both risk management and product innovation advantages over suppliers such as Power NI who operates in a stand-alone manner. Risk management can be optimised through offering products that most closely match the actual generation portfolio (for example gas tracker products when gas is the predominant generation fuel), and by actively managing the exposure to these products through ‘locking out’ the risk when customers actually sign up for these tariffs. This can be done for example by buying forward gas and assigning generation capacity in proportion to the number of customers opting for these tariff options, or rolling back such contracts where customer numbers do not materialise.

A non-integrated supply company, which takes only a small regulated supply margin, is comparatively disadvantaged by not having the flexibility to manage its risks and offer products as innovative as those available from those firms that operate in an integrated fashion in the SEM or across a number of markets. Overtime, a stand-alone Power NI without

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[http://www.uregni.gov.uk/news/utility\\_regulator\\_comments\\_on\\_power\\_ni\\_tariff\\_announcement/](http://www.uregni.gov.uk/news/utility_regulator_comments_on_power_ni_tariff_announcement/)



any generation capacity with which to integrate for risk management and tariff innovation purposes will be significantly disadvantaged as against its existing and prospective competitors who operate under the integrated model. The substantially higher costs for market risk management, manifesting in comparatively higher end user prices in the maximum tariff, will result in a continued high level of market share loss, putting the viability of a stand-alone Power NI supply business at serious risk. Alternatively this could result in the continuation of the situation where Power NI competitors remain satisfied with their market share and continue to leverage substantial margin resulting from these unnecessary costs within the Power NI maximum tariff, i.e. the “price to beat”. The option of moving to a ‘petrol pump’ model where tariffs change frequently in line with underlying market prices is not in the interests of customers but can not be discounted in the absence of the more generally used risk management options.

### **Regional Market Integration**

ACER recently published its Framework Guidelines on Capacity Allocation and Congestion Management (CACM) for Electricity<sup>5</sup>. These Guidelines require the implementation of CACM by 2014, with a potential derogation for the SEM until 2016 provided such derogation guarantees a reasonable degree of integration with the markets in adjacent jurisdictions and is justified on the basis of a cost benefit analysis.

The advent of the Regional Electricity Market (REM) will introduce further competitive challenges for all market participants in the all-islands (United Kingdom and Ireland) market but particularly for those suppliers that operate under a separated business model. It will be absolutely essential that all suppliers in Northern Ireland and RoI have optimal risk management capabilities established, based on best practice, significantly in advance of REM, in order that they can be best positioned to compete with those major international utilities who will be their competitors in an all-islands market and the wider REM. ESB considers that retention of the form of regulation proposed by UReg (maximum tariff) for any significant period will not be in the best interests of Power NI or customers.

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<sup>5</sup> FG-2011-E-002 29<sup>th</sup> July 2011

## **Utility Regulator's Proposals**

ESB supports the Utility Regulator's view that the emergence of energy supply competition should lead to reduced prices and that customers should benefit from its introduction or at least be no worse off subsequent to its emergence.

Recognising that supplier entry and tariff offerings in the domestic and SSME sectors are relatively recent events, ESB considers that UR proposals in terms of a regulated maximum tariff for Power NI and the implementation of customer protection measures to be a pragmatic approach at this stage in the development of the market.

While continued regulation of Power NI cost base can result in some benefits for customers, the cost of wholesale power will remain the main driver of end-user prices and the maximum tariff for Northern Ireland. The ability of a supplier to purchase fixed-price power at the optimum time, to align these power purchases in combination with its own affiliate generation reflecting its changing customer demand profile is what distinguishes one supplier from another in the market and provides a basis for lower prices to customers. In ESB's view, the procurement of wholesale power is not something that lends itself to being readily regulated, in terms of its timing and volumes, while still allowing for differentiation between suppliers. As a result, ESB believes that it will prove challenging for UReg to structure maximum tariffs such that they aren't so low so as to discourage supplier entry, or too high so as to have negative consequences for customers.

With respect to the regulated maximum tariff, ESB agrees that it must be fixed at an efficient level below which all suppliers' prices must be set in order to be competitive. However, the maximum tariff must be set at a level that provides sufficient margin for suppliers to encourage entry into the Northern Ireland market and cover their costs of entry including resource, process and IT systems costs. This is particularly important for ESB Electric Ireland, itself a stand-alone supplier, which has recently announced its intention to enter the Northern Ireland domestic market on a trial basis during 2012. For ESB Electric Ireland which is in a position where it cannot adopt best practice to optimise its market risk positions, the regulated maximum tariff, set at a benchmark level that allows some margin, will support that market entry business case, albeit that ESB Electric Ireland's competitiveness under such a continued scenario will be challenged over time.

On the other hand, the maximum tariff must be set at a level that forces efficiency across all aspects of the supply business and incentivises suppliers to utilise best practices so as to minimise all costs, in particular wholesale power costs which are the primary driver of end user tariffs. In the absence of such efficiencies being enabled and encouraged, customer welfare may be compromised. ESB is of the view that over time, market dynamics will give rise to efficiency in retail market prices in the best interests of customers.

ESB believes that those integrated suppliers, who can optimise their wholesale market risk positions through a combination of fixed-price power contracts and internal hedging against their own generation output, will enjoy commercial advantages over those standalone suppliers who rely solely on the contracts market to manage their market risks. ESB is of the view that for competitive forces to emerge to their maximum in the Northern Ireland retail market, all suppliers must be in a position to minimise their own costs so as to compete initially with the regulated "price to beat" and thereafter with all other integrated suppliers. For any supplier who, through regulatory direction, operates a standalone Supply business without the capability to optimise, or part-optimize their wholesale market risk position internally with their affiliate generation, namely Power NI and ESB Electric Ireland, removal of this restriction will enable cost inefficiencies to be driven out of the business and allow for downward pressure on its tariff offerings over time.

While ESB sees the merit in UReg proposals to retain the maximum tariff as a means to prevent other suppliers' tariffs rising above that level, such controls can only have a limited lifespan once real competition emerges. In a situation where Power NI experiences steady customer losses over time, then the viability of its Supply business may come under extreme pressure in terms of its overall costs base against its rapidly declining customer base. A risk management strategy utilising fixed price power contracts alone could result in significant K-Factor under recoveries when customers switch to more competitively priced suppliers and hedge positions and customer demand positions misalign. While tariff reviews outside the normal yearly cycle may limit this K-Factor build up, any resulting upward pressure on incumbent's maximum tariff will provide further profit margin to those other suppliers, some of whom may choose to maximise this revenue stream. ESB is of the view that retention of a regulated maximum tariff for a period of 3 years may prove not to be feasible once switching levels increase and Power NI market share begins to decline at pace. The timeframe for completion of the Harmonisation Project will therefore be a key milestone in the advancement of competition and potentially as a driver for changes to the regulatory approach to energy supply competition in Northern Ireland.

In a market environment of upward movement in wholesale fuel prices where the incumbent supplier is experiencing significant loss of market share and the regulatory machinery continues to incorporate maximum tariff regulation and K-Factor recovery mechanisms, the likely outcome will be upward movement in the regulated maximum tariff. ESB believes that UReg should at this stage consider "sunset" mechanisms to enable transition from the maximum tariff and K-Factor approach as soon as significant competition (i.e. switching) in the domestic and SSME customer segments of the market commences. These transition options must recognise the need for Power NI to optimise its market risk positions in the manner that has least cost consequences for the consumer in Northern Ireland.

### **ESB's Progressive Deregulation Proposal**

ESB has previously provided its proposal for "Progressive Deregulation" to UReg. ESB's proposal will provide benefits for all suppliers in the market and as a consequence will be good for all customers.

ESB proposes a progressive sequence of modifications to the ring fencing provisions throughout its various generation and supply licences that would result in a situation in which ESB's separate Supply and Generation businesses could operate effectively in a manner indistinguishable from its competitors who already operate in such a fashion. This integration will allow cost inefficiencies, brought about by these very separation requirements, to be driven out of ESB's business, thereby further stimulating sustainable competition between all suppliers across the retail markets in Northern Ireland and RoI. These efficiencies will enable ESB prepare for the further competition that will arise subsequent to commissioning of the East-West interconnector in 2012 and thereafter the REM.

ESB's proposal will also enable a greater volume of DC hedges to be offered to all suppliers and will provide guarantees to the market on the overall volume of power-contracts that ESB will auction. ESB's proposal will have lasting benefits for competition and for customers and will also provide for increased regulatory oversight across the contracts' market.

ESB believes that the implementation of its proposals will provide the necessary market environment, within which the current regulatory mechanisms of maximum tariff with K-Factor recovery in Northern Ireland can be transitioned to one that will facilitate full competition while still protecting customers' welfare. As such ESB requests that its progressive deregulation proposal be supported by UReg for approval by the SEM Committee, at the earliest opportunity.

## SUMMARY

UReg proposals to maintain maximum tariff regulation in the domestic and SSME sectors in Northern Ireland is a pragmatic approach at this stage in the development of the market. This will ensure that customer tariffs reflecting Power NI cost-to-serve act as the benchmark for any other supplier to beat. However, it will be necessary that the maximum tariff each year is set at a level that enables supplier entry in Northern Ireland while at the same time not impacting on customer welfare.

The Harmonisation project will facilitate both retail markets in Northern Ireland and RoI co-existing as one practical retail market underpinned by the SEM. Completion of the Harmonisation project will remove barriers to entry into the Northern Ireland retail market and should stimulate increased competition.

ESB believes that it may be prudent for UReg to consider at this time sunset conditions for the maximum tariff regulation approach that will enable transition, in line with the direction being taken across Europe, to full retail competition with customer welfare protection.

ESB is of the view that, following completion of the Harmonisation project, as Power NI market share begins to decline and any misalignment between its hedged position and customer demand arises, Power NI costs will increase. While tariff reviews outside the normal yearly cycle may limit K-Factor build up, any resulting upward pressure on incumbent's maximum tariff over a declining customer base will provide further profit margin to those other suppliers, some of whom may choose to maximise this revenue stream. Over time, Power NI may need to adopt a different approach, to management of market risks on behalf of its customers, than the current regulatory regime provides.

ESB believes that all suppliers should have the capability to purchase fixed-price power at the optimum time and to align these power purchases in combination with their own affiliate generation, while reflecting their changing customer demand profile. This will afford them the capability to best manage market risks on behalf of their customers.

ESB's progressive deregulation proposals allow ESB to reduce its own costs and be more innovative in its tariff design, thereby putting downward pressure on customer tariffs and providing further sustainable competition stimulus across the markets. ESB's proposals will increase contract market liquidity while also providing for increased transparency and regulatory oversight in the contracts market. In an environment of uncertain wholesale fuel costs, where SEM prices and tariffs in the two retail markets are significantly influenced by international markets, ESB's proposals have real benefits for customers in both jurisdictions.

ESB is willing to meet with representatives of UReg to discuss further this response.

## **ELECTRICITY SUPPLY BOARD**

**Fergal Egan**

**REGULATORY AFFAIRS & CORPORATE STRATEGY**

**23<sup>rd</sup> September 2011**