Consultation on the Utility Regulator's Electricity Licence Fee Methodology

Energia Response

26 November 2010

Introduction

Energia welcomes this necessary review of the electricity licence fee methodology. As a leading energy supplier in Northern Ireland and the Republic of Ireland, Energia has given careful consideration to the options put forward, namely:

Option 1 – Refinement of current interim arrangements

Option 2 – Apply CER's methodology

Option 3 – Apply Ofgem's methodology

Option 4 – Continue with the interim arrangements without any change

Energia favours Option 3 to apply Ofgem's methodology. Among other reasons it is our considered view that this strikes the best balance in meeting the relevant considerations identified in the consultation paper.

The remainder of this response provides the detailed basis for favouring Option 3.

Considerations

We refer below to the considerations identified in the consultation paper as relevant for reviewing the licence fee methodology.

i. Cost reflectivity – licence fee charges should reflect the full costs incurred by the Utility Regulator and licencees should bear an appropriate proportion of those costs;
ii. To encourage the active use of licences – reflects the principle that obtaining a licence indicates an intention to use it and assume the responsibilities associated with it;
iii. To be mindful of current industry structure – for example that there is a larger number of small licence holders given the increased focus on renewables and licencable activity created for the SEM
iv. Transparent and understandable – the licence fee methodology should be straightforward to apply and easy to understand; and
v. Harmonisation – in the context of SEM it is desirable, where possible, to avoid any inconsistencies with CER's licence fee methodology.

Energia can understand the basis for most of the above considerations. However, it is important to recognise that harmonisation should not be pursued as a goal in and of itself. Rather we would argue that harmonisation is desirable if it can deliver demonstrable benefits. In the context of a licence fee methodology administered by separate regulatory authorities in their own jurisdictions it is difficult to see how harmonisation per se delivers any real efficiency gains[1]. Energia would argue instead that the aim should be towards best practice and convergence upon this. With that in mind we evaluate below what lessons can be learned from the approaches currently used in the Republic of Ireland (RoI), Northern Ireland (NI), and Great Britain (GB) and conclude based on this that Option 3 is the preferred option.

Lessons learned from the RoI approach

From our experience in the Republic of Ireland we can identify lessons learned from the CER approach as follows:

- It relies on market participants submitting timely and accurate data which reconciles with SEMO and ESB MRSO data in order to bill correct licence fees.
- The burden of administering the scheme is an increasing function of the number of competitive (generation and supply) licences, with no discernable value added to the consumer.
- Quarterly reconciliations can be difficult in the context of the new trading arrangements as it can sometimes take four months after the end of a quarter to receive actual trading data.
- Because it is based upon a Statutory Instrument is it difficult to change and therefore cannot evolve in line with changing market conditions or identified efficiency gaps.

Given the above Energia is hesitant to recommend the CER's approach under Option 2 as a model to follow. We also understand that change to the CER methodology is desirable but difficult to implement because it is embedded in legislation.

Lessons learned from the NI approach

From our experience in Northern Ireland we can identify lessons learned from the interim Utility Regulator approach as follows:

[1] Any potential advantages associated with consistency of approach are superseded by cost reflectivity, transparency, and understandability.

- It is not very transparent in that the licence fee request does not show a full reconciliation from the Utility Regulator's (and more recently CCNI) gross spend as per its corporate plan to the licence fee charged, including the basis for apportioning costs between electricity, gas and water.
- The licence fee applicable to supply licence holders relies upon forecast demand year ahead which is estimated by the Utility Regulator with no input from suppliers. This is then subject to a year end reconciliation based upon actual demand. The problem with this approach is that suppliers have no visibility or control over under / over-recoveries from one year to the next which lacks transparency and creates budgeting difficulties for suppliers. This is a material problem as over / under-recoveries associated with forecasting errors have exceeded 25% in the recent past.
- The interim arrangement is administratively burdensome in a competitive market where the number of suppliers and generators is increasing and individual supplier demand is dynamic and difficult to predict year ahead (or even 6 months ahead).
- It is not conducive to competition because regulated businesses (including the PES supplier) can recover licence fees as part of their regulated entitlement but competitive suppliers cannot, especially given unpredictable and substantial over / under-recoveries and associated reconciliations.

We note that proposed changes to the interim methodology under Option 1 do not satisfactorily address the above weaknesses. For example mid-year licence fee adjustments and an increased de-minimis annual fee will not prevent the need for discrete, substantial and unpredictable over or under-recoveries and will not circumvent the problems with the current methodology in a competitive market. Neither will the proposed revisions address the transparency issues identified above.

Lessons learned from the GB approach

From our understanding of the Ofgem approach we can identify the following lessons to be learned:

- The current methodology has been in existence for over a decade and has been able to evolve as necessary in line with changing market conditions and industry structure.
- It does not rely on the submission of data by market participants and is conducive to a competitive market.

- It is very straightforward to apply and easy to understand. Costs are allocated to monopoly licence holders in a transparent manner (using customer numbers) and this is recovered through network charges in the normal manner.
- Given that the number of suppliers is ever shifting, the fact that only network companies are charged directly is important because this minimises the administrative burden.
- The letter that accompanies each licence fee request shows a full reconciliation from Ofgem gross spend as per its corporate plan to the licence fee charged. This is important for transparency and cost reflectivity.
- Whilst the licence fee process does not actively seek to encourage the use of licences the imposition of a £500 minimum charge should however discourage frivolous applications.
- Ofgem has flexibility through standard licence conditions to charge licence fees to competitive licence holders directly but has not exercised this power to date.

Conclusions

In summary the Ofgem approach is easy to administrate, easy to understand, and is transparent. It has also been tried and tested and is considered to be serving its purpose well with no plans for reform in the foreseeable future. Energia would therefore recommend that key aspects of the Ofgem approach under Option 3 be applied in Northern Ireland.

Namely, that all licence fees are charged to T&D along the lines of the Ofgem model and that the published licence fee request provides greater transparency reconciling the licences fee with NIAUR and CCNI's gross spends as per their corporate plans, including the basis for apportioning costs between electricity, gas and water.

Finally we note NIAUR's desire to promote active use of licences and suggest this could be achieved in conjunction with the Ogem approach by charging all licence holders a nominal fee.