Response by Energia to the Utility Regulator

Consultation on NIE's Payment Security Policy

21 May 2014

1. Introduction

Energia welcomes the opportunity to respond to this Utility Regulator (UR) consultation on NIE's payment security policy. We responded to the NIE consultation on this issue in December 2013. Our views have not changed and we therefore include our previous submission to NIE as an Annex to this response.

The UR consultation states that "[a]ny changes to the Payment Security Policy must look at the overall level of risk, the risk allocation and the balance between the potential risk of bad debt to NIE and cost to the supplier/consumer of providing additional cover".

Against this assessment framework we recommend the status quo of Option 1.

The remainder of this response addresses the questions presented in the consultation paper.

Question 1: What is the realistic security cover shortfall that should be considered when reviewing the current Payment Security Cover policy?

NIE's proposed options for reform are incorrectly referenced against a notional security cover shortfall of approximately £50m. This is inconceivably based on the 3 largest suppliers in Northern Ireland defaulting at the same time and is not based on the increased credit afforded to suppliers specifically as a result of the change to NIE's billing arrangements in May 2012.

Question 2: What is the likelihood of a Supplier/Suppliers defaulting and NIE being unable to recover the debt within 6 months or earlier?

This would be a highly unlikely event based on historical experience and in reality it is hard to envisage a supply company in difficultly not being sold as a going concern as the company value is contained in its customer book. The risk of bad debt is therefore negligible and in the unlikely event of this occurring it can be recovered by NIE over an extended period (akin to that under RP5) thus smoothing out the impact, of what would be a one-off occurrence, on the customer.

Question 3: Do Suppliers consider that the 1% charge is a 'typical rate' for them to provide additional cover?

No. In our opinion this does not reflect current market conditions and we suspect that only suppliers availing of their parent company's investment grade credit rating could hope to secure a letter of credit at such a low rate, if at all, given the significant increase in the cost of debt and debt facilities in recent years.

Question 4: Will an increase in Supplier cover be seen as a barrier to entry to new Suppliers?

Yes. The cost of credit cover is greater for smaller suppliers, new entrants and suppliers without associated ownership of substantial assets thus an increase in supplier credit cover creates a barrier to entry and potentially distorts competition in the market. New or small entrants may find it difficult to obtain LoC facilities at all and may be forced to use cash collateral as security therefore the proposed increases would add an extra burden and provide an increased barrier to entry and/or future growth.

Question 5: Which of NIE's options strikes the best balance between the risk and the cost to the consumer?

Any change to the status quo must be proportionate to the changed circumstances in Northern Ireland and must be in keeping with the existing balance of risk versus cost to the customer as already determined appropriate by the UR. Options 2, 3 or 4 as put forward by NIE do not satisfy these essential criteria and for this and other reasons detailed in our previous submission we do not support them. We conclude that the status quo of Option 1 is the only acceptable option and on balance we remain firmly convinced that no change in payment security cover is in the best interests of Northern Ireland's customers as it strikes the correct balance between cost and risk for customers.

Question 6: Should any other options / risk cost recovery mechanisms be investigated?

The risk of bad debt is negligible. However should it materialise we suggest that NIE could recover any bad debt over an extended period (akin to that under RP5) thus smoothing out the impact, of what would be an unlikely one-off occurrence, on the customer.

Annex 1

Response by Energia to NIE Consultation published 30 October 2013

Proposal to increase payment security cover provided by suppliers under NIE's payment security policy

20 December 2013

2. Introduction

Energia welcomes this opportunity to respond to NIE's consultation paper on payment security cover provided by suppliers under NIE's Payment Security Policy ("**PSP**"). Having carefully considered the consultation paper and the proposals therein Energia cannot reasonably support any of the options for reform put forward by NIE. The status quo of Option 1 is the only acceptable option and we firmly believe that on balance, taking into account the relevant trade-offs, that no change in payment security cover provided by suppliers is in the best interests of Northern Ireland's customers.

However, if the Utility Regulator ("**UR**") considers that a change from the status quo may be worthy of consideration we would strongly suggest that further review, analysis and consultation is necessary. Crucially, any change must be proportionate to the changed circumstances in Northern Ireland since the PSP was last approved by the UR in April 2012 and must be in keeping with the existing balance of risk versus cost to the customer as already determined appropriate by the UR. Options 2, 3 or 4 in the current consultation paper do not satisfy these essential criteria and for this and other reasons we do not support them.

The remainder of this response elaborates on these and other pertinent points.

3. Discussion

NIE's proposal for change is predicated upon the increased credit afforded to suppliers as a result of the change to NIE's billing arrangements in May 2012. It is noted that the existing PSP was approved by the UR on 23 April 2012. The level of security cover set by this, and considered appropriate by the UR, strikes a reasonable balance between the potential cost to the customer associated with bad debt risk and the certain cost to the customer of providing additional security cover. There are also indirect costs to be considered; not least that increasing security cover creates a barrier to entry, especially for smaller suppliers and for those without substantial assets behind them.

If considered appropriate, any deviation from the status quo must therefore be with reference to the increased credit afforded to suppliers as a result of the changed circumstances in Northern Ireland. Furthermore, any change must *continue* to strike the right balance between the potential *risk* of bad debt and the real and certain ongoing cost to the customer of providing additional security cover. Consideration must also be given to the potential for competitive distortion as a result of increased security cover. Finally, it is worth bearing in mind that supply companies are virtually worthless if liquidated. Thus in reality it is very difficult to envisage a supply company in difficultly not being sold as a going concern. The risk of bad debt is therefore negligible and in the unlikely event of this occurring it can be recovered by NIE over an extended period (akin to that under RP5) thus smoothing out the impact, of what would be a one-off occurrence, on the customer.

With the above in mind, we offer a brief non-exhaustive critique of NIE's proposals below. From this, we conclude that the status quo of Option 1 is the only acceptable option and on balance we remain firmly convinced that no change in payment security cover is in the best interests of Northern Ireland's customers.

4. Critique

- NIE's proposed options for reform are incorrectly referenced against a notional security cover shortfall of approximately £50m. This is inconceivably based on the 3 largest suppliers in Northern Ireland defaulting at the same time and is not based on the increased credit afforded to suppliers specifically as a result of the change to NIE's billing arrangements in May 2012.

- It is assumed in assessing the cost of additional credit cover to the customer that 'typical' bank charges of 1% per annum apply in providing a letter of credit. This does not reflect the market reality that only suppliers with an investment grade credit rating could reasonably expect to secure a letter of credit at this very low rate. It will be significantly higher for other suppliers, especially smaller suppliers and those without substantial assets behind them. Thus not only does NIE's analysis significantly underestimate the cost to the customer it also gives no consideration to potential barriers to competition associated with increased credit cover.

- The cursory impact analysis of Options 2, 3, and 4 summarised in the table on page 2 of the consultation paper presents misspecified costs and benefits. It defines the benefits with reference to an identified credit cover shortfall of £50m which is fundamentally flawed for reasons already stated. It then implausibly values this avoided 'bad debt risk' effectively assuming 100% likelihood of default *and* the simultaneous default of multiple suppliers – there is no reasonable assessment of likelihood of default. This is then compared with the cost of increased credit cover assuming that a 1% bank charge applies. This is far too low for a 'typical' rate and to assume that all suppliers are equal with respect to their cost of credit cover is unrealistic and fails to recognise the potential for competitive distortion associated with increased credit cover requirements.

- As well as being misspecified as explained above, the costs and benefits in the impact assessment are depicted as like-for-like when they are not. Assuming for example that the risk of bad debt was adjusted for the likelihood of default (which it is not) it would still not be correct to compare this with the annual cost of increased credit cover unless the likelihood of default was also annualised. Thus for example a likelihood of default of 1% over a period of 10 years would be annualised as 0.1% in any one year.

- Despite its flaws, as summarised above, it is concluded from the impact assessment that "[f]or all options the cost of providing the additional payment security cover is significantly less than the benefit provided by reduced risk to customers". We cannot agree with this conclusion given the assessment it is based on.