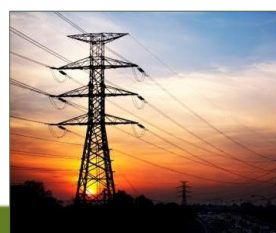


# Review of the Effectiveness of Competition in the Northern Ireland Retail Market – Phase II Regulatory Implications

An Information Paper  
May 2015



# About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

## Our Mission

Value and sustainability in energy and water.

## Our Vision

We will make a difference for consumers by listening, innovating and leading.

## Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

## Abstract

Protecting consumers is at the heart of the Utility Regulator's (UR) role and ensuring there is sufficient competition in the Northern Ireland (NI) energy market is an integral part of our statutory duties. Phase 1 of this review assessed the state of competition in the NI energy markets and highlighted areas which may require intervention. It endorsed the maintenance of price controls on dominant suppliers as an appropriate regulatory response. This second phase of the review will consider the regulatory options for the NI energy supply markets which can replace the status quo should the current form of price regulation cease. We therefore intend to develop and critically analyse a set of options for the NI market which can be used as a regulatory framework in the event that the current form of regulation is changed.

## Audience

Consumers and consumer groups; industry; and statutory bodies.

## Consumer impact

The strategic goal of this project is to ensure that consumers are effectively protected in the NI regulated energy markets. Consumers will see the benefit of a new regulatory framework where competition is not sufficiently effective to adequately protect consumers. The direct consumer impact of this is likely to be on the end user price, if a new form of framework is put in place, as it would replace the current form of end user price regulation on the incumbents.

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## Glossary

CMA	Competition and Markets Authority
GB	Great Britain
I&C	Industrial and Commercial
I-SEM	Integrated Single Electricity Market
NI	Northern Ireland
Ofgem	The Office of Gas and Electricity Markets in Great Britain
REMM	Retail Energy Market Monitoring
SEM	Single Electricity Market
UR	The Northern Ireland Authority for Utility Regulation or the “Utility Regulator”

## Introduction

Protecting consumers is at the heart of the Utility Regulator's (UR) role and we pursue this, where appropriate, through promoting effective competition in the Northern Ireland (NI) energy markets. The UR operates to ensure consumers are adequately protected in these markets through competition alongside regulation if that competition is not deemed effective enough to adequately protect consumers.

During 2014 the UR commissioned Cornwall Energy to review the condition of energy supply competition in NI, the findings of which will be discussed further in the Background section of this paper. The findings of Phase 1 have outlined the context for Phase 2 to be developed.

The UR is now beginning Phase 2 of this project, which will assess the options for a future regulatory framework (potentially including continued price regulation) in a market where competitive forces are limited. Any revised regulatory framework is likely to be implemented *after* a cessation of the prevailing electricity and gas price control regimes which apply to dominant former incumbent suppliers only.

The outcomes of this project will sit alongside other important initiatives the UR will complete this year to ensure, as best we may, that retail energy markets are working to the benefit of consumers now and into the future (such as the commencement of Retail Energy Market Monitoring (REMM) and the Consumer Protection Strategy).

Phase 1 of the UR project assessed the NI energy supply market effectiveness along similar lines as those followed by the UK Competition and Markets Authority (CMA) and Ofgem in their *State of the market assessment*<sup>1</sup>, but recognising significant physical, size and market maturity differences.

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<sup>1</sup> The Competition and Markets Authority, Office of Fair Trading and Ofgem, "*State of the market assessment*", (March 2014), <https://www.ofgem.gov.uk/publications-and-updates/state-market-assessment>

Phase 2 of the project will cover the NI electricity and gas domestic and small I&C retail markets only. The larger end of the I&C energy markets will not be within the scope of Phase 2 as these larger sectors were found on balance to be sufficiently competitive in Phase 1. However we are watchful of the health of competition in all sectors of the market and we intend to monitor these going forward, for example through the REMM project, as well as through liaison with customers, suppliers and consumer bodies.

In parallel the current CMA review of GB energy markets<sup>2</sup> will also complete later this year. In their recent “Updated Issues Statement”<sup>3</sup> the CMA has stated that its focus and concerns are not on the wholesale energy market in GB, but rather the retail sector is where the market may have problems. Initial findings are due to be reported upon in May/June 2015. These may be used to inform any policy the UR develops where their findings are relevant to the NI context.

The purpose of this paper is to formally communicate to stakeholders the commencement of the UR’s “Review of the Effectiveness of Competition in NI Energy Retail Markets Phase 2 – Regulatory Implications” and explain our approach.

More detailed consultation and project development will of course take place later in 2015 and stakeholders will have extensive opportunities to provide feedback as the project develops.

## Background

Since the liberalisation of the energy retail markets in electricity and gas in NI the UR has followed a policy of continuing to price control the former incumbent gas

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<sup>2</sup> <https://www.ofgem.gov.uk/gas/retail-market/market-review-and-reform/state-competition-energy-market-assessment>

<sup>3</sup> <https://www.gov.uk/government/news/energy-market-investigation-updated-issues-statement>

and electricity suppliers who remain dominant in certain market sectors, whilst progressively lowering the threshold for price regulation as competition developed in the larger user end of the markets.

This regime to date has been successful and today domestic and small business customers enjoy both the benefits of competition with a choice of providers, alongside price regulation which ensures that there is a regulated price (which is transparently set) that customers can avail of should the competitive market not provide reasonable offerings. The regulated price allows the dominant suppliers to cover their efficient cost levels, together with a regulated profit allowance. The market has tended to price at a discount to the regulated tariffs and as such they have to a large extent acted as a price to beat or price cap on the market. This model has helped to ensure that the NI market has not encountered the problem of a lack of price transparency which customers and media in the GB market have complained of; and has been welcomed by consumer bodies. The model effectively allows the UR to deliver customer protection whilst also promoting effective competition where possible.

However, in the future this model may no longer be tenable in the context where the incumbent suppliers in both gas and electricity are deemed to be no longer dominant. In that case, it may not be appropriate to retain price controls on these suppliers alone. Therefore, we initiated a review of the market (carried out by Cornwall Energy) to:

- 1) Assess the state of competition in NI presently;
- 2) Inform a project second stage that will examine the options for a continuing regulatory framework if the dominant suppliers' market positions relative to other suppliers change, such that it is no longer appropriate to continue with the current price controls.

The Cornwall Phase 1 report laid out the findings in relation to the state of retail competition in the NI electricity and gas retail markets. The report made a number

of secondary recommendations (e.g. around measures to improve customer switching rates, need for a price comparison website), which will be dealt with separately by the UR outside the scope of this proposed assignment. However the primary findings of the report, which set the context within which we will assess options for future regulation were:

- The NI market has achieved reasonable levels of switching given the context of the market and its maturity.
- The Power NI (former electricity supply incumbent) share of the domestic and small I&C market remains high, with a lot of the pricing strategies of competitors focused on discounting of the Power NI price; gas incumbent market shares remain similarly high.
- There are limited supply players in the energy supply market and it is highly concentrated.
- Given the fundamental lack of scale of the NI market, this is unlikely to change and the number of suppliers in the market is unlikely to materially increase.
- Whilst competition has been reasonably effective up to now, given the structural characteristics of the market and the lack of sufficient critical mass to attract a larger number of suppliers, relying on competition to protect customers is not enough on its own to effectively protect customers. Northern Ireland has only 787,000 domestic electricity customers and 167,000 domestic gas customers in the greater Belfast Area. (NI has less than 3% of the total number of domestic electricity customers in GB and is only 70% the size of the market in greater Manchester).
- Those customers who wish to switch have arguably already done so, and it should not be expected that switching rates will continue as they have up to now.

The report concluded that the requirement for some form of price regulation is likely to continue for the foreseeable future; and that this form of regulation should co-exist with the ongoing development of competition. The Cornwall paper stated *“the NI experience strongly suggests that regulation and competition can successfully co-exist”*.



## Wider context

The NI gas and electricity retail market liberalisation commenced during the last decade. This ongoing programme of work continues to take place within the wider context of European legislation requirements to open energy markets across the continent but also maintain high standards of public service and to ensure the protection of final customers; and the UR domestic statutory duties to protect consumers. Given the importance of the issues under consideration, we have clarified the legal position in relation to maintaining end-user price controls in an EU context.

Following this advice we are clear that promoting effective competition and protecting consumers are both obligations of a national regulator under EU law. There is a duty to achieve each of them. It is for the member state and NRA to decide on the policies which strike the correct balance in achieving both obligations in the context of each particular jurisdiction.

Price regulation is compatible with existing EU law and can be employed by a regulator as a means of protecting customers. Legal precedent supports this. It is therefore for the regulator in the jurisdiction to decide if price regulation is appropriate given the circumstances within that member state.

Against this background, structural reforms to introduce the Single Electricity Market (SEM) have been completed and are now being reviewed to bring the electricity trading arrangements in NI and the Republic of Ireland into line with European rules. The Integrated Single Electricity Market (I-SEM) project is currently underway and will complete in 2016. This will need to be considered in the context of the options developed.

As already discussed in the Introduction section to this paper, the UK Competition and Markets Authority (CMA) will also complete their review of the GB energy market this year. Initial findings are due to be reported upon in May/June 2015.

These may be used to inform any policy the UR develops if they are relevant to the NI context.

## Purpose of Project

The UR is now beginning Phase 2 of this project which will assess the options for a future regulatory framework (potentially including continued price regulation) in a market where competitive forces are limited. Any new regulatory framework is likely to be implemented after any cessation of the prevailing electricity and gas price control regimes.

The UR's control of prices currently remains only on the former incumbent suppliers and this is as a result of their ongoing dominance in the price controlled sectors. This dominance may gradually erode. This could potentially lead to a situation where an incumbent's market position relative to other suppliers changes to a point where they can no longer automatically be deemed to be dominant in the small I&C market or the domestic market or indeed both. Therefore, it may in the future be inappropriate to retain price regulation on only the incumbent suppliers in isolation, as is the situation currently. Given the inherent oligopolistic tendencies of the NI supply markets described in the Phase 1 report, the UR is keen to examine its regulatory options going forward in the medium term.

The current incumbent price controls will be kept under review and will be reassessed when the market conditions are appropriate.

This 'Information Note' constitutes formal external project commencement. The project will include the development of a consultation paper (examining and analysing the relevant choice of options and a high level methodology /implementation model for those options) which is expected to be completed between May and July, followed by review of the consultation responses around October/November, followed by formulation of the final report.

The project analysis will aim to:

- Research other jurisdictions' regulatory frameworks in energy supply markets.
- Identify, develop and critically analyse a set of options for the NI market which can be used as a regulatory framework in the event that the incumbent market

position relative to other suppliers moves to a position where they are no longer dominant.

- Define each of these potential options in detail.
- Undertake stakeholder engagement in the development of these potential options e.g. in the format of structured interviews and/or workshops.
- Develop methodologies for the implementation of the identified options, which will be included in the consultation paper to allow consultees to make an informed consideration of the options.
- Consideration of any outcomes of the ongoing CMA review of the GB energy market, and the potential regulatory impacts/lessons for NI, and if this has an influence on the options which we may consider.
- Consider the legal and regulatory policy implications of all options.
- Consider the factors which will bring about the need for any change in regulatory regime (e.g. relative supplier market shares, switching statistics, new entrants, customer behaviour, number of existing suppliers etc).

There will potentially be proposed stakeholder workshops (one post consultation and one post final report) dependent on interest. At this time we envisage that a final report/decision paper will be issued at the end of 2015.

## Scope of the review

Phase 2 of the review will cover the retail energy markets in both electricity and gas in NI. At present we retain price controls in electricity and gas in both the domestic and small business markets. It may be the case going forward that we have different options for the domestic and small business sectors – we intend to consider this issue as part of the project.

Phase 2 will need to assess the scope of the option analysis and whether it should cover domestic and smaller I&C or domestic only. The CMA review may help in this regard as will the future margin analysis which will form part of the retail market monitoring (REMM) framework.

## Timeline

Date	Milestone
May – July 2015	Analysis and Formulation of Proposals
August 2015	Consultation Paper Issued
September	Stakeholder Workshop (dependant on interest)
November – December 2015	Review of responses and development of final report/decision paper
December 2015	Publication of final report following UR Board approval
January 2016	Post-report workshop