

# Review of the Effectiveness of Competition in the Northern Ireland Retail Market

An Information Paper

July 2014



# 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 duty. The purpose of this review is to establish the basis for assessing the current state of competition and, in turn, highlight areas that may require intervention, further guidance for market participants, monitoring frameworks or relaxation / removal of regulations and retail price controls as the sector opens up. Through collecting and analysing quantitative and qualitative data, we will provide the context for understanding the sentiment of different consumer groups and how these are encouraging or preventing wider market effectiveness.

# Audience

Consumers and consumer groups; industry; and statutory bodies.

# Consumer impact

The direct consumer impact of this phase project is limited as it is an empirical review to assess if energy retail competition in Northern Ireland is effective. Should the assessment require the UR to formulate a new policy or regulatory approach, this will be undertaken in second phase of the project.

# Contents

|   |    |
|---|----|
| Introduction.....                           | 2  |
| Background .....                            | 5  |
| Wider context.....                          | 7  |
| Review .....                                | 8  |
| Defining the NI energy retail markets ..... | 8  |
| Scope of the review .....                   | 11 |
| Weak customer response .....                | 12 |
| Vertical integration .....                  | 12 |
| Barriers to entry and expansion .....       | 13 |
| Weak competition .....                      | 14 |
| Possible tacit coordination .....           | 15 |
| Review of Participants.....                 | 16 |
| Stakeholder briefing event .....            | 16 |
| Timeline .....                              | 17 |

## 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                       |
| QTR   | Quarterly Transparency Report  |
| REMM  | Retail Energy Market Monitoring  |
| RoI   | Republic of Ireland  |
| 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 this is done, 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.

We recently issued an overarching strategy paper<sup>1</sup> setting out our approach to the regulation of energy retail markets in NI. These markets in NI have been developing in recent years, with the arrival of new suppliers in both electricity and gas supply and the opening of new areas for gas supply. Where competition is not sufficiently developed or effective, the UR protects consumers through regulation and this applies to the relevant areas of the electricity supply market as much as to other sectors of the energy industry.

The UR is also responsible for issuing licences for gas and electricity companies to operate in NI. It is our duty to make sure that these companies meet relevant legislation and licence obligations. To fulfil our legislative requirements we closely monitor the retail markets through our Quarterly Transparency Reports (QTRs).

In the UR 2014-15 Forward Work Programme, we announced that a significant and strategically important project planned for this year is **to conduct a review of the effectiveness of competition in the retail energy markets in Northern Ireland**. The project will provide a basis for assessing the effectiveness of retail competition and the implications for our statutory duties. This will help to inform the development of a new regulatory framework, if appropriate, that is specifically designed in light of the findings to adequately protect consumers.

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<sup>1</sup> UR, "Strategic Approach to Energy Retail Markets and Consumer Protection: An Information Paper", (May 2014), [http://www.uregni.gov.uk/uploads/publications/Strategic\\_Overarch\\_Paper.pdf](http://www.uregni.gov.uk/uploads/publications/Strategic_Overarch_Paper.pdf)

There will be two distinct stages to this project:

1. The first is to undertake a formal review of the effectiveness of retail competition in our energy markets, and the factors which might limit that competition. It will consider the information requirements necessary to monitor the effectiveness of competition (and feed these back into the Retail Energy Market Monitoring (REMM) framework going forward to allow ongoing review); and
2. In light of the findings of phase one of the project, phase two is to define the appropriate UR policy response and regulatory framework to deal with the issues identified and assess if there is any change required to the current regulatory regime. This regulatory policy review will be dependent upon the outcome of Phase 1 and will look at a wide range of regulatory mechanisms (price controls, consumer protection licence conditions, requirements from the regulatory framework in different market sectors).

The review will sit alongside other important initiatives the UR will complete this year to ensure that retail energy markets are working to the benefit of consumers now and into the future.

The review will be of NI electricity and gas retail markets and will be conducted at the same time as a review by the UK Competition and Markets Authority (CMA) of GB energy markets. The review of the GB energy markets is being undertaken following a recommendation by the GB energy regulator, Ofgem, in response to growing concerns that wholesale and retail markets in GB are not working in the best interests of consumers.<sup>2</sup>

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<sup>2</sup> Ofgem, "Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain", (June 2014), <https://www.ofgem.gov.uk/publications-and-updates/decision-make-market-investigation-reference-respect-supply-and-acquisition-energy-great-britain>

The UR committed to undertaking this review of NI retail market effectiveness prior to the request by Ofgem for the CMA to review GB energy markets. However, there are synergies and potential lessons that could be learnt from the more mature GB retail markets. The UR will assess market effectiveness along similar lines as those followed by the CMA and Ofgem in their *State of the market assessment*<sup>3</sup>, but recognising significant physical, size and market maturity differences.

The review will establish the basis for assessing the current state of competition and, in turn, highlight areas that may require continued or greater regulatory intervention, further guidance for market participants, monitoring frameworks or relaxation/ removal of regulations and retail price controls as the sector opens up.

The purpose of this paper is to formally commence the first phase of the UR's review of the effectiveness of competition in NI energy retail markets, explain our approach and how individual projects we have identified as priorities in our 2014-15 Forward Work Programme combine to deliver our strategy on consumer protection and retail market regulation. More detailed consultation and project development will of course take place within each of the identified individual projects, and stakeholders will have extensive opportunities to provide feedback as each of the projects develops.

At the end of the first phase of this project, we will publish a report on our findings. As will be demonstrated in the following sections, this assessment is largely an empirical analysis of well-established market assessment criteria. This report will form the basis for the second phase in the project; the appropriate regulatory response. The second phase will be extensively consulted upon.

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<sup>3</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>

## Background

Electricity retail markets were initially opened for large non-domestic consumers in 2002, with the smaller non-domestic market being opened over the following couple of years. In 2007, the domestic market was opened to competition but it was a further three years before the first new entrant entered into the NI market.

Power NI is the former incumbent electricity supplier and is still demonstrably the largest supplier to domestic and small business customers. Domestic electricity customers and smaller non-domestic industrial and commercial (I&C) customers are protected by a regulated tariff control which is set out in Power NI's supply licence. I&C customers above this threshold, and customers of other electricity suppliers in NI, are currently not covered by the UR's supply price control regime.

Natural gas was introduced to NI in 1996 and there are now around 185,000 households and 12,000 businesses with a gas supply (including power generators), compared to 80,000 in 2004. The gas distribution network in NI is currently divided into two distinct areas:

- the Greater Belfast area was opened to supply competition in 2007; Phoenix Natural Gas is the distribution network owner; and
- the "Ten Towns" area, which encompasses the major towns outside Belfast, was opened to supply competition for I&C customers on 1 October 2012. The smaller business and domestic market in this area will not open to competition until April 2015. Until then all customers in this market will be supplied by Firmus Energy, an integrated supply and distribution network business. There is also a major project to deliver gas in the future to consumers in the west of NI.

In Greater Belfast, SSE Airtricity (following the purchase of Phoenix Supply Ltd) is the former incumbent supplier. Domestic and smaller non-domestic I&C



customers of SSE Airtricity are protected by a maximum average price approved by the UR as set out in its supply licence. I&C customers using above this threshold, and customers of other gas suppliers in the Greater Belfast area, are not covered by UR's supply price control regime.

In the Ten Towns area the incumbent (Firmus Energy) is the sole supplier for domestic and small business consumers. The costs of the incumbent are controlled through a price control.

At the end of March 2014 the NI electricity markets comprised:

- 784,057 domestic electricity customers;
- 60,355 non-domestic electricity customers;
- four active domestic electricity suppliers; and
- eight active non-domestic electricity suppliers.

In addition:

- Power NI (the ex-incumbent electricity supplier) held 73% domestic market share and 50% non-domestic market share by meter point;
- domestic electricity prices were around the EU-15 median, but generally slightly above GB prices; and
- non-domestic (particularly larger I&C) face higher than the EU-15 median electricity costs;

Also at the end of March 2014 the NI gas markets comprised:

- the Greater Belfast area had 165,429 domestic and small business gas customers and 3,189 large non-domestic customers; and
- two active domestic and four non-domestic gas suppliers in the Greater Belfast area.

In addition:

- SSE Airtricity (the ex-incumbent) held 72% domestic market share and 67% non-domestic market share (by connection points) in the Greater Belfast area;
- the Ten Towns area had 20,273 domestic gas customers and 2,163 non-domestic customers;
- there is one active domestic (Firmus) and two non-domestic gas suppliers in the Ten Towns area;
- Firmus (the sole domestic supplier) holds 92% of the large non-domestic market (by connection points) in the Ten Towns area; and
- all NI domestic gas prices are the lowest in the EU-15.

### Wider context

The NI gas and electricity retail market liberalisation commenced during the last decade. The programme of work continues to take place against the wider context of European legislation to open energy markets across the continent and the UK domestic statutory duties to protect consumers.

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 has only just commenced and will not be completed until 2016, but depending on the final design will have implications for the retail market.

Furthermore evidence from other competitive energy markets, including data on consumer engagement, shows regulators and policy makers should be concerned with delivering effective markets and effective regulation as competitive pressures alone may be insufficient to ensure optimal consumer welfare.

## Review

In the first instance, it is necessary to define the NI retail markets to allow us to segment the sectors by customer grouping so that findings and conclusions can be appropriately targeted.

To assess market effectiveness the review will gather quantitative and qualitative evidence across five key market characteristics. These are explained below in more detail but have been selected as they are well understood indicators of features of imperfect markets. They are consistent with the established criteria that were used in the GB *State of the market assessment* and are appropriate for this review. However, it must be undertaken in the context of the specific characteristics of the NI market place.

This review will not assess the Ten Towns gas market area as the market will not open to retail competition for household and smaller I&C customers until April 2015.

### Defining the NI energy retail markets

In some regards the generality of energy consumers will want the same outcomes from the market. These can be loosely defined as having fair access to safe, sustainable and secure supplies at a reasonable price with sufficient information to make informed choices regarding their consumption and tariff/ contract renewal options.

Specific groups of consumers though have differing needs and desires regarding the quality, quantity and ability to pay for their energy. This in turn will drive how they choose to interact with the retail market (or choose not to as the case may

be) and motivate competing retailers to innovate around service, price or products.

It is essential to define the retail markets by customer grouping, as although the product being sold is homogenous the customer base is not. Successful retailers across all markets will differentiate their potential market in terms of where profits, opportunities and threats lie—regulators must also do the same to understand where consumers may be disadvantaged and if regulatory intervention is necessary or proportionate.

We set out below in Table 1 and 2 the planned segmentation of the NI energy retail markets by consumer grouping. These categories are split by access to fuel for the domestic retail market and by consumption levels in the I&C markets.

As well as domestic customers having access to regulated tariffs, regulated tariffs provided by the gas and electricity incumbents are in place for smaller I&C customers, with customers having choice between these and new entrant offers. Above defined consumption thresholds prices are not regulated. The review will assess market effectiveness for larger I&C customers where no price regulation exists and for those where regulated tariffs are in place.

Within the smaller I&C market the large majority of customers have relatively low consumption levels. Given the characteristics of these “micro” I&C consumers and as the NI economy features many smaller businesses, the review will further segment I&C markets where regulated prices exist to include a category for low consuming businesses.

**Table 1. Consumer segmentation—electricity**

| Customer category         | Definition   | Rationale   |
|---------------------------|--|---|
| <b>Household</b>          | A household in Northern Ireland.   | In an effective market consumers should seek out tariffs that meet their requirements and by their choice drive supplier service levels, maintain competitive pressure on prices and drive innovation.  |
| <b>Very small I&amp;C</b> | Any business that has an annual consumption below 20MWh/yr.                | Around 64% of the I&C electricity market comprises businesses that fall within this consumption band. The review will assess the competitiveness of this sector of the economy. Power NI customers have a regulated price.  |
| <b>Small I&amp;C</b>      | Any business that has an annual consumption between 20MWh/yr and 50MWh/yr. | Around 19% of the I&C electricity market comprises businesses that fall within this consumption band. The review will assess the competitiveness of this sector of the economy. Power NI customers have a regulated price.  |
| <b>Larger I&amp;C</b>     | Any business that has an annual consumption above 50MWh/yr.                | Larger businesses are generally more knowledgeable purchasers and provide intelligence on market effectiveness, such as wholesale markets, policy and network access before issues filters down to the mass market. I&C businesses are often deemed important to the wider economy and may compete internationally. |

**Table 2. Consumer segmentation—gas**

| Customer category         | Definition  | Rationale  |
|---------------------------|---|--|
| <b>Household</b>          | A household in the “Greater Belfast” gas market area. | In an effective market consumers should seek out tariffs that meet their requirements and by their choice drive supplier service levels, maintain competitive pressure on prices and drive innovation.<br><br>Where households have access to gas they should benefit from a less expensive and lower carbon intensive fuel for heating. |
| <b>Very small I&amp;C</b> | Any business that has an annual consumption below     | Around 57% of the I&C gas market comprises businesses that fall within this consumption band. The review will assess the competitiveness of this sector of the economy.  |

|                       |   |  |
|-----------------------|---|--|
|                       | 73.2MWh <sup>4</sup> /yr.   | SSE Airtricity customers have a regulated maximum average price.   |
| <b>Small I&amp;C</b>  | Any business that has an annual consumption between 72.3MWh/yr and 732MWh/yr <sup>5</sup> . | Around 36% of the I&C gas market comprises businesses that fall within this consumption band. The review will assess the competitiveness of this sector of the economy. SSE Airtricity customers have a regulated maximum average price.   |
| <b>Larger I&amp;C</b> | Any business that has an annual consumption above 732MWh/yr.                                | Very large consumers are generally expert purchasers and provide intelligence on market effectiveness, such as wholesale markets, policy and network access before issues filters down to the mass market. I&C businesses are often deemed important to the wider economy and may compete internationally. |

### Scope of the review

To assess the effectiveness of NI markets the review will focus on the following five characteristics that will highlight a) if the market is not working in the best interests of consumers, b) structural reasons that may be preventing the most efficient outcomes and c) evidence for phase two of the project to determine the appropriate UR policy response and regulatory framework to deal with any issues identified.

We will gather a combination of quantitative and qualitative data and seek the views of existing NI market participants, consumer representatives, third-sector organisations and, through structured interviews, the opinions of participants in neighbouring markets (the Republic of Ireland and GB).

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<sup>4</sup> 2,500 therms/yr

<sup>5</sup> 25,000 therms/yr

### **Weak customer response**

As an immature market, many customers have only relatively recently had the opportunity to choose their gas (in Greater Belfast) and electricity provider. Where consumers have access to clear information about the price and product being offered by competing suppliers, and processes to enable switching are effective and rapid, it should result in consumer actions placing competitive pressure on market participants to not only keep prices as low as possible but also to improve service levels.

A key aspect to understand customer response is to quantify switching levels, reasons for changing provider, and why some customers do not engage in the market. Customer attitudes to switching will be assessed primarily through an omnibus survey targeting consumer opinion on pricing, switching, ease of comparing offers and tariff availability. Switching levels and trends in customer switching levels and complaints data will give valuable insight into the strength or weakness of customer response to the market.

There may also be other reasons for low consumer engagement, such as knowledge of the competitive market, incumbent-supplier advantages with the former monopoly suppliers, the limited number of active competitors, a lack of trust (including in the processes that enable the market), or circumstances specific to the consumer that prevent effective participation.

### **Vertical integration**

It is a feature of many gas and electricity markets for companies to integrate retail (supply) and production (generation) functions as a means to reduce costs and better manage risks. For example, a generation company that owns a retail business has a direct route to market for their output and can use their customer

base as a financial hedge against volatile wholesale energy prices. The reduction of risk can translate into lower costs to consumers.

Where companies order themselves into a vertically integrated structure it could be to the detriment of the market due to:

- a reduction in wholesale trading activity across the market that reduces liquidity and results in other suppliers struggling to access the products they need to meet their customers' needs;
- vertically integrated suppliers are likely to have stronger credit ratings, allowing them to post lower levels of collateral than single-sided smaller new entrants;
- a lack of transparency on the "transfer price" between the upstream and downstream businesses that can lead to perceptions that customers are not getting a fair deal; and
- if prevalent across the market it frustrates retail competition by making it more difficult for new entrants (without an upstream presence) to grow and compete on a fair basis.

We will determine if the current market design incentivises market participants to vertically integrate. This is an important question in NI given where the market liberalisation programme is, and reform to electricity wholesale arrangements (I-SEM). We will assess if vertical integration is a cause for concern for current and potential new entrants.

The review will also look at supplier's upstream positions to determine the impact it has on pricing (including timings of price changes) and the ability for non-vertically integrated players to compete fairly.

### **Barriers to entry and expansion**

As the retail markets are open to competition in NI it is essential to understand any factors that prevent or unduly hinder new companies entering the market.



Determining barriers to entry is an important topic for the NI energy market due to its size and contestability.

Issues may include the market entry process (such as cost and complexity), whether new entrants are confident they can access wholesale markets to offer competitive retail tariffs, credit and collateral arrangements, and real (or perceived) contestability opportunities where large numbers of consumers are not already engaged in the market.

Although outside the direct control of the UR, it may be that prospective new entrants are deterred by policy uncertainty or the state of the wider economy. We will assess this primarily through structured interviews with active participants in the market, as well as those who have chosen not to participate or have withdrawn.

### **Weak competition**

A market where a large proportion of customers do not actively engage can lead to weak competitive pressures being exerted on existing suppliers. In such a situation, low levels of competition can result in suppliers taking advantage of those customers that do not, or are unlikely to switch (sometimes referred to as “sticky” customers) by charging them higher prices for their energy and using the additional revenue to undercut new entrants (who are without “sticky customers”) offers.

This is important in NI where competition in the household market in particular is dominated by ex-incumbent suppliers. With price controls still in effect, we will determine the current health of competition in NI through analysis of energy companies’ current tariff offerings, as well as how this has changed over time. Depending on how the NI retail market develops, it may also be the case that a dual fuel market emerges, which can deliver real benefits to those consumers that

have access to both gas and electricity, but could be to the detriment of single fuel customers that may be deemed to be less attractive to compete for.

### **Possible tacit coordination**

Where competitive pressures (for whatever reasons) are not sufficiently strong it can lead to a situation where suppliers operate in a manner that benefits all parties without any actual agreement (which would be illegal).

For example, suppliers may not pass on cost reductions in final prices to customers where there is a belief that others will act in the same manner, as to do so could result in more vigorous competition between suppliers and erode gains.

This behaviour is possible where competitors have good knowledge of costs faced by all in the market, and when they are likely to change. Aside from creating consumer detriment due to prices being higher than they otherwise would be in a heavily competed market, it may further decrease consumer engagement as it could lead to the perception that market participants are “all the same” and there is little to be gained from switching.

It may also be the case that tacit coordination can result in higher profits for companies due to suppressed competitive pressure from a new entrant acting as a disruptor to the market and reduce the likelihood that existing players will “break from the pack” due to the increased risk that operating differently could reduce their profitability.

Many of the new entrant suppliers in the NI market currently move their prices in response to adjustments to regulated prices. The review will assess current pricing trends (such as timing of price changes, product types and availability) and the prevalence of tacit coordination among suppliers by analysing the behaviour of

energy companies over time, looking at various factors including timing of price movements and product availability.

### **Review of Participants**

An important part of the review will be to undertake structured interviews with key stakeholders to garner their views and experience of NI retail markets. This will allow us seek views from across the sector on the issues set out above and for stakeholders to highlight to us how they see the market developing and the implication for the role of the UR. The following is not an exhaustive list, but it is our intention to seek structured interviews with the following stakeholders:

- suppliers active in NI;
- suppliers active in the Republic of Ireland and GB that are not active in NI;
- prospective new entrants (where we can identify any);
- large industrial users;
- public sector users (possibly via group purchasing entities);
- business representatives;
- third-sector entities advocating on behalf of vulnerable households; and
- the NI Consumer Council.

### **Stakeholder briefing event**

Another key element of the review will be to invite stakeholders to a briefing event which will be held at the UR offices from 11.00 to 13.00 on Wednesday 6<sup>th</sup> August. This will be an opportunity for us to provide more detail on how we will conduct the review and answer stakeholder questions.

If you would like to register your interest in attending this event, please contact Robert Stewart ([robert.stewart@uregni.gov.uk](mailto:robert.stewart@uregni.gov.uk)) by Thursday 31<sup>st</sup> July.

## Timeline

| Date                   | Milestone  |
|------------------------|--|
| July                   | Commence stakeholder engagement (structured interviews)  |
| August 6 <sup>th</sup> | Stakeholder briefing event                               |
| August                 | Commence assimilation of interviews and analysis of data |
| September              | Analysis, review and drafting of findings                |
| October                | Publication of final report                              |
| Late-October           | Post-report workshop                                     |
| November               | Commencement of the 'second phase' of the review         |