NIAUR's Consultation on Electricity and Gas Retail Market Competition in Northern Ireland

NIE Energy Supply's Response

16 July 2008

Summary

It is NIE Energy Supply's view that the most significant barriers to the development of competition within the electricity retail market in Northern Ireland are; the low retail margin that currently exists, the difficulty in obtaining appropriate hedges against the SEM pool price, general contract market liquidity and limited market size.

- NIE Energy Supply's regulated gross retail margin is low, forecast at 5.5% for 2008/09. This is the result of both the efficiency of NIE Energy Supply business and the current pass-through price control, with a "k" correction factor which is designed to reduce risk for NIE Energy Supply. This level of gross margin, in all probability, is too low to attract new entrants and/or promote substantial increases in competition.

- It is fundamental in any electricity retail market for electricity suppliers to secure stability in their generation cost portfolio. The natural way of achieving this is through vertical integration. In the context of the retail electricity markets in Ireland generally, both the current restrictions on incumbents securing generation cost stability from a level of vertical integration and the unavailability of suitable hedges against the SEM pool price, particularly peak cover, present significant problems. A number of factors have led to the shortage of suitable hedges, including; a rigid annual directed and non-directed contract market, cautious under stating of hedging volumes versus legacy production capability, basic and inflexible annual products, and distortions from renewable support mechanisms. Notwithstanding the developing vertical integration within the non-regulated sector of the electricity market in Ireland, it has been estimated that the market is undercontracted by as much as c.15%.

  Not only is the contract market predominantly annual, but mainly as a result of regulatory requirements, it has a fixed seasonal profile (ie tariff

year cycle – October to September). The contract market currently is incompatible with many non-domestic customers in Northern Ireland, who prefer to operate on a financial year cycle.

- Improving contract market liquidity is important and we assume that NIAUR along with CER will address the issue in more detail in future consultations. The lack of liquidity in the current SEM contract market is a significant problem and needs to be considered in a structured and thorough manner. Improvements are more likely to stem from more flexible regulatory frameworks.

- The limited size of the Northern Ireland electricity retail market, along with low gas penetration, makes it less attractive for new entrants. This context also limits opportunities to achieve supply-side economies. Indeed, the all Island market only represents approximately 10% of the GB market – which is a market that only has six significant energy retailers active. It is, therefore, unrealistic to see the all island market attracting more suppliers than GB.

NIE Energy Supply concludes that in order to produce conditions that would be more conducive to supporting competitive supplier entry, two key strategies need to be considered-

Reduced scope in current price control – As NIE Energy Supply only accounts for c.30% of the non-domestic market it therefore makes sense for this sector of the market to be deregulated during 2009. The removal of price control and the associated "k" correction from this sector of the market would require higher supplier margins, however, this added risk premium should be more than off-set by increased competition in the wholesale market (delivering lower wholesale prices), that in turn supports increased competition and customer choice.

Increased and more diverse range of hedging products – Customers' and suppliers' hedging needs (ie timing, term and shape) should have much more

of a bearing in the design of any regulatory hedging frameworks going forward. The two key sellers of contracts, ESB PG and PPB, should be further incentivised to; maximise the volumes of hedges that they make available to the market, consider more flexible and active selling channels and increase the range of hedging products offered to the market.

These are not mutually exclusive strategies, as the availability of more sophisticated hedges would be an essential requirement for NIE Energy Supply to manage risk to a reasonable level, in the context of partial deregulation and the associated removal of “k” correction.

General Comments

As regards the (mainly electricity) options discussed in the paper:

- NIE Energy Supply agrees that synchronisation of retail market processes is worth pursuing but the value is likely to be limited except where the markets can be commercially related. Moreover, the timetable of electricity markets is already significantly influenced by regulation. It would be unfortunate if further regulatory restriction of this or other markets were introduced, just to facilitate synchronisation.

- It is agreed that information on projections of other key wholesale elements (ie UoS, levies, market operator charges) would assist in developing a more competitive landscape. However, NIE Energy Supply does not believe that there is a transparency issue in the supply price control, but support reduction in its scope where customers are protected by competition.

- Redefinition of a shallow retail business by moving more activities to distribution, or a common services model, reduces or even removes the scope for competition in those activities. It is not clear what further opportunities for removal of supplier activities (in addition to meter reading) that NIAUR has in mind. However, it is acknowledged that the common services option needs to exist in the formative years of developing a more competitive market, though it should not necessarily be mandatory.

- NIE Energy Supply agrees that divestment or market share reduction in the context of Northern Ireland would be likely to lose economies of scale and raise prices.

- NIE Energy Supply believes there would be advantages in an increase in gas connections but think that further analysis may be needed. It would be sensible also to consider the permitted gas retail margin.

- It is disappointing that on page 18 of the consultation paper that NIAUR felt it necessary to comment in the manner that they did, regarding the independency of NIE Energy ie *" there are several active players in the industrial electricity market. While it may be debated whether one is truly independent of NIEE, given the same overall parent ownership".*

  NIE Energy Supply strongly refutes this statement, particularly in the context of the rigorous and detailed work that has been undertaken with NIAUR regarding the ring-fencing of the respective businesses within the Viridian Group and related compliance arrangements.

Responses to Specific Questions

Q1. Do respondents agree with our overall summary of NI energy retail market competitiveness and do you feel we have missed anything of significance that should have been noted at this stage?

NIE Energy Supply agrees that, while there is significant competition in the LEU and SME sectors of the market in Northern Ireland, there is at present little in the domestic market. However, the latter is not surprising since the domestic market only effectively fully opened for retail competition on 1 November 2007.

Retail competition has been permitted in Northern Ireland since 1992 but has not been feasible in practice for smaller customers until November 2007, when they were able to settle on the basis of load profiles rather than metered half-hourly amounts.

There was limited opportunity for retail competition even for larger customers until 1999 when suppliers had access to sources of generation other than the Bulk Supply Tariff used for supply by NIE Supply. The supply margin alone did not provide much headroom for competitive entry.

In GB, dual fuel was a major driver for customer switching with suppliers able to make competitive offerings. In Northern Ireland, natural gas accounts for c.15% of the domestic heating market and consequently dual fuel is less likely to be a stimulus for the development of competition.

Q2. Are there additional indicators of the current state of competition in the retail markets that we should be considering?

Market shares and customer switching rates are the obvious indicators. However, it is not clear that it is appropriate to consider these indicators only for the NI market in isolation. Some qualitative research may also be useful, from time to time, to augment the regular quantitative analysis.

Q3. Do respondents agree that the analysis has identified the major potential barriers to competition in the domestic and non-domestic electricity markets or are there additional barriers that you feel we should take into consideration?

The list of barriers cited seems comprehensive. However, some are much more important than others. The three most important are the low retail margin, the difficulty of obtaining hedges against the SEM pool price and contract market liquidity.

Retail margin

The gross retail margin in Northern Ireland is low. NIE Energy Supply's gross margin is around 5.5%[1] but those in the competitive GB market appear to be much higher. In the 1999 price control review Ofgem reported supply business costs and margins in 1998/99 as accounting for about 13 per cent of a typical domestic customer's annual bill or 17% after Ofgem's transfer of costs from PESs' distribution to supply businesses.

There seems to have been further increases in margins in GB after 2000. In April 2004 Ofgem published a review of the residential electricity retail market, which included an analysis of prices. It found that the gross supply margin (including costs) was 26% in electricity but only 13% in gas. Other analysis concluded that an entrant could expect to earn an 8%[2] net margin on a standard credit customer and a 16% net margin on a direct debit customer. However, gas margins were much lower. Any snapshot of this kind is of limited value because margins have been fluctuating by large amounts as wholesale electricity generation prices have moved much more than retail prices. Nevertheless, NI margins appear to be low compared to those in GB since the introduction of retail competition.

One reason that the NIE Energy Supply margin can be low is that its price control has a correction factor (K factor). A pass-through control with a

[1] Forecast for 2008/09 tariff year
[2] Current price control governing NIE Energy Supply has a target net margin of 1.8%

correction factor allows an incumbent supplier to reduce its risk. Whereas a non-regulated supplier has to operate a pricing system with a margin that is sufficiently high to cover its cost risk because it will be unable to recoup any losses by setting future tariffs above the market price.

An incumbent supplier subject to pass-through price control can do that and so it might be viewed as an advantage. However, this issue can only be addressed by raising the retail margin and so, in the short term at least, potentially increasing final prices. However, it is reasonable to conclude that this would only be a short term impact, as any additional risk premium is likely to be more than off-set by a more liquid and competitive wholesale market.

There would be difficulty in enforcing a pass-through price control without a k factor. However, the scope of the pass-through control, with “k” correction, could be reduced where customers are protected by competition and where separate costs of supply can be identified reasonably. This outcome could be achieved by the phased deregulation of tariffs - eg within the non-domestic sector initially.

Though, if the current form of price control was carried forward for the domestic market, it would continue to produce a regulated retail margin that is too low for substantial competitive entry to be stimulated. The continued existence of the k-factor would permit the margin to be that low but it is not an important feature independently of that point with the exception that, in years after an over-recovery, NIE Energy Supply can be compelled to price below the market price.

Therefore, in general, regulated gross margins would need to increase to facilitate greater competition and ultimately the phasing out of tariff regulation over time. This margin increase would be justified alone on the basis of the greater retail risk arising from sharp increases in wholesale prices. This risk is not recognised within the current price control formulation.

Availability of Hedges and Liquidity

A significant feature of the current SEM is the general availability of hedging cover, particularly peak cover. NIE Energy Supply itself is not fully covered at peak, despite engaging in all auction processes during the main contracting periods. Generators appear unwilling to write contracts for all their plant because of the risk of exposure in the event of breakdown.

The growing numbers of renewable generators, who are protected by the ROC support mechanism or similar arrangements in RoI, appear to be particularly unwilling to offer contracts and this presents an increasing problem. The SEM itself is the hedging mechanism at peak. Nevertheless, large portfolio generators with substantial reserve plant should be willing to write at least one-way options and the authorities might usefully enquire into ESB PG's readiness to do so.

A further problem for independent suppliers in the retail market is that the contract market is predominantly an annual one. Domestic customers are not likely to want to switch every year and retailers will want some stability in their generation cost portfolio. This might be obtained through contracts, if such markets were to develop, but is more likely to occur ultimately through a level of vertical integration. It is unusual for an electricity supply business to stand alone as a separate entity. Generators and suppliers can (and do) trade shorter term (say one year) contracts but a hedged portfolio needs to cover a much longer period. It is often easier for upstream and downstream businesses to hedge their opposite market risks through integration rather than through longer term contracts, which are difficult to design to cover all the possible eventualities. Indeed, vertical integration has often been the preferred strategy of choice in other markets.

Not only is the contract market predominantly annual but, mainly as a result of regulatory requirements, it has a fixed seasonal profile. This has proved inconvenient for industrial customers operating on a different profile but suppliers find it difficult to offer the annual contract they prefer (or longer

contracts) because they cannot obtain the appropriate contracts for differences. The annual structure of transmission and distribution charges and of the PSO levy (together with uncertainty over their values in future years) provide further barriers.

Other factors

We consider the other barriers identified to be second order considerations although some improvements may be possible.

- Transparency of charging methodology: NIE Energy Supply's charging methodology is set out in its Tariff Methodology Statement. Similarly the principles underpinning its hedging strategy are set out in its Hedging Policy Statement. These make the process transparent. They do not enable competitors precisely to predict all NIE Energy Supply's tariffs, but that is an unreasonable expectation. Indeed NIE Energy Supply itself would not be able to do so before the hedging process has been completed.
- Prepayment customers: This sector has not seen much competition in GB. Clearly access to the keypad system is required for entry, and this is available to suppliers. Northern Ireland prepayment charges are low relative to those in GB and, although this is in large part due to the superior "keypad" meter and prepayment infrastructure used in Northern Ireland. We do not believe NIE Energy Supply has any scale advantages with respect to contracts with payment agents (ie Paypoint and Payzone). Indeed in the context of domestic suppliers in the UK and Ireland, NIE Energy Supply would have one of the lowest levels of payment transactions (which is a function of customer numbers).
- Data: The lack of availability of data on quantity consumed was identified as a possible barrier in the gas market. Data availability was identified as an issue in the electricity market but no particular problem was identified. Currently all households are NIE Energy Supply customers and potential targets for entrants. Their propensity to switch is likely to be predictable using other commercial information rather than data held by electricity companies. Of course, Data Protection

legislation limits NIE Energy Supply's ability to make available data on electricity customers.

- Credit cover: We recognise that credit cover could be a problem for supply organisations that are not vertically integrated, as they would have reduced opportunities to minimise credit cover requirements via netting and reallocation. Consequently, electricity supply is unlikely to be appropriate for small-undercapitalised businesses that have difficulty meeting the demands of a fully collateralised wholesale market and credit cover requirements.

Q4. Do respondents agree that the analysis has identified the major potential barriers to competition in the domestic and non-domestic gas markets or are there additional barriers that you feel we should take into consideration?

NIE Energy Supply currently has less expertise in the gas market but some of the comments made on the electricity market analysis will be relevant here too.

Wholesale market liquidity is not a problem but there may be difficulties with the size of the permitted retail margin and the degree of vertical integration in gas supply and distribution.

The prospect of dual fuel supply by existing energy suppliers is perhaps the most promising potential source of competition in domestic gas supply.

Q5. Have we missed anything important in relation to potential actions - are there additional regulatory actions that the Utility Regulator should consider beyond those described?

The consultation paper does not explain in detail how the opportunities for potential action were selected and it is not entirely clear how the options were arrived at.

The possibility of relaxing the supply price control (increasing the gross margin) is mentioned in the paper but not discussed. The low margin is perhaps the single most important barrier to competition. It was perhaps not discussed because it seems counter-intuitive to consider raising prices, in the short term, to promote competition in order to further customers' interests. However, this was done in GB, albeit in the more favourable circumstances of falling fuel prices. Customers' long-term interests need to be weighed against their short-term interests. Supply competition promotes not only efficiency in the retail business itself but also efficiency in generation through greater competition in its procurement.

It would be sensible also to consider the permitted gas retail margin.

The option of improving liquidity in the wholesale electricity market is mentioned but no specific proposals are put forward: bulletin board platforms are mentioned and NIE Energy Supply has recently helped to set one up along with all other key participants in the SEM. There are other possible options, including further generation business divestment and investigations of the quantity of individual generators' contract offers. Given the absence of discussion here, we assume that this will be addressed in a further consultation.

Q6. Do you agree with the initial assessment of the impact of the proposed regulatory actions on the electricity and gas retail markets? Do you think we have materially mis-estimated potential impacts?

NIE Energy Supply's responses are given under the headings of the individual measures.

Generic options

***Synchronisation of retail market processes and systems with other markets (market size)* -** this is worth pursuing but the value is likely to be limited except where the markets can be commercially related. For example,

synchronisation with the GB market (and it is not clear what this would mean) would be more meaningful if there were more substantial physical interconnection with it.

The timetable of electricity markets is already significantly influenced by regulation. It would be unfortunate if further regulatory restriction of this or other markets were introduced, just to facilitate synchronisation.

***Scope, transparency and structure of price controls (price-control distortions)* -** NIE Energy Supply does not believe that there is a transparency issue in the supply price control. However, use of system, PSO and system service charges should be published well in advance to enable retailers to base their offers on them.

NIE Energy Supply support reduction in the scope of the price control where customers are protected by competition and where separate costs of supply can be identified reasonably.

***Shallow supply model (market structure)* -** Redefinition of the retail business by moving activities to distribution (or common services models) reduces or even removes the scope for competition in those activities.
It is not clear what further opportunities for removal (in addition to meter reading) that NIAUR has in mind. For example, back office billing and customer relationship management are core activities and it is difficult to see how a retailer could abandon responsibility for them. In any case, many economies of scale can be obtained by outsourcing.

***Divestment/market share reductions* –** This, in the context of Northern Ireland, would be likely to erode economies of scale and raise prices. Furthermore, there is no precedent in the larger GB market for this suggested approach.

The limited size of the Northern Ireland electricity retail market, along with low gas penetration, makes it less attractive for new entrants. This context also

limits opportunities to achieve supply-side economies. Indeed, the all Island market only represents approximately 10% of the GB market – which is a market that only has six significant energy retailers active. It is, therefore, unrealistic to see the all island market attracting more suppliers than GB.

***Data availability and transparency (operational rules and governance)* -** It is assumed that customers' permission would be required for T&D businesses to pass information on them to retailers. If NIAUR is able to exempt the businesses from the obligation to obtain permission, by imposing an over-riding licence obligation on them, it should take care that there is a reasonable expectation that the consent would be forthcoming if it were sought.

Electricity options

***Removal of K-factor (price-control distortions)* -** The k-factor cannot be considered in isolation from the size of the margin. It is that, rather than the k-factor itself, that constitutes the barrier. Removal of the k-factor would require a tariff basket control and a higher margin.

Further improving contract market liquidity (market structure) - A bulletin board platform has recently been established by suppliers/generators and ESB PG generation divestment is in progress. The lack of liquidity is a serious problem and needs to be considered in the light of these developments and other factors. Improvements are more likely to stem from a reduction in regulatory intervention (e.g. the rigid annual framework, discouragement of vertical integration and ROC distortions) rather than an increase.

Gas Options

Further Incentivising gas network connections and roll out (market size) - NIE Energy Supply agrees that there would be advantages in an increase in gas connections but think that further analysis may be needed. It is not clear

that it would be efficient to offer connections at prices significantly below their cost. Any such subsidy would need to be justified by the external benefit of the competitive market gain. If there are disincentives to connections caused by the structure of ownership of gas distribution, these might perhaps be better addressed by other regulatory measures such as business separation.

Q7. Do respondents agree with our analysis above in relation to scenarios and their interplay with options, and with our proposed actions?

The discussion of scenarios is brief. Three types of product offering are identified and three types of market structure.

The three structures considered are

i) separated domestic and non-domestic markets,
ii) strong integrated all-island players and
iii) fringe niche players.

All of these seem quite likely to occur simultaneously. Domestic and non-domestic supply are different and likely to attract different specialists. The all-island market is unified and offers economies of scale.

Niche players are already present, and indeed ESCo models are now being viewed as credible, particularly in the context of sustainable energy supply.

The interesting questions relating to options are whether with deregulation the PESs will ultimately compete with each other on an all-island basis (and if any divestment is appropriate to further facilitate this) and should these all-island supply entities need to be vertically integrated (as in GB, New Zealand etc) or whether it is realistic for them to operate in the longer term on the basis of a liquid wholesale market.

The three product offers are;
a) simple price competition on basic products,

b) bundled multi-utility products and
c) value added (energy efficiency, smart metering etc.) offerings.

All three offerings are likely to be made but a) may be the dominant form with dual fuel options offered where relevant. It is very likely that a shallow retail model would inhibit offerings b) and c).