

**NIAUR Consultation
NIE Energy Supply Price
Control 2010/2011**

**NIE Energy Supply's
Response**

18 February 2010



1 SUMMARY AND INTRODUCTION

The Northern Ireland Utility Regulator (NIAUR) has published proposals for a one year extension to the price control on retail electricity sales by NIE Energy Supply (NIEES) but with a reduction in NIEES's allowed revenue.

This is NIEES's response to those proposals. It considers the approach adopted by NIAUR and suggests that it takes too little account of the relationship between regulated supply margins and actual competition. The response then considers the impact of increasing competition on price controls, the costs and risks of supplying customers in NI and the comparable earnings/revenues of retail electricity suppliers elsewhere.

A reasonable assessment of NIEES's price control suggests that it is already too low and NIAUR's proposal to reduce it further is unwarranted.

- The sum allowed to NIEES is much less than earnings/revenues of comparable businesses in GB and Ireland.
- The proposed, and even existing, sums give inadequate weight to the likelihood of operating cost rises, the existence of significant risks of economic loss and the need to provide appropriate shares of the benefits of cost savings between customers and shareholders.
- The proposed allowance is substantially below what is normal in competitive markets and is likely to discourage competition.

The operating cost allowance should remain unchanged and the net margin should be increased to 2%, which would result in a gross margin of less than 5.5%¹. This is much lower than margins elsewhere and would still be at a level which is unsustainable in the longer term.

¹ Based on current level of regulated turnover

2 OBJECTIVES AND METHOD

In NIEES's view there are three main objectives of a price control in a transition to a competitive market, as is the present situation in the all-island market. It should:

- Protect customers from abuse by suppliers with market power and, in particular, ensure that they do not suffer prices that are higher or service quality that is lower than competitive levels;
- Promote competition by allowing entry. This is unlikely to happen unless prices are set as they would be in a competitive market – by reference to potential entrants' prices and margins and not by reference to the costs of the most efficient company; and
- Encourage efficiency, both by providing incentives for companies to reduce costs and by ensuring that prices reflect costs.

We believe that these objectives accord with NIAUR's duty to "protect the interests of electricity consumers with regard to price and quality of service, where appropriate by promoting competition."

However, we do not consider that the method adopted by NIAUR for deciding a price control is consistent with these objectives. NIAUR's method appears to be to forecast operating costs on the basis of costs achieved by NIEES in the previous year and to add a margin. We challenge both the cost forecast and the margin level proposed by NIAUR and would also point out that there are at least two other methods of determining a price control which can be argued to be superior. These are to set the price at:

- The level that would be charged by competitive entrants, which would both encourage competition as well as leave sufficient headroom for it to be profitable;
- The level that recovers a revenue that is comparable to that recovered by similar organisations² in other jurisdictions, which introduces "comparative competition" and incentivises efficiency by enabling an efficient company to keep part of the savings produced.

² eg ESB CS's allowed revenues

This response addresses the details of NIAUR's approach, in which we consider that NIEES's risks and costs are seriously underestimated, and also considers the other two approaches. In doing so it discusses:

- The implications of competitive entry (section 3);
- NIEES's operating costs (section 4);
- NIEES's margin (section 5);
- Margins elsewhere (section 6); before
- Drawing conclusions in section 7.

3 COMPETITIVE ENTRY

The possibility of competitive entry raises three major features each of which introduces a difference between the application of a price control to an incumbent subject to competition as opposed to that of a price control to a standard monopoly utility.

3.1 Headroom

If a price control is applied too tightly on the incumbent it leaves too little headroom for competitive entry to occur. NIEES's costs and margins are significantly lower than those of electricity suppliers elsewhere and there is little doubt that NIAUR's proposals would set a supply price below the competitive level.

3.2 Risks

The possibility of entry greatly increases the risks to which the incumbent is exposed. Monopoly electricity suppliers are able to operate with low margins because a correction (k) factor enables them to correct any under-recovery of costs in future years. Where entry is possible, on the other hand:

- Any fall in generation costs after the incumbent has contracted to supply its customers may result in both a loss of customers and a price level that does not enable cost recovery on the remaining customers;
- Any significant under-recovery would not easily be made good in future years;
- Any contracting gain, on the other hand, where electricity prices rise after the contracting round, must be returned to customers in future years by prices at less than competitive levels.

The price controlled incumbent is therefore exposed to an asymmetric risk which is potentially of a very large size. An attempt is made to quantify this risk in section 5.1.

3.3 Costs

Competition causes other costs in addition to the cost of the increased risk. These are mainly costs associated with switching or churn – changing customer details, communicating with them, issuing additional bills and increased bad debt – but also include such things as increased communication and trading costs. These are escalating costs that NIEES is already exposed to, currently driven by increased competition in the non-domestic market.

4 OPERATING COSTS

4.1 Incentives

An objective of RPI-X price control is to incentivise companies to increase efficiency.

This requires the benefits of increased efficiency to be shared between the company and customers.

This is usually done by letting the company retain the savings for a time and then adjusting allowed prices to pass the benefit to customers. These sums can be discounted to present values and the net present value (NPV) of what is retained by the company compared with the NPV of the gain to customers. This enables their relative shares to be calculated.

A standard utility price control that allows the savings to be retained by the company for five years would (at a 7% discount rate) give 30% to the company and 70% to the customer. That assumes a rolling incentive that allows gains towards the end of the period to be retained in the next price control period as is the case for transmission and distribution in Northern Ireland. If costs are rebased at the end of each five year period to the level of costs in the fourth year (which is probably the latest data available) and efficiency gains are distributed evenly the ratio would be something like 20%:80%.

Since 2005 NIEES has been subject to short price control periods - 2005-07 and 2007-09 extended to 2009-10. The proposal now is a one year price control for 2010-11 based on the estimated costs for 2009-10. All these control periods pass very little of the saving to the company and so give it little incentive to cut costs. A one year period is particularly severe. If the gains are achieved on average in the middle of the year the company receives only 4% of the value. This is unlikely to cover its costs and risks in attempting to achieve the savings and so they will be unlikely to occur.

4.2 “Northgate” savings

NIAUR’s consultation paper rests the case for a reduction in assumed operating costs on the reduction achieved in the costs of call centre and other activities that were previously outsourced to Northgate Information Solutions Ltd but have now been moved in-house.

NIEES has done well through its significant efforts to achieve this level of savings. The initial savings were mainly achieved by unexpectedly high use of agency rather than permanent staff and by using NIEES existing staff to manage the contact centres during an interim period rather than having a separate call centre management team. This absorbed a substantial amount of NIEES management effort and involved savings throughout NIEES's activities in order to free the necessary resources.

If these savings are passed to customers at the end of this financial year the ratio of the gain to the company relative to that for customers would be 10%:90%³, substantially below what is normal for regulated companies.

4.3 Cost increases

NIEES considers that other costs are likely to increase. In particular:

- Competition costs (as described in 2.3) are likely to rise. Ofgem has estimated competition costs at £16 a customer⁴, which would total almost £13 million for NIEES, and NERA has estimated an even higher number⁵. This level of cost may occur in Northern Ireland as competition is much less developed. However, as has been shown in RoI, the situation can change rapidly and the cost implications are likely to be significant compared with the £19.258 million total operating costs allowed to NIEES in the existing control and the £17.858 million now proposed by NIAUR.
- Current service pension costs have been reassessed and will rise by £150,000 per annum.
- Bad debt has increased in the recession and is close to 0.5% of turnover as opposed to the 0.4% assumed in the price control. 0.1% of turnover is about £550,000.

NIAUR's paper dismisses these additional costs, saying that it "is confident that in the event that the extra possible costs presented by NIEES materialise, the level for potential efficiencies for 2010/11 will be sufficient to fully offset [them]". No evidence is given for this. NIEES has previously given evidence to NIAUR⁶ showing that productivity growth in the energy retail sector is unlikely to exceed that in the

³ At a 7% discount rate.

⁴ Ofgem, Energy Supply Probe Initial Findings, October 2008

⁵ NERA Analysis of Energy Supply Margins, Graham Shuttleworth, December 2009

⁶ Responses of 21 September 2007 and 14 December 2006.

economy as a whole, which would be necessary for such savings to be forthcoming. If anything, the reverse is likely. There is no evidence to support NIAUR's view on potential efficiencies.

Costs in the first six month period of insourcing were unusually low because not all staff transferred and there were abnormally high attrition rates. The contact centre cannot operate on that basis for long and new staff are being recruited, management and HR resources increased, and terms and conditions improved to reduce attrition. This is likely to cost in the region of £300,000 per annum. In any case, if there are additional savings, it would be reasonable for NIEES to retain them for a time.

In short, NIAUR's proposals on operating costs:

- Take an unreasonably high share of the savings NIEES has generated, thereby reducing NIEES's incentive to achieve future savings; and
- Ignore factors likely to cause cost increases.

5 MARGIN

NIAUR proposes to retain a net margin of 1.7% or £10.5 million. This is no longer adequate given the size and asymmetry of the risks to which NIEES is exposed and the rise in its working capital costs.

5.1 Risks

NIEES is exposed to risks on generation costs. These include:

- **Pool price:** An efficient portfolio is likely to have less than 100% cover and so some exposure to pool prices. The shortage of liquidity in the SEM contract market actually means that pool price exposure is substantial, particularly at times of peak demand.
- **Volume:** The volume of sales may differ from what is expected through factors such as customer migration, economic activity (such as the present recession) or weather. These will affect both the degree of cover and the average cost.
- **Fuel price:** Contracts for differences may be indexed to fuel prices. NIEES does not have any such contracts at present but total fuel hedging may not always be in customers' interests.
- **Plant availability:** Some contract cover may depend on the performance of generating stations. As is the case for fuel prices, NIEES does not have any such contracts at present but non-portfolio generators are likely to include such terms. Indeed, it may be the case that many new intermittent renewable generators will stay outside the contract market altogether. There is also uncertainty at present about the future of some important generating plants, including Kilroot.

The risks are asymmetric, resulting in an expected cost or loss to NIEES. Retail competition means that under-recoveries are increasingly unlikely to be totally recouped in later years while the operation of the price control means that over-recoveries must be returned. Over-recoveries are in any case less likely than under-recoveries. If pool prices turn out to be higher than contract hedge prices tariffs will fail to recover the costs that result from exposure to the higher pool price. If pool prices are lower than hedge prices customers may migrate leaving NIEES with a loss on the contracts no longer needed to serve them.

A substantial under-recovery is not a remote possibility. The SEM contracting round is compressed into a short period, the fuel prices that determine pool prices (and so

future contract prices) are volatile and an electricity supplier can easily find itself with a portfolio that is substantially out of the market. The last year is a case in point. NIEES's contract portfolio has been something like 40% more expensive than outturn prices. This has not resulted in severe losses because there has not been significant entry into the NI market. In RoI, on the other hand, the situation has been different. Competitors to ESB Customer Supply (ESBCS) have been able to offer tariffs at a 10-15% discount and around 20% of customers have switched. This could easily have resulted in a 5% under-recovery of over €100 million. ESBCS already has a significant under-recovery of around €80 million from previous years and there would seem to be very little prospect that it will be possible to recover the total loss of perhaps €200 million or more in future.

These sums dwarf NIEES's margin. Such a one-sided risk⁷ warrants a much larger figure. The present NI customer switching arrangements enable 9% to change supplier each year and new arrangements due to come into effect early in 2012 will remove any constraint.

NIEES has argued before for a 2% net margin, which would raise the allowance by £1.2 million. This would be equivalent to a 5% risk of an on average £24 million loss, which in our view represents a modest assessment.

5.2 Working capital

NIEES's working capital costs are now much higher. NIAUR notes this but says "this was the position at the end of 08/09 only and will constantly fluctuate". While it is true that the exact figure will change it will do so around a very different base.

Payment for generation is now made earlier with the SEM being settled each week. This has fundamentally changed the working capital requirement.

There has also been under-recovery against the price control and a k-factor of £32.5 million. Interest is credited to the under-recovery, but only at the base rate. Current market conditions mean that companies borrow at well above that rate.

⁷ Had prices moved the other way ESBCS would not have made a large profit but would have been forced to return any gains in subsequent years.

6 BENCHMARKING

Previous responses to NIAUR⁸ have demonstrated that NIEES's margins (both net and gross) are lower than those elsewhere. Recently published figures provide further confirmation of that fact.

NIEES's gross margin is 5.3% - £29.75 million, £37.19 a customer. Operating costs represent £24.07 and the net margin £13.11. NIAUR proposes to reduce it to 5% - £28.35 million or £35.44 a customer.

ESBCS's allowance for 2008-09 was €182.31 million, about £160 million, which is a gross margin of 8.5%. There are slightly over 2 million electricity customers in RoI so this represents about £80 a customer. The figure will be significantly higher now that ESBCS's market share has fallen.

Ofgem's supply probe found that the GB gross margin per electricity customer was £102 or 20.2%. However, this includes meter reading, at a cost of £9, which is not a part of retail businesses in the SEM. The comparable margin is therefore £93 or 18.4%. Ofgem estimated the basic cost to serve at £40 a customer, the cost of competition at £16, overheads at £5 and other costs at £5 leaving a net margin of £28. NERA has challenged the calculations and suggests that costs are higher and the net margin is lower.

Suppliers' margins in GB and RoI are considerably higher than in Northern Ireland even though these companies are much larger than NIEES and might be expected to benefit from economies of scale.

⁸ Particularly that of 14 December 2006.

7 CONCLUSIONS

We think we have demonstrated that a reasonable assessment of NIEES's price control suggests that it is already too low and that NIAUR's proposal to reduce it further is unwarranted.

The sum allowed to NIEES is much less than other comparable sums in GB and Ireland.

The proposed, and even existing, sums give inadequate weight to the likelihood of operating cost rises, the existence of significant risks of economic loss and the need to provide appropriate shares of the benefits of cost savings between customers and shareholders.

The proposed allowance is substantially below what is normal in competitive markets and is likely to discourage competition.

The operating cost allowance should remain unchanged and the margin should be increased to 2%, which would result in a gross margin of less than 5.5%.

This is much lower than margins elsewhere and would still be at a level which is unsustainable in the longer term.

8 OTHER ISSUES

The bulk of this response has concerned the revenue total to be allowed to NIEES. There are three other points which we would also like to make.

8.1 Scope of the price control

NIEES has suggested that customers with annual consumption of over 150 MWh should be excluded from the price control even when that consumption is spread over more than one site. Such customers are similar to the single site over 150 MWh customers in that they have a significant demand and are likely to have the knowledge and incentive to deal with competing suppliers. The fact that they have a number of sites and so a need for several meter readings has comparatively little impact on their relations with suppliers, who are able to aggregate the readings and profiles relatively easily.

8.2 Percentage or fixed net margin

We prefer the percentage net margin to be largely fixed but set at a, higher, more sustainable level, consistent with comparable markets. Costs of working capital and financial risks, which are recovered in the net margin, are proportional to value. In the case of working capital, which is a net balance, it may be more than proportional.

However, allowed costs are more complex to determine, particularly in respect of the impact of competition. The overall cost of competition to a regulated incumbent can be significant as commented on earlier in this response.

The current allowed cost framework recognises fixed costs to be a large proportion of the current efficient cost structure for NIEES. In addition to substantial fixed costs, there are other costs that correlate more to the value of supply eg payment agency and bad debt costs. Indeed bad debt risk is probably also more than proportional, with bad debts rising sharply with high energy costs.

The collective effect of the above, combined with a context of increased competition, will require overall gross margins to increase relative to turnover. This can be observed in other markets such as GB.

8.3 RPI indexation

We assume that NIAUR intends to retain the present licence RPI indexation clause, in which 2009-10 and 2008-09 values are the same but subsequent years are indexed by October RPI inflation. The sums of money quoted in the paper are in 2008-09 or 2009-10 prices.