

NIAUR'S Consultation on the Development of its 5 Year Corporate Strategy

NIE Energy Supply's Response

19th September 2008



Summary

NIE Energy Supply (NIEES) welcomes the opportunity to comment at this early stage on the development of NIAUR's five year Corporate Plan.

NIEES believes that the strategy is comprehensive and demonstrates the range of key issues that require consideration across the utility sector in Northern Ireland.

Of all the challenges, NIEES believes that the two most significant relate to "fuel poverty and social action" and the "development of competition in the retail energy sector in Northern Ireland".

The strategy recognises that fuel poverty is a major issue in Northern Ireland. NIEES shares NIAUR's view that policies primarily need to flow from Government to ensure that the most vulnerable customers in society are protected, and that the problem of fuel poverty requires co-ordinated action across many fronts.

NIEES will be emphasising the importance of the Energy Efficiency Levy Scheme in tackling fuel poverty, in its response to NIAUR's separate consultation on that matter. We firmly believe that this scheme should continue to be the primary mechanism for electricity supply companies to make a real difference in protecting vulnerable households in Northern Ireland from the threat of increasing wholesale fuel prices worldwide.

With respect to the retail energy sector, it is our view that the most significant obstacles to the development of competition within the electricity retail market in Northern Ireland are; the difficulty in obtaining appropriate hedges against the SEM pool price, general contract market liquidity, limited market scale, and the low retail margin that currently exists.

NIEES welcomes the fact that NIAUR has identified all these factors as being of strategic importance in its plan.

The Development of 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 understating 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 under contracted 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.

There is a significant risk that the very rigid and concentrated contract market timetable within SEM can result in tariff wholesale inputs being high relative to other neighbouring markets (ie GB), when there is a short term hike in world fuel prices coinciding with the contract selling window, as was seen this tariff year.

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. 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 limited size of the Northern Ireland electricity retail market, along with low gas penetration, make 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'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.

In its response to NIAUR's consultation retail competition in NI, NIEES promoted two key strategies to produce conditions that would be more conducive to supporting competitive supplier entry. These are:-

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

NIEES 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.

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. NIEES believes that following a period of common services support, it is in the best interests of the general retail market design to consider a “deeper” retail construct, for example by including meter operations and data collection as a supplier’s direct responsibility. Smart metering will be central to the development of retail competition and multi-utility product offerings, therefore NIAUR should consider how they can support more retailer involvement in the development of smart metering in the Northern Ireland utility market.