Power NI is the new name for NIE Energy

NIAUR Consultation

NIE Energy Supply Price Control 2011 – 2013

Power NI's Response to Consultation Proposals

15 July 2011

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1 Introduction

Power NI welcomes the opportunity to respond to NIAUR's consultation on the NIE Energy Supply Price Control 2011-2013 Proposals for Consultation Paper, issued on 20 May 2011. NIE Energy (Supply) at the time of writing this response is in the process of changing name to Power NI. As the name change date is imminent, Power NI rather than NIE Energy Supply (or NIEES) is referenced throughout this response.

Power NI currently supplies[1] 50% of the total Northern Ireland electricity consumption, only 10% of the sector not subject to price control and 79% of the price controlled sector. This price control determination covers the 79% price controlled market share supplied by Power NI.

It is Power NI's understanding that NIAUR have appointed new consultants to support further net margin analysis. This is a welcome development and Power NI looks forward to engaging with both NIAUR and their consultants in that regard.

Power NI expects that the additional work undertaken by the new consultants will be published in a revised set of proposals, which in turn would be consulted upon, leaving sufficient time for all stakeholders to feedback comments prior to any final determination.

While there has already been significant slippage in this review this should not compromise the thoroughness of the consultation process in respect of the revised proposals.

[1] Per NIAUR Quarterly Transparency Report, May 2011

2 Executive Summary

Power NI believes that the proposals set forward by NIAUR represent a severe and unjustified reduction in entitlement. The changes represent a reduction in net margin at a time when considered analysis of market conditions illustrate that an increase is required.

Additionally, the opex proposals are significantly below the reasonable level an efficient business should be allowed.

2.1 Process

A price control review process should be set against a backdrop of striking a balance between protecting customers and ensuring that suppliers are able to finance their activities in a sustainable way.

Power NI reasonably expected that this price control review process would be thorough, transparent and timely. Specifically, the allowed net margin should be sufficient to ensure the business is able to the finance its operational activities, taking into account the new and increased level of risk to which the business is exposed; and operating cost (opex) allowances should cover all reasonable costs that an efficient business would expect to incur.

There is clear evidence that significant aspects of Power NI's operating environment and hence risk exposure have changed, thus necessitating a fundamental reappraisal of margin and cost allowances.

The process to date has not been sufficiently detailed. The consultation document itself benignly portrays the proposal as a rollover of previous controls, references high level margin benchmarks and presents no evidence to justify the net margin proposal. The paper is also absent of any detailed and robust analysis of the margin required.

At no stage is the severity of the financial impact of the proposals on Power NI set out. The quantum of the proposed cut represents a circa <u>18%</u> reduction since 2009/10 to core entitlement, despite turnover being largely flat.

2.2 Form

The proposed form of control represents a fundamental policy change. This policy change potentially has significant implications on vulnerable customers, energy efficiency and general service delivery; while placing greater risk and uncertainty on Power NI. This has also not been sufficiently described or impact assessed within the consultation.

2.3 Scope

Despite including a 'review of scope' within the terms of reference for this price control, it has not been discussed in the consultation paper. Power NI considers it inappropriate and manifestly inequitable to continue price regulating a sector which is demonstrably competitive. Prolonging a price control in these circumstances is not only inconsistent with NIAUR's duty to promote stable and sustainable competition, it fundamentally hampers customers getting access to a full range of products, on equal terms, from all suppliers currently operating within the non-domestic sector in NI. Power NI urges NIAUR to amend the scope of the price control, and has provided analysis that would support the extension of full competition to customers with consumption >50MWh and Groups.

2.4 Margin

Power NI commissioned NERA Economic Consulting (NERA) to undertake a robust assessment of the required net margin going forward. Power NI remains confident of NERA's conclusion that an assessment of net margin should be by reference to the underlying requirement for capital and the required return on capital.

Since the original analysis of required margin, submitted to NIAUR on 31 March 2011, NERA have updated the analysis using more recent market data, and refining certain base assumptions. This analysis concludes upon a net margin requirement of £17.8m.

Power NI believes NIAUR confuse customer number expectations with actual risk. Forecasts do not remove the underlying risk of alternative results and their related impacts.

Power NI does not accept NIAUR's assertion that "k" correction acts to insulate the business from market risk. At best the "k" factor corrects for under and over recoveries relative to Power NI's regulated allowances. It does not protect the business from market risk compared to the market risk that would be borne by an unregulated competitor.

2.5 Opex

In terms of opex allowance, NIAUR have conducted a bottom-up analysis of operating costs and subjectively disallowed certain opex lines; taking the lower of Power NI's submitted figure or another benchmark. This approach gives no consideration to comparative overall efficiency levels or inherent allocation differences.

Power NI believes that a top down approach has a stronger regulatory precedent, offers credible results, suffers less from boundary issues and errors, passes empirical tests and allows a wider more robust view of efficiency to be taken.

Power NI has and will continue to be faced with an unavoidable cost of competition[2] which impacts opex cost items. This has been seen in other markets and should be acknowledged within Power NI's cost allowances.

The benchmarking analysis of comparable supply companies undertaken by NERA illustrates that the Power NI cost to serve is more than 50% lower than key comparators. Power NI therefore is already an extremely efficient business and believes that the detailed information provided through the data submission process represents a reasonable assessment of forecast cost items[3].

2.6 Next Steps

Mindful that the intensive tariff setting process is underway, Power NI urges NIAUR to be cognisant of this important activity when considering the next steps to this process.

[2] Includes greater Front Office activity due to increased call volumes, call duration, higher debt management and general communication activities

[3] Subject to adjustment for new increased cost items highlighted later in this response

In an attempt to conclude this review Power NI urges NIAUR to continue to engage with Power NI and NERA in undertaking a detailed assessment of required net margin and opex.

Power NI is committed to working with NIAUR in that regard and hopes that a revised review timetable can be agreed to build upon the detailed analysis already provided.

3 Review Process

3.1 Background

In recent years Power NI has been subject to a series of short term price controls, often with retrospective application. This process imposes a brief assessment period and challenging timeframe to give due consideration to the complex scenarios involved as well as the general electricity market backdrop. Power NI believes that this has resulted in major issues not being fully analysed.

Once again this price control review has been compressed into an extremely short period and is set against the context of what Power NI believes was an unreasonably severe previous control.

The 2010-11 review was characterised by significant reductions in opex entitlement, disallowances due to what Power NI argued was the erroneous treatment of efficiency gains (caused by short price control terms) and a holding down of the target net margin at an extremely low 1.7%. A level that Power NI argued strongly was not sufficient to finance ongoing business activities in a sustainable way given the very real increase in risks to which the business was being exposed.

Power NI reluctantly accepted the 1 year control on the understanding that in the subsequent review -

- The process would be thorough, transparent, timely and make fair, reasonable judgments based on a building block approach to cover all aspects of business requirements.

- Operating cost allowances would cover all reasonable operating costs that an efficient business may incur.

- A net margin would be set to be sufficient to ensure the business could secure access to the necessary capital to support ongoing business activities.

- Clarification would be provided regarding retail regulation, including how the scope of price control would change relative to Power NI's observable reduction in market share in the business sector.

- The process would be cognisant of the new and increased level of risk that the business is exposed to.

3.2 Review Principles and Objectives

Of particular importance within this price control are the capital requirements to support the business's operations, the implications of competition and risk.

The level of asymmetric risk is higher than has ever been experienced by Power NI. To ensure ongoing viability, allow risks to be managed and encourage efficiency, a margin level should be set which is higher than previous years. This margin should be more akin to those seen in comparable markets such as in GB rather than using inappropriate benchmarks such as Phoenix Supply.

NIAUR while keen to promote competition and ensure a reasonable price is charged to consumers should be cognisant of other duties, for example, to ensure licensees are able to finance their authorised activities.

Other important principles of best practice regulation should be observed i.e. regulatory certainty and giving due consideration to all aspects and effects of the market as well as changes in the operating environment.

It is within this context that this price control should be framed and therefore it is important to recognise that Power NI is faced with increased competition, a changing environment and greater risks. These factors render historical price control precedents inappropriate.

Power NI strongly believe that NIAUR should recognise the effect of the margin and that this should be set at a reasonable and appropriate level following a detailed building block approach to analysis. Considering net margin in isolation, while driving opex allowances below an efficient level represents an unreasonable strategy.

In Power NI's view there are four main objectives of a price control in an increasingly competitive market such as the present situation. It should:

- Protect customers from prices that are higher or service quality that is lower than competitive levels;

- Ensure that suppliers are able to finance their activities;

- Promote competition by facilitating additional entry. This is unlikely to happen unless prices are set as they would be in a fully competitive market by reference to potential entrants' prices and margins and not by reference to the costs of the most efficient company and returns on capital consistent with a monopoly network business; and

- Encourage efficiency, both productive efficiency (by providing incentives for companies to reduce costs) and allocative efficiency (by ensuring that prices reflect costs). When prices reflect costs, customers are able to make efficient choices that ensure goods and services are consumed when the benefits obtained from them exceed the costs of providing them.

Power NI believes 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" and acknowledge that there is a balance to be struck between consumer costs and allowing sufficient margin to enable a supplier is able to secure appropriate finance.

Power NI does not consider that these objectives lead to the method of deciding a price control adopted by NIAUR; which has been to forecast operating costs on the basis of a level of costs below that achieved by Power NI in the previous year and to add a small margin consistent with a low risk regulated business.

NIAUR have engaged in a series of short term price controls that are increasingly truncated and have lacked the supporting analysis that a regulated business would have the right to expect.

Short price control terms remove the incentive for efficiency. A standard utility price control that allows efficiency 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. This 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%.

The 2010-11 review disallowed efficiency gains which therefore resulted in Power NI share of gains within the previous period to be capped at an estimated c4% to 8%. Under a 5 year price control an expected share would have been in the region of 30%. Even if NIAUR introduces a two year price control and does not review it at the half way stage (as is the present proposal) the company share would be only 10%.

Such continuous review therefore compromises the basic premise of incentive regulation, which is to provide a reasonable return for risks taken in securing savings, with the greater proportion of savings passed to the customer.

3.3 2011/13 Review Process

The retrospective nature and late start to the 2011-13 process is of concern. In an attempt to expedite this process Power NI provided a comprehensive data submission, as per NIAUR's challenging timetable. The submission detailed all the key financial data, both historical and forecast.

Consistent with our aim to engage in a thorough process Power NI also commissioned NERA to undertake focussed independent analysis on the key building blocks of the supply price control. Power NI shared reports with NIAUR prior to the consultation on operating cost benchmarking and a detailed assessment of margin.

Power NI is disappointed with a range of aspects of this review process and proposals, namely –

- The quantum of the potential cut represents an 18% reduction since 2009/10 to core entitlement. This is despite turnover being largely flat (i.e. reduction in customers and sales is off-set by increased forecast wholesale costs) and a significantly changed and higher risk operating environment.

- The proposals generally lacked supporting detail and rather benignly portray this control as a continuation of previous controls. There is a distinct lack of objective evidence and methods to support proposals.

- The 1.7% net margin figure appears to be based on benchmarks from other markets without the evidence to support their appropriateness.

- The misleading characterisation of the 2010/11 price control, describing it as being determined on an absolute margin percentage, where in effect it was a carry forward of an absolute net profit of £10.5m[4] from the previous price control. Indeed this net profit equated to 2.2% of regulated turnover.

- The thrust of NIAUR's work appears to be a "granular" analysis of operating cost allowances. Power NI has already indicated concerns about this approach and how it could lead to an unrealistically low operating cost allowance. Failure to take a holistic approach but rather subjectively disallow certain opex lines, taking the lower of the submitted figure or another benchmark does not represent best practice, as the approach gives no consideration to comparative overall efficiency levels or inherent allocation differences.

- The fundamental change to the form of the control which alters business focus from encouraging energy efficiency and protection of vulnerable customers to turnover.

- The framing of the price control focuses on treating Power NI as akin to a networks business rather than an energy retailer that operates in a competitive environment, manages significant risks on behalf of customers and has very different financing challenges given that the business is not asset rich.

- The timescale for the review which was at the outset overly ambitious and has resulted in a potentially retrospective implementation. Such a

[4] 2009/10 prices

scenario runs contrary to NIAUR's stated objective[5], increases regulatory risk and disrupts the tariff setting process.

The review process should strike a balance between protecting customers and ensuring that Power NI is able to finance its activities.

Power NI reasonably expected the review process would be thorough, transparent and timely. Specifically, the allowed net margin should be sufficient to ensure the business is able to finance its operational activities, taking into account the new and increased level of risk to which the business is exposed; and opex allowances should cover all reasonable costs that an efficient business would expect to incur.

The process has not been sufficiently detailed, benignly portrays the proposal as a rollover of previous controls, applies high level margin benchmarks without analysing their relevance and has not taken account of financial and electricity market changes.

The proposal in fact represents a severe reduction in core entitlement without detailed analysis or justification. Power NI believes several aspects of the analysis require revisiting.

[5] The Utility Regulator Corporate Strategy 2009-2014, page 12 states that a key priority area includes timely and effective price controls

4 Price Control Form

This price control review focuses on core entitlement, essentially Power NI's regulated gross profit margin (or the sum of allowed core operating costs and net margin) technically referred to as the St term. The existing form of control has been in place for the past 11 years and was widely consulted upon before its introduction. The form importantly offers a reasonable degree of certainty in respect of entitlement outturn. Two thirds is fixed with the remainder a customer number variable.

This approach was chosen back in 1999 by Ofreg as it:-

- Promoted good customer service as good service should mean greater customer retention and therefore maximise the variable element of entitlement.
- Created a framework that supported the promotion of energy efficiency as entitlement revenues were independent of sales and price.
- Overall the form incentivised exemplary retail behaviour consistent with NIAUR's stated objectives regarding environmental sustainability, the protection[6] of vulnerable customers.

NIAUR's proposals appear to benignly portray without any explanation or impact assessment what is in fact a radical change. In effect these proposals penalise Power NI for providing good service to low consumption, vulnerable customers.

As stated above the current form was chosen to introduce a climate change/energy efficiency perspective. It removes any incentive to sell more units of electricity and therefore it would seem at odds to the very clear carbon reduction policies in Northern Ireland to now introduce an incentive to sell more electricity.

From a social perspective, Power NI is conscious that older people and low income customers consume very modest amounts of electricity. Power NI

[6] akin to the objectives underpinning the IME3 proposals

was the first energy company in the UK to remove standing charges, which were particularly disproportionate for this group of vulnerable customers. Power NI has also been particularly proactive in going beyond any social action plan obligations and continues to direct significant customer service effort towards these customers. Should the price control form suggested by NIAUR be implemented, this would put pressure on Power NI to focus customer service efforts towards high consumption (profitable) customers. Power NI does not consider this to be in the interests of vulnerable customers and contrary to NIAUR's obligations in that regard.

As stated previously this represents either a fundamental shift in regulatory policy with potentially extensive ramifications or a proposal which has significant unintended consequences. Power NI is concerned that due to the lack of detail, impact assessment, analysis and general articulation of this proposal, the implications may not be fully clear to market stakeholders and as such may be implemented by default.

Additionally, the consultation paper misleadingly characterises the 2010/11 price control, describing it as being determined on an absolute %, where in effect it was a carry forward of an absolute net profit of £10.5m[7] from the previous price control. For clarification therefore, the monetary value and not the percentage was the fixed outcome of the price control review. This clearly had advantages in terms of certainty, predictability and risk.

Power NI is concerned that the proposed move to a fixed percentage of actual turnover introduces higher risk, less certainty, lower predictability and has not been fully analysed. By NIAUR's own admission the detailed operation of the proposal also suffers from the "absence of regulatory precedent"[8]

> The proposed form of control represents a fundamental change with potentially significant implications on vulnerable customers, energy efficiency and general service delivery, while placing greater risk and uncertainty on Power NI without completing due diligence.

[7] 2009/10 prices
[8] Page 18 of proposal document

5 Price Control Scope

Power NI believes that if a market is demonstrably competitive, the prolonged application of a price control will compromise the proper operation of a competitive market and is in effect counterproductive. Contained within the recent forward work plan NIAUR state they will be working towards "developing energy retail competition"[9] and acknowledge that this has been a long term vision.

Unnecessarily extending price controls in competitive sectors is a policy which differs from other markets and creates undue regulatory risk. This could impact the efficient securing of capital as global financial institutions have an expectation of regulatory consistency.

Over recent years extensive competition and switching has taken place within the commercial sector. This has also recently begun to develop in the domestic market. This clearly illustrates the evolving nature of the electricity market in Northern Ireland, an evolution which will continue throughout the life cycle of this price control.

A lingering feature of this competitive but still regulated sector, is the asymmetrical character of regulation, which historically was necessarily required to favour new competitors over the incumbent, where the incumbent is dominant. However, any unnecessary extension of such a regulatory dynamic, when demonstrably the market influence has shifted from the incumbent to the competitor community[10], introduces suboptimal competitive market conditions and thus could compromise the regulator's ability to comply with its statutory duty of promoting stable and sustainable competition.

The consultation paper omits to discuss the issue of the scope of the price control within the business market and although NIAUR have recently published a competition position paper[11] it remains a significant issue with regard to the scope of this Power NI price control.

[9] Utility Regulator Draft Forward Work Plan (1 April 2011 – 31 March 2012), published October 2010
[10] Power NI serves only 10% of this sector per the NIAUR Transparency Report, May 2011
[11] Regulatory Approach to Energy Supply Competition in Northern Ireland, A Utility Regulator Position Paper, 01 July 2011

Currently, the electricity market is not subject to price control in the >150MWh pa sector. Power NI believes that this threshold is unnecessarily high and is in fact inhibiting competition in the business market. This restriction is illustrated by recent customer frustration regarding the lack of quotes available from suppliers as well as the lack of tailored products. Additionally, the restrictions tend to concentrate high risk customers with Power NI as a proportion of the total number the regulated customers served decreases. This higher risk customer portfolio is at odds with the proposed extremely low net margin allowance.

5.1 Power NI Proposal

Based on NIAUR's latest quarterly retail market transparency report, there are grounds for a further phase of market opening and removal of price control restrictions. Power NI proposes that the next phase of enabling a fully open market would apply to two additional groups of customers (below):

- any individual site using more than 50MWh pa
- any group (i.e. an account with more than one site) consuming more than 50MWh pa.

These groupings were not identified in the recent position paper which appears limited to sectors defined by use of system (UoS) tariffs. Power NI believes that the market should not be restricted by historic (UoS) tariff groupings but apply a practical customer focussed criteria which enhances rather than restricts the options available to consumers. Businesses operate in a dynamic environment and seek to avail of economies of scale by grouping diverse supply points in their portfolio. Simply relying upon existing reporting mechanisms to define important policy decisions ignores the reality of customer requirements.

Whilst the term 'deregulation' is commonly applied, Power NI believes that 'removal of price control' is a more appropriate description. Removal of price control is consistent with statutory duties of protecting consumer interests through the promotion of competition. Customers always retain the added reassurance of regulatory powers in the area of consumer protection.

NIAUR both in its 2010-11 price control consultation paper and the terms of reference for the 2011-13 price control review, make reference to undertaking a review of the last phase of 'deregulation' implemented in April 2009, and carrying out a separate consultation exercise on future reduction of the scope of retail price controls. Power NI is therefore disappointed that a position paper which does not propose further adjustment to the price control scope, nor defines triggers, has only been recently published.

CER by contrast have made significant progress in this area for the Republic of Ireland. Their decision paper on a 'Roadmap to Deregulation'[12] identifies the appropriate criteria which would be used to decide on 'deregulation' of a specific market sector.

(i) There are at least three suppliers active in the relevant market; and

(ii) There is a minimum of two independent suppliers[13], each of which has at least 10% share of load(GWh) in the relevant market; and

(iii) ESB PES and ESBIE combined serves or will serve within a specified period a defined percentage of consumption market shares in a relevant market. For each of the business markets, the percentage market share is 50% or less. In the domestic market, the percentage market share is 60% or less.

5.2 Analysis of Northern Ireland business market

NIAUR's latest quarterly retail report provides very useful information on the market sectors which clearly identifies that the first two CER conditions have been met in every business sector. The third condition, which if applied to Northern Ireland, would combine the market shares of Power NI and Energia.

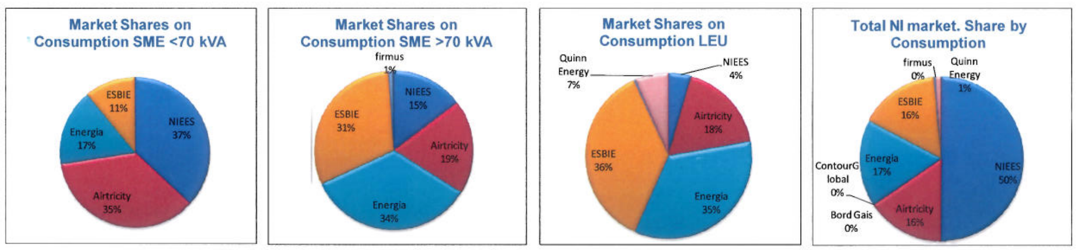
This condition is met in every business sector except the SSME <70kVA group where the combined market is 54%. Power NI is not therefore

[12] Review of the Regulatory Framework for the Retail Electricity Market. Roadmap to Deregulation. Decision Paper. CER/10/058. 21 April 2010

[13] With no common parent company shared with other suppliers.

proposing full removal of price control in the business sector in the immediate term.

Rather, Power NI is proposing that, from 1 October 2011, two new groupings be removed from the scope of price control: customers using more than 50MWh per annum and groups using more than 50MWh (aggregated across all sites). There is further analysis of this below together with the reasons for the proposed next phase of deregulated.



Source: NIAUR Quarterly Transparency Report May 2011

1. > 50MWh

There is very active competition in this sector[14]. Power NI estimates that of its 37% market share within the SSME <70kVA sector, only 36.5% (ie c18% of the total sector) of this customer group use more than 50MWh per annum. Applying this criterion would change the total sales within the combined Viridian group to c40%[15], well under the 50% requirement in (iii) above[16].

2. Groups

Notwithstanding Power NI's current restrictions which prevent tendering for 'fixed price' contracts in the market;[17] Power NI is further precluded from proactively competing in many group tenders as it is only allowed to quote

[14] In the last year, an average of 360 business customers per month has switched to another supplier.
[15] Although it should be recognised that as this represents partial price control removal the licence conditions regarding business separation remain in effect ensuring that the supply businesses within the Viridian Group continue to operate in an entirely separate ring fenced and transparent manner.
[16] We assume that the majority of electricity consumed by volume across this sector of the market is in the >50MWh sector.
[17] Due to the lack of liquidity in the hedging market

the regulated tariff prices[18] for sites consuming less than 150MWh pa. Power NI believes that this greatly restricts competition in the business market and for that reason; groups should be excluded from full price regulation.

Power NI analysis suggests that this would bring a further circa 5,000 individual sites within scope of full price competition with annual consumption of circa 240 GWh pa.

A natural further phase of removal of retail price control could apply to the entire business market, depending on meeting the defined criteria, from 1 October 2012.

5.3 Summary

Power NI would encourage NIAUR to give urgent consideration to further reduction of the scope of price control in the business sector and proposes an interim step from 1 October 2011 focused on customers consuming greater than 50MWh and group customers. Power NI believes that there is evidence of active price competition in these sectors.

The removal of the retail price control will allow consumers to engage with a greater number of suppliers who are able to tailor products, participate in the tendering process, provide quotations and compete for their business on a level playing field. This is a requirement which has been clearly communicated by consumer associations and customers alike as it provides increased 'real' competition whilst having the comfort of consumer protection through normal regulatory arrangements.

Power NI believes that this interim step would have a positive effect on the electricity market, is consistent with NIAUR's statutory objectives[19], removes a real current competition inhibitor, is consistent with GB and

[18] This is restrictive in terms of product type and importantly duration. Many customers tender in April for the financial year which crosses into the new regulated tariff year which is not set at that time. This often automatically excludes the Power NI tender.

[19] As reaffirmed by the National Audit Office, which states that "the processes used by Ofgem, Ofcom and Postcomm for removing retail price controls were consistent with their statutory duties of protecting consumer interests through the promotion of competition." and "The removal of price controls is an important step in the development of competition"

European policy decisions, and facilitates headroom to consider the recent position paper. To delay this proposed next step in order to conduct a policy review assumes that all sectors of the market are at the same level of maturity, which is clearly not the case.

Power NI considers it inappropriate and manifestly inequitable to continue price regulating a sector which is demonstrably competitive. This ongoing pricing restriction prevents Power NI offering the tailored products which customers are asking for, inhibits competition and tends to concentrate high risk customers with Power NI.

Facilitating the extension of full competition to customers with a consumption >50MWh and Groups is consistent with the stated regulatory objectives and is in direct response to customer demand. Consumers will be able to access a greater variety of suppliers, products and competitive processes; while still having the assurance of wider regulatory consumer protection.

6 Required Margin

6.1 Approach to determining required margin

In the determination of the allowed net margin NIAUR look to regulatory precedent as justification for the 1.7% proposal. Power NI have consistently argued that given the fundamental changes in the financial, wholesale and retail electricity markets, historic precedents are no longer appropriate but rather a structured building block approach should be adopted. To support such an exercise Power NI engaged NERA Economic Consulting to provide expert, independent advice which has been shared with NIAUR at the relevant stages of analysis.

NERA's approach to determining a required net margin uses best practice methodologies underpinned by UK Competition Commission guidelines[20], focusing on calculating fair returns on the capital required to manage the Power NI business over the period of the price control.

This is not a unique approach as similar methodologies have been used in the regulation of electricity retailers in the Australian market[21] and other industries with minimal fixed assets e.g.:

- CC (2002) supermarkets,
- CC (2006) supply of bulk liquefied petroleum gas,
- CC (2010) movies on pay TV.

Power NI requires significant capital in running its operations including:

- working capital
- correction of under-recovery
- collateral and
- risk capital.

[20] Competition Commission guidelines state that profitability should be assessed in terms of rates of return on capital in the market or markets concerned -CC3 – Market Investigation References: Competition Commission Guidelines

[21] Paper produced by SFG Consulting for the Independent Pricing and Regulatory Tribunal (IPART) in August 2009 (Estimation of the regulated profit margin for electricity retailers in NSW)

6.2 Benchmarking

NIAUR cited a number of benchmarks when considering the net margin. While benchmarking in this case can provide a general guide to the range of applicable margin levels it is inherently unreliable as the particular circumstances and drivers for the margin levels vary significantly, dependent upon market conditions and circumstances.

In relation to the benchmarks included in the paper it is worth noting that –

- The MMC decision in 1995 to allow Scottish Hydro a 0.5% level was justified as a 7% regulated return on normal working capital, there was no competition and full vertical integration so no risk capital requirements.

- The 1998 Offer decision to allow a 1.5% margin was set in a context of high supplier opex costs and therefore incentivised further efficiencies which facilitated an out-turn margin of 3% or higher. The Offer decisions also assumed that suppliers could fully hedge, thus minimising risk capital requirements.

- The CER decision of 1.3% was also set against high opex to incentivise efficiency gains. ESB Customer Supply is also state owned which therefore largely removes the risk of insolvency.

Additional benchmarking information is available such as –

- The Ofgem report of 2011 which quotes net margin levels of around 3% for vertically integrated suppliers in a competitive market and a range of 7% - 9% for independent retailers with no generation assets. While it is noteworthy that these margins are set in a market in which competition is long established in comparison to Northern Ireland it does not suffer from the same lack of hedging contract market liquidity.

- The IPART decision in Australia allowed a 5.6% net margin in relation to a dominant independent supplier.

- The Tasmanian regulator allowed a 3.7% net margin for the monopoly independent retailer.

6.3 Margin as a function of risk

Power NI faces significant underlying risk due to its lack of vertical integration and exposure to volatile wholesale prices, and in addition the arrival of retail competition has added very significant additional risk.

Retail competition increases the risks to which an incumbent is exposed. Monopoly electricity suppliers are able to operate with low margins because a correction (k) factor guarantees their ability to correct any under-recovery of costs in future years. Where market 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 from the remaining customers;

- Any significant under-recovery is unlikely to be made good in future years as it would further reduce the competitiveness of the business;

- Any contracting gain, on the other hand, where electricity prices rise after the contracting round must be returned to customers.

The price controlled incumbent who faces competition is therefore exposed to an asymmetric risk which is potentially of a very large size. This is illustrated by the recent experience of ESB Customer Supply. When high cost contracts were secured competition was able to significantly undercut. The resultant customer losses created such an under recovery that it was both politically and financially impossible to recover.

Power NI is exposed to significant risks on generation costs. These include:

- Pool price: An efficient hedging portfolio is likely to have around 80% cover and so a modest degree of 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 or weather. These will affect both the degree of cover and the average cost.

- Hedging Options: As described through the recent Market Power and Liquidity Consultation there is already significant contract scarcity with the real prospect of volumes being further reduced and price premiums applied to the NDCs in particular. The general operation of the hedging market forces Power NI to contract at specific and limited times. This exposes Power NI to both an inability to gain sufficient hedges and critically point in time strike prices. This inflexible system of locking into hedges can result in significantly higher prices offered to customers should fuel prices change.

  The hedging process is also subject to regulatory intervention, for example, Power NI was blocked from securing 2.9%[22] of hedges from its affiliate during 2010 despite there being clear evidence that the hedges were economic and that Power NI complied with the processes laid down for transacting such hedge purchases.

  The lack of contract volume availability disproportionally impacts Power NI. Vertically integrated deregulated businesses use the contract market to balance their overall position, whereas non vertically integrated organisations have to rely upon the hedging market to manage risk.

  Scarcity therefore creates a price premium which is applied to an entire volume potentially facilitating the manipulation of retail prices to artificially high levels. This is passed on to Power NI consumers in a disproportionate manner.

These asymmetric risks expose Power NI to only an expected cost or loss. Retail competition means that under-recoveries are increasingly unlikely to be recouped in later years while the operation of the price control means that over-recoveries must be returned. 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. Power NI did so two years ago. This only failed to result in severe losses because significant entry into the NI market was not then possible.

[22] Of winter demand

In RoI competitors to ESBCS were able to offer tariffs at a 10-15% discount over a sustained period. This margin contained such a significant headroom that it facilitated an unprecedented estimated €5.5 million pa spend on sales and marketing. This very quickly moved the RoI market to such a level that full deregulation has occurred.

It is worth noting that this took place in a two year period, the same amount of time which this current price control covers. The projected accumulated under-recovery on allowed revenue for ESBCS by September 2010 was circa £150 million and it made a loss of £65 million in 2008 and £37 million in 2009. In addition to the significant financial losses ESBCS experienced a huge reduction in their customer base and therefore in effect, a capital devaluation.

A K factor therefore at best corrects for under and over recoveries relative to regulated allowances; it does not insulate Power NI from market risk. It is plausible that a retailer, not subject to price controls, would set their tariffs using a mechanism that mirrors the regulatory K factor with appropriate margin for risk mitigation and capital requirements.

Failure to acknowledge and allow for these risks exposes Power NI to potentially incurring the type of financial losses, customer reduction and capital devaluation as seen by ESB. Unlike ESB however Power NI is a privately owned non-vertically integrated organisation which simply could not survive such a scenario. This is clearly a foreseeable risk with precedent within the same wholesale market.

Within the consultation paper NIAUR appear to confuse expectation with risk. Forecasts do not remove the underlying risk of alternative results and their related impacts. It is feasible that a forecast may be set at a certain level however due to the range of possible outcomes and market factors there is significant risk of a different outcome i.e. large scale customer loss.

6.4 Margin based on Sales

NIAUR states that the “more orthodox approach [to remunerating investors in] regulated supply businesses is to allow a margin on turnover”. This statement risks confusing the form of a price control with the underlying methods used to set the allowed remuneration. Hence, even though regulators have tended to express the allowed remuneration for regulated supply businesses in terms of a margin on turnover, they have often/normally justified the margin by reference to the underlying requirement for capital and the required return on this capital. Similarly, in assessing the fairness of supply margins in competitive settings, regulatory authorities often define fair margins by reference to a fair return on capital employed.

The regulatory framework in NI requires NIAUR to ensure that Power NI has a reasonable prospect of earning a net margin that is sufficient to enable the business to finance its operations.

NIAUR proposes that the St net margin should be based on actual turnover (ie on an ex-post basis). Power NI believes that this is an inappropriate driver to determine net margin.

The net margin should be assessed in terms of a fair rate of return on the capital required to manage the business. As Power NI is fundamentally a risk management business, returns are more likely to be influenced by:-

Market risks

- Retail sales positions – typically fixed priced tariffs for variable volumes, and switching risks etc
- Procurement/hedging – typically fixed volume /fixed price contracts, currency considerations, mix of contract types etc

Operational risks

- Volatility in bad debt, brand reputation, systems failures etc

Regulatory risks

- Entitlement disallowances, changes in form of regulation, lack of regulatory certainty etc

Importantly energy retail businesses such as Power NI need risk capital to cover the above-mentioned risks, and retail margin must provide a fair return on this capital requirement.

Like all energy retailers, Power NI has to organise its core financing in advance of any trading period, based on best forecast modelling. It therefore is inappropriate for the returns to be calculated on an ex-post basis and on the poorly correlated driver of turnover.

Power NI therefore proposes that net margin should be calculated in terms of the forecast capital requirement for the business during the price control period.

Power NI believe the current form of the price control facilitates such an approach, where the fixed and the customer variable parameters could be agreed in advance of the price control period, using a forecast return on capital as an input. Significantly, this approach provides the regulatory certainty that is important in the context of attracting capital into the business to facilitate its sustainable operation.

6.5 Required Margin

Power NI commissioned NERA Economic Consulting (NERA) to undertake a detailed and robust assessment of the required net margin going forward, which was shared with NIAUR and is referenced in the NIAUR consultation paper. Power NI remains confident of NERA's conclusion that an assessment of net margin should be by reference to the underlying requirement for capital and the required return on capital.

Since the original analysis of required margin, submitted to NIAUR on 31 March 2011, NERA have updated their analysis, using more recent market data, and refining certain base assumptions. This analysis concludes with a higher net margin requirement of £17.8m as compared to the original assessment of £14.5m.

This new analysis used updated base case assumptions which were adjusted following direct interaction with NIAUR[23] on 8 June 2011 and includes updates to forward fuel indices, demand forecasts, hedging volumes, comparator analysis and half yearly tariff reviews.

[23] Energy BAG meeting held on 8 June 2011

A summary of the new base case assumptions are as follows:-

6.5.1 *Comparator choice*

The NERA analysis used a merchant independent power producer as the mid range comparator. In response NIAUR suggest that in a detailed margin calculation an appropriate comparator for Power NI would be a regulated networks business. As an energy network is a natural monopoly with no exposure to competition or to volatile energy markets, Power NI consider this to be wholly inappropriate.

NERA have revisited the comparator choice and concluded the merchant IPP type comparator remains an entirely suitable choice given its exposure to volatile power markets and energy trading activities. However, NERA have identified Centrica (with an A- rating) as potentially a better comparator. The new WACC assumption is therefore now 11.7% (as opposed to 12.5%) with the probability of insolvency decreasing from 0.36% to 0.27%.

6.5.2 *Tariff changes*

NERA include the assumption that mid year corrective tariff changes will become a feature of the NI energy retail market.

It should be noted however that such an assumption was not included in the opex items and does incur additional cost.

6.5.3 *Collateral and Hedging Constraints*

There are likely to be constraints on the ability of the business to secure ideal levels[24] of hedging cover. The new base case assumes collateral limits that would in practice constrain the level of hedging to c 50% of the ideal level of cover.

The lack of contract market liquidity could in practice place a similar constraint of achieving ideal levels of contract cover going forward.

[24] On average, c 80% hedging levels, assuming ideal build-up of near quarter cover as per Power NI's hedging strategy.

6.5.4 *"K" correction assumptions*

NERA have examined the impact of "K" on a regulated supplier, i.e. looking at a regulated supplier with "K" versus a regulated supplier without "K". Hence, NERA's updated analysis has built in the benefits of "K" correction which in essence reduces the probability of default. The analysis also however includes an assumption that "k" will be negative, reflecting the actual position of "k", which has an off-setting and upward impact on total capital requirements.

The updated analysis concludes that the required profit margin should be £16.8m, plus an additional £1m to cover for forecasted carry forward of "K".

This can be expressed as a net margin of 3.6%, around double the margin proposed by NIAUR in their initial consultation.

7 Operating Costs

7.1 General Comments

This opex review follows the 2010/11 decision which implemented a severe reduction in opex entitlement; including disallowances due to what Power NI believes was the erroneous treatment of efficiency gains. This is a function of short price control terms (1 year versus 5 year). As stated previously the disallowed efficiency gains in the 2010/11 review resulted in Power NI's share of gains within the previous period to be capped at an estimated circa 4% to 8%. Under a 5 year price control an expected share would have been in the region of 30%. This compromises the basic premise of incentive regulation i.e. providing a reasonable return for risks taken in securing savings.

Additionally and for the avoidance of doubt, Power NI expect that all reasonable IME3 compliance costs will be treated as a pass through item, including new tariff notice conditions and any compounding impact arising from multiple tariff changes. As the IME3 details were not available at the time of data submission no cost estimation for the related changes were requested or included in the opex figures. Should NIAUR consider IME3 compliance as a St opex item, the relevant cost areas will require amendment.

As part of this review, NIAUR have conducted a bottom-up analysis of opex. While this represents a reasonably transparent approach, it is subject to significant error. Such an approach does not take a holistic view but rather subjectively disallows certain opex lines, using the lower of our submitted figure or another benchmark.

Assessing individual opex categories and taking the lower of Power NI's own costs and an external best practice benchmark is particularly flawed for two reasons:

- There is a likelihood of variation in reported individual cost categories and cost allocation methods when considering the micro level.

- Even if there were no variations the method would imply a need for Power NI average efficiency to exceed best practice in order to achieve the baseline target.

Choosing therefore, from either the efficient Power NI current level or an industry best practice at a micro level, places an unreasonable expectation on Power NI.

The methodology employed also does not reflect good practice as it gives no consideration to the comparative overall efficiency levels or inherent allocation differences. Power NI has little confidence in the overall opex conclusions. Consideration should be given to a top down approach as it would have stronger regulatory precedent, offers more credible results, suffers less from errors, passes empirical tests and allows a wider and more robust view of overall efficiency levels.

7.2 Benchmarking

As agreed during the price control discussions Power NI provided NIAUR with a benchmarking paper summarising an independent analysis undertaken by NERA Economic Consulting[25]. This paper contained a comprehensive assessment of Power NI's costs compared to ESB PES and GB suppliers. A high level benchmark against Phoenix Supply Ltd was also included.

While it is not Power NI's intention to repeat the full content of that paper, it is worth noting NERA's concluding comment and a summary of the 2010 cost to serve benchmark analysis –

"our analysis strongly suggests that NIEES' [Power NI] operating costs are substantially below those of its comparators at least in part because NIEES [Power NI] is an efficiently run operation."[26]

[25] Benchmarking of Power NI's Operating Costs A Report for Power NI, NERA Economic Consulting, 25 February 2011

[26] Page 23 of NERA Benchmarking Paper

Supplier	£/Cust/Annum	% vs Power NI
ESBCS	64	137%
Average GB	50	85%
Phoenix Supply	39	44%
Power NI	27	

This report clearly shows that Power NI is a highly efficient organisation with a best in class comparative cost to serve. Power NI would urge NIAUR to revisit the NERA paper when considering an appropriate opex allowance. NERA have significant experience in completing this type of analysis and the paper represents a balanced and detailed assessment of Power NI's operating costs.

Power NI also note that during the price control interactions, IPA Economics, who were appointed by NIAUR to assist with opex assessment stated that in a top down assessment, comparator companies cost to serve was circa £60 per customer. It is disappointing therefore that within the paper there has been no attempt to characterise the exceptional efficiency of the business as compared to its peers.

Power NI consider NIAUR's opex proposals to be significantly below the reasonable level an efficient business should be allowed.

7.3 Opex Analysis

7.3.1 *Switching Rates*

Various scenarios and predictions can be made regarding the forecast level of switching which will take place over the duration of this price control. Power NI however disagrees with NIAUR on a number of principles surrounding the effect of competition.

NIAUR maintain that a reduction in customer numbers will reduce customer queries and debt. Such a direct correlation may be relevant to a monopoly business in which there is no prospect of competition and a low level of risk however this does not reflect the changing environment and market which Power NI is currently participating. With the advent of competition and as a result of doorstep selling in particular, call durations have increased by circa 29%[27]. Additionally, final account billing increases the number of customers who are pursued for debt. Power NI therefore considers it unreasonable to apply such a correlation.

7.3.2 *Headcount and Staff Costs*

Power NI considers correlating headcount to customer numbers as a flawed approach. Increasing levels of contact centre service effort will require headcount changes in order to maintain service at the current levels. Call durations increase as a result of competition and Power NI expects call volumes to increase post any tariff announcement; especially if mid year adjustments are introduced. Additionally, higher final account debt management activity will be required to maintain low debt levels.

These costs are directly attributable to competition and the consequences of increased retail market activity.

Additionally, in preparation and response to the Enduring Solution Project, Power NI prudently expects to require additional support while training for and supporting the cut over and initial sub-optimal running of new systems.

However, Power NI believes that this matter could be dealt with under the Enduring Solution Programme[28] itself.

7.3.3 *MBIS*

In the consultation proposals NIAUR accept the majority of the MBIS cost items as provided in the information submission. However, it is proposed that Power NI's allowance for communications and marketing will be reduced significantly.

The proposed levels of communication costs are characterised as a freeze, however at 2009/10 levels. In real terms therefore, this is a reduction of the 2010/11 approved levels[29] and a disallowance of submitted forecast. Power NI argues that with increased competition, customer communication must also increase to avoid confusion. Customer confusion will manifest itself in

[27] Call duration comparison 2011 vs 2010 (BE Contact Centre) – HE Contact Centre c23% uplift
[28] And thus considered for recovery under the Et term
[29] As set by NIAUR through the 2010/11 Price Control Decision

greater volumes and duration of calls. Power NI considers the submission made as justifiable and extremely efficient, representing only 14% of the levels approved by CER in the last ESB Customer Supply Price Control[30].

NIAUR's position seeks to reduce communication expenditure based upon the justification that increasing or maintaining the value of the business should be funded by shareholders. Power NI fundamentally disagrees with this premise.

Although increasing customer share was not the context in which this submission was made (demonstrated by the levels requested being manifestly lower[31] than would be required for a proactive marketing campaign). Power NI consider any consequential benefit and brand support from proactive communication as an entirely reasonable aspect of a price control determination. By seeking to disallow an efficient level of opex for communication and brand support, thus exposes the business to greater operational risk which consequentially should be acknowledged in a higher allowed margin.

The loss of synergies line items were also disallowed in the NIAUR proposal. Items such as accommodation and relocation are not related to the divestment of NIE but rather the pre-existing desire for physical business separation and therefore exit of Power NI Contact Centres from NIE sites. This activity has been on the agenda and discussed with NIAUR over some time and would have occurred regardless of the sale of NIE.

The remaining synergy costs which have been rejected are due to a reduction in the economies of scale available to Power NI as a member of a smaller Viridian Group. Power NI believes NIAUR have adopted an inequitable asymmetrical view towards these costs; costs which would be significantly higher if the business undertook the activities on a standalone basis. In past price control determinations NIAUR have been consistently reducing opex allowances reflecting the economies of scale available to Power NI as the Viridian Group expanded. To disallow increases in these costs now the Group has reduced in size reflects an inconsistent approach. It is not appropriate for NIAUR to penalise Power NI for being part of a smaller group.

[30] Prior to deregulation and rebranding change to Energy Ireland
[31] By a factor of at least 3 or 4 times

Following recent financing and banking services discussions post the data submission to NIAUR, Power NI will need to revisit the MBIS agency item as a result of bank transaction charge rate changes. Power NI will submit details regarding this issue to NIAUR for consideration in the final decision.

Additionally, Power NI has historically not tended towards mid year tariff changes. It is likely that this situation will not persist and mid year changes will become increasingly common. Opex items such as printing and postage as well as general communication costs linked to additional tariff changes were not included in the original submission, and therefore should the assessment of margin include an assumption of a mid year tariff change, this must be reflected in the appropriate opex line items.

7.3.4 *Debt figures*

Power NI forecast bad debt to be 0.56% of total revenue for the two year duration of this control. NIAUR by contrast has proposed a bad debt level of 0.5%.

Power NI believes that debt levels remaining unchanged is an unrealistic target. Given the current credit crunch, global uncertainty, the inherent levels of fuel poverty in NI, public sector spending cuts and a general poor economic outlook an increase in debt levels are to be expected. In addition the level of final bill debt and stranded debt in the case of keypad customer switching will increase with competition and can only be recovered through costly legal channels[32].

Power NI believes the bad debt percentage as submitted represents a reasonably optimistic[33] view of an uncertain cost item and is at a lower level than the 1% of credit revenue NIAUR proposes to allow Phoenix Supply (as keypad represents one third of Power NI customer base 1% of credit revenue would equate to 0.66% if applied to the Power NI Price Control). Additionally Phoenix Supply are not exposed to the levels of competition equivalent to Power NI and therefore do not have the same level of final bill debt.

[32] Issues acknowledged by CER in their recent paper - Customer Bad Debt in Electricity and Gas Markets, CER/10/106

[33] Given the passage of time and prevailing market / economic conditions between submission and decision, Power NI feel that an upward projection may be appropriate

7.3.5 *Corporate Charges*

Corporate charges have historically been incurred as a function of activities carried out on behalf of Power NI at a Viridian Group level. As with all group owned businesses certain activities will be conducted on their behalf bringing to bear some economies of scale and general oversight.

Since the sale of NIE however the Viridian Group is now significantly smaller and while the total Viridian Group corporate cost has reduced by 40% in the financial year ending March 2011, the charges are apportioned across a smaller number of businesses. Power NI proposed costs represent a direct proportional allocation.

The corporate charge covers areas such as Treasury, Group Technology, Group Tax, Group Legal, Group Human Resources, Payroll and financial system administration. The completion of such activities would require substantial additional resource and cost if Power NI were to operate on a standalone basis. Undertaking such functions at a corporate level therefore provides a degree of efficiency and economy of scale which could not be replicated within the business in isolation.

7.4 Opex Summary

Power NI believes that the detailed information provided represents a reasonable assessment of forecast cost items. Starting from a benchmarked, efficient cost base, the submission contains a relatively small cost increase which is directly related to competition and market changes.

A cost of competition has been seen in other markets and should be acknowledged.

Power NI also believes that due consideration has not been given to benchmarks at a macro level, especially as Power NI is broadly34 regarded as an efficient business. Additionally, failure to recognise the different environment in which Power NI now operates and reducing Opex below an

[34] Both the NIAUR consultants IPA and Power NI consultants NERA agree the Power NI cost to serve is significantly below its comparators

efficient level threatens Power NI's customer service provision, and significantly increases business risk.

NIAUR have conducted a bottom-up analysis of operating costs and subjectively disallowed certain opex lines, taking the lower of Power NI's submitted figure or another benchmark. This approach gives no consideration to the comparative overall efficiency levels or inherent allocation differences.

Power NI believes that a top down approach has a stronger regulatory precedent, offers credible results, suffers less from boundary issues and errors, passes empirical tests and allows a wider and more robust view of efficiency to be taken.

Top down benchmarking analysis of opex clearly shows that Power NI is a highly efficient organisation with a best in class comparative cost to serve.

Power NI believes that the detailed information provided through the data submission process represents a reasonable assessment of forecast cost items. NIAUR's opex proposals are significantly below the reasonable level an efficient business should be allowed.

8 Next Steps

Despite the price control being behind schedule, Power NI believes that significant additional work is required on the detailed proposals. Power NI understands that NIAUR have appointed additional consultants to support further net margin analysis. Power NI welcomes this development and looks forward to engaging with both NIAUR and their consultants in that regard.

In consideration of responses and the requirements for additional analysis it would be useful if NIAUR could outline plans for engagement and the general next steps to be undertaken in this process. Power NI would welcome a binding terms of reference being developed.

Power NI is mindful that the intensive tariff setting process is underway and would urge NIAUR to be cognisant of this important activity when considering the next steps to this process.

In an attempt to conclude this review Power NI urges NIAUR to continue to engage with Power NI and NERA in undertaking a detailed assessment of required net margin and opex.

Power NI is committed to working with NIAUR in that regard and hopes that a revised review timetable can be agreed to build upon the detailed analysis already provided.