

Electricity and Gas Retail Supply Price Controls 2017 (SPC17)

UR Approach Consultation

Power NI Response

8 December 2015

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1. Introduction

Power NI welcomes the opportunity to respond to the Utility Regulator's (UR) 'Electricity and Gas Retail Supply Price Controls 2017 (SPC 17) UR Approach Consultation'.

As described in the Consultation Paper, Power NI remains subject to price control regulation. The setting of a reasonable and equitable control is therefore of fundamental importance to the on-going financeability and operation of the business.

The first stage of any price control must look at the contextual setting in which the review will take place, the existing framework and the potential new or increased risks that the business will face over the control period. In approaching this consultation response Power NI has considered each of these areas.

This paper will outline the key considerations for SPC17 and will seek to answer the relevant questions posed before drawing conclusions on the recommended approach.

2. Contextual Setting

Wholesale Market

As described in the UR's Consultation Paper, the development of the ISEM represents a fundamental redesign of the wholesale electricity market with a targeted implementation date part way through the first year of any potential new price control term. As the UR is aware, the ISEM will require suppliers, such as Power NI, to completely change their approach to the wholesale market, transitioning from being a passive real time taker of electricity to an active trading entity that is balance responsible for its metered volumes. This exposes Power NI to significantly greater risk and will require the implementation of specific ISEM trading and risk management functions.

While providing a sizeable implementation challenge, the ISEM project also has an impact on the detailed price control considerations. It is generally accepted that the ISEM will increase working capital and operating costs, however the precise nature of these are currently unknown. Full clarity is unlikely to be forthcoming until post ISEM go-live. This introduces a substantial degree of subjectivity into the forecast costs and renders an objective assessment impracticable. To progress a conventional new price control determination would require significant business model and cost estimation, exposing Power NI to risk and undermining the evidence based decision making regulatory principle.

Additionally, as the ISEM is of fundamental importance to all electricity stakeholders, both the UR and Power NI should be fully engaged with and focussed on the successful implementation of the project.

Retail Market

Any price control review would also be set within an increasingly competitive and changing retail market. Market shares of participants are changing and new suppliers are entering all sectors of the market.

In parallel with the changing dynamics of the retail market, both the CMA in Great Britain and UR are reviewing aspects of energy retail market effectiveness. Unfortunately the CMA has recently announced a delay to the publication of their investigation findings and remedies. These recommendations are likely to influence the UR in developing the future direction of regulatory frameworks to be applied to the Northern Ireland retail market.

Whilst Power NI remains impatient at the slow pace at which a roadmap for deregulation is being developed, it is at least understandable that the UR will wish to take into account unfolding developments in GB. Accordingly, maintenance of the *status quo*, represented by the existing price control¹, pending greater clarity on the future of regulation would be preferable to implementing a new price control while the regulatory future remains undescribed.

¹ the short duration of which was partly influenced by the necessity for UR to advance its thinking on the future of retail market regulation in Northern Ireland.

Additionally, we would reiterate that EU regulatory policy continues to urge the removal of price controls in energy retail markets. It would therefore be potentially nugatory to undertake a review with a mind to putting into place another full price control while critically assessing the continuing existence of price controls.

Precedent

The impact of a changing wholesale and retail market is an issue which arose in the past. In 2007 the UR acknowledged the fundamental change brought about by the introduction of the SEM and in the NIE Supply 2007-2009 Price Control Decision² stated:

“This document forms a further continuation of NIE Supply’s present price control (2000 – 2005, extended 2005 – 2007); this extension covers 1st April 2007 until 31st March 2009, straddling the introduction of new all-island wholesale arrangements and the introduction of full retail market opening from 1st November 2007.”

The UR also acknowledged a changing retail context in the NIE Energy Supply Price Control 2009/10 Decision Paper³ which stated:

“This document forms a further continuation of NIE Energy Supply’s current price control (2000-2005, extended 2005-2007 and extended further for the period 2007-2009); this extension covers 1st April 2009 until 31st March 2010. The new price control is being introduced at a time of advancement in energy retail competition which will bring about a period of change for the Northern Ireland electricity industry.”

² Published on 5 December 2007

³ Published 19 May 2009

3. Existing Control and its benchmarked positioning

As the UR is aware the existing control is characterised by –

- **A low opex allowance**

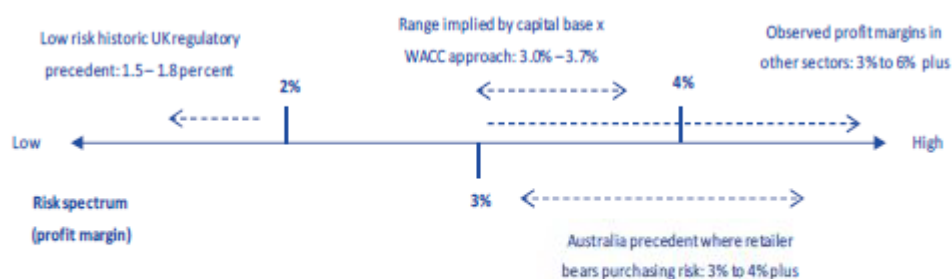
Within the 2014 Price Control Decision Paper, the UR stated that “we accept Power NI are at, or near, the efficiency frontier”⁴ and held the allowed operating expenditure levels consistent with this view.

The 2013 determination of the current price control allowed a low opex entitlement as compared to an average cost to serve observed by the “big 6” suppliers in GB. This is despite the GB suppliers having significantly more scale.

Notwithstanding future cost pressures in the NI electricity retail sector including i-SEM, Power NI’s current opex allowance and its relative position to other relevant energy retailers, reinforces its position at the efficiency frontier.

- **A margin figure set at the low end of the range**

As the UR has previously stated, a significant amount of work was undertaken in the analysis of Power NI’s net margin allowance under the 2014 Price Control process. Power NI argued that the 2.2% proposal and subsequent decision was positioned at the low end of the range determined by our consultants, CEPA.



Source: CEPA

The UR using ECA as support adjusted this calculation and determined that the 2.2% decision was at a mid point of a lower range. It was stated in the Decision Paper that:

“The UR believes the 2.2% decision to be a fair and reasonable allowance for the margin given the change in risk profile that Power NI has experienced as a result of the emergence of a competitive market.”⁵

⁴ Page 47

⁵ Page 9

Since this decision the risk profile of the business has increased due to deepening competition. It would therefore be reasonable to assume that any subsequent control would at least retain or likely increase the allowable net margin.

- **Duration**

The existing price control was set for a period of three years. The determination cited reasons such as market change as a factor in the decision. Although Power NI characterised this as a short duration control and the UR characterised it as a medium duration control, both organisations were cognisant that a three year duration is shorter than the regulatory norm of 5 years. The negative consequences of this include the increased workload upon UR and Power NI of conducting and inputting to reviews more frequently than may be optimal; and potentially undermining the inherent incentive within the price control framework for the business to drive efficiency in the knowledge that efficiency gains realised by the business would be retained for up to five years under a more traditional price control determination cycle.

In the event that the regulatory norm is disrupted by harvesting efficiency gains early, as could be the case where there is a review following a short price control, this runs contrary to the concept of incentive based regulation and fails to encourage medium to long term cost efficiency development.

4. Cost and risk uncertainty post March 2017

In addition to the potential ISEM impact on cost and margin considerations described above, there are a number of additional unknowns which would increase the complexity of any potential price control assessment.

Cost Challenges

- **Real wage inflation**

In the July 2015 Budget the Chancellor announced that a National Living Wage would be implemented starting at £7.20 and rising to £9. This would replace the £6.50 Minimum Wage. This will have both a direct and indirect impact upon Power NI's costs.

Direct impacts will be in relation to certain front line staffing costs and a consequential impact on general wage levels in the context of the costs of skilled occupations required to support multi channel customer engagement in a complex market environment.

Power NI also expects that service providers will experience cost increases which will be reflected in the available contracted rates of essential bought-in services.

- **Micro-generation volumes**

The Northern Ireland market has witnessed a significant increase in the number of micro-generation installations. While a temporary settlement solution has recently been implemented to account for the wholesale volumes, a permanent solution will be required. The key driver for the interim solution was the impact of the expected decision in relation to SMART metering.

While the assumption is that SMART metering will include a micro-generation solution it must be recognised that a decision not to progress in relation to the implementation of SMART metering will necessitate a traditional metering solution and a programme of work to enable it.

- **Customer engagement costs – share of voice comparators**

In previous controls discussion has taken place in relation to the ability of Power NI to maintain sufficient communication channels and engagement with customers. This would undoubtedly become an ever increasingly relevant topic in a retail market that is clearly heating up. Announcements such as Electric Ireland's spend of circa. £5m in Northern Ireland, alongside an aggressive national marketing campaign by SSE Airtricity, represent a serious competitive threat to Power NI. Additionally, the activity on new entrants such as Go Power, Click Energy and Open Electric cannot be underestimated.

Historically the UR has not recognised marketing costs within its allowance decisions. In future Power NI will be highlighting that such a decision runs contrary to one of the important Cornwall Energy Competition Review and CMA observations, i.e. that customer engagement is a key market effectiveness enabler. A failure to allow Power NI to fund a reasonable “share of the voice” reduces the level of knowledge, competitiveness and engagement in the market.

An under allowance in this area is also contrary to the principle that a determination is a proxy for business decisions that would be made in a competitive reality. The UR’s failure to recognise increasing competitor activity treats Power NI in a different manner to our competitors. Power NI believes this is an area of increasingly undue discrimination and contrary to the UR’s statutory duties.

- **Energy Efficiency Obligation**

Power NI understands that an Energy Efficiency Obligation remains a possibility. Such an obligation placed upon suppliers is likely to be difficult to comply with, especially since significant efficiency work has been undertaken over the past decade. This will result in a higher spend to result ratio than previously witnessed.

Understandably, Power NI would seek allowance to meet its obligations under any scheme and given that a penalty for non-compliance has been mooted, Power NI would expect specific licence conditions to deal with all eventualities from a recovery perspective.

- **ISEM**

We have already touched upon the potentially significant impact of the introduction of ISEM. In summary, the implementation of the ISEM will lead to increased opex costs for Power NI. Current systems will have to remain in place to accommodate SEM resettlement while the ISEM is running in parallel. New systems will also undoubtedly be more complex and deliver significantly greater functionality than current solutions. It is reasonable to assume that such systems will incur a greater on-going opex cost. The transformation to a trading entity will also require increased trading resources with real consideration given as to whether a 24/7 trading desk may be required.

Margin challenges

- **Increased competition**

As described above, increased competition presents real challenges to the business. As was recognised during the last control review, ‘K’ does not represent an absolute guarantee of recovery. As competition increases the potential for ‘K’ to reduce risk to the business diminishes. Reflecting the increasing risk and financing costs, the UR increased the allowed net margin from 1.7% to 2.2%. It is Power NI’s expectation that given the factors which led to an increase in margin have deepened; future controls would again recognise this in the allowed net margin.

- **ISEM**

As also described above, it is generally accepted that the ISEM will increase Power NI's working capital and operating costs. The full extent of this is currently unknown. Clarity is unlikely to be forthcoming until post ISEM go-live.

There are two key related assumptions that can be supported at present. The first is that suppliers will have to make significantly earlier payments i.e. next day has been mooted. Secondly, as all parties must be balance responsible, a supplier must be able to actively trade its way to balance through the market timeframes.

Both of these changes require a significant change to the operational model of Power NI. The transition to a trading entity will be a fundamental shift from the current operational model, requiring increased working capital provisions and exposing the business to higher levels of risk.

5. Response to Consultation Questions

Q1. Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?

A1. No response.

Q2. Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If so, why and how? Please provide supporting information and evidence.

A2. No response

Q3. Do respondents consider that the existing structure and form remains appropriate for the next Power NI price control? If not, please explain what you believe the structure and form should be.

A3. Power NI considers the current structure and form of the price control as generally appropriate.

Q4. Do respondents consider that the proposed review of the gas supply licences are appropriate? If not, please explain your reasons.

A4. No response

Q5. Do respondents agree that with the UR proposal to review price regulation in the 0-50MWh sector of the market? Please provide suitable evidence, including legal opinion if applicable, as to why price regulation should or should not remain in this sector.

A5. Power NI strongly believes that it is time for the UR to consult on the removal of price regulation in the non-domestic sector. For the following reasons this issue simply cannot wait to be part of the price control decision.

- European Context and the absence of harm

Within previous correspondence Power NI has outlined concerns in relation to Phase 2 of the “Review of the Effectiveness of Competition” highlighting ACER and the European Commission’s views on the retention of price regulation. The Commission has repeatedly stated its requirements in relation to price regulation. Publications such as the EC Communication “Making the internal energy market work” (November 2012, but published January 2013) states that regulating of prices should cease.

In particular, section 3.2.1 states that:

“Member States should seek to cease regulating electricity and gas prices for all consumers, including households and SMEs, taking into account universal service obligation and effective protection of vulnerable customers. Suppliers should clearly spell out the different cost elements in the final cost for their customers, to encourage well-informed decision-making. The Commission will continue to insist on phase-out timetables for regulated prices being part of Member States' structural reforms. The Commission will continue to promote market-based price formation in retail markets, including through infringement cases against those Member States maintaining price regulation that is not meeting the conditions laid down by EU law.”

ACER has also commented on the position of regulated prices:

“Regulated end-user prices are not compatible with the objective of establishing liberal competitive retail markets. Therefore, CEER will develop guidance, based on experiences at national level, on the approaches to be used to facilitate the phasing out of regulated end-user prices, as soon as practicable, whilst ensuring that customers are properly protected where competition is not yet effective”⁶

The European commentary highlights the negative impact that price regulation has on competition and that any active market intervention to address a clear identified harm must be time limited. Further, the focus on the domestic context emphasises that there should be specific policy reasons for the retention of price regulation, which is not the case for the non-domestic sector in Northern Ireland. As set out in our previous correspondence concerning the “Review of the Effectiveness of Competition”, the analysis conducted by Cornwall Energy does not adequately consider this context.

In Northern Ireland the non-domestic market has active competition, unrestricted switching, Codes of Practice (including a Marketing Code) and will soon have full Market Monitoring. Given the level of competition in the non-domestic market in Northern Ireland, we fail to see what specific and identified harm is mitigated by the continuation of price regulation.

- Previous decision to retain price regulation

During the 2014-17 Price Control process, Power NI strongly argued that the retention of price regulation for the non-domestic market was no longer appropriate. The UR did not accept this position and expressed a view that Power NI, together with Energia, retained a dominant position and therefore price regulation should be retained to provide consumer protection.

It seems clear to us that the current market conditions necessitate a consultation on the removal of price regulation in the non-domestic sector as there is a clear lack of dominance. Further, the retention of price regulation in the non-domestic sector is ineffective, distortive and has disproportionate effects on the development of competition and the wider electricity supply market.

⁶ ACER - Energy Regulation: A Bridge to 2025 Conclusions Paper (19 September 2014), and in particular, para 51

- Absence of dominance

The UR analysed the non-domestic market by reference to three market sectors (0-50MWh, 50-100MWh, and 100-150MWh per annum) during the previous price control process. Disappointingly, the UR does not publish market share information that allows for a like-for-like comparison with the data included in the price control decision. Nevertheless, Power NI has reviewed the information made available in the Quarterly Transparency Reports to assess the Power NI non-domestic market share. Using <70kVa as a proxy, the Power NI/Energia market share of the rolling 12 months consumption in Northern Ireland has been less than or equal to 50% for in excess of a year. As a result, the dominance trigger set by the UR has been met and a consultation exercise should be undertaken.

The Cornwall Energy Report does not clearly distinguish between domestic and non-domestic consumers. Nevertheless, we note that the Cornwall Energy Report highlights that the current segmentation of the market for the purposes of the assessment of dominance is unhelpful and should be considered further.

Separately, from a European perspective, the relevant market for the assessment of dominance may be the Island of Ireland, rather than Northern Ireland alone. This is due to the operation of the single electricity market, with price coordination and an aligned regulatory framework. This further strengthens the evidence that Power NI is not dominant in the non-domestic sector and therefore price regulation should be removed.

- Ineffective

The UR's 2013 Decision Paper included an assessment as to whether competition was sufficiently effective so as to "protect the interests of consumers in relation to price". The Decision Paper concluded that the UR considered the 0-50MWh non-domestic sector remained in need of regulatory intervention.

Power NI considers this decision was fundamentally flawed. Price regulation is not in place for the entirety of this sector but rather a sub-section of a sub-section of the market share figure described above i.e. it is not in place for the entire 50% of the combined Power NI/Energia share but rather a percentage of Power NI's share only.

Based upon latest figures, Power NI supplies only 29,613 MPRNs or 274GWh of annual sales on price regulated tariffs. Positioning this within the August UR Quarterly Transparency Report this means that only 22% of consumption in the <70kVA reported sector or 6% of non-domestic consumption is subject to price regulation. In terms of customer numbers this equates to 46% of <70kVA or 43% of non-domestic consumers are subject to price control.

For the majority of customers price regulation offers no protection.

- Distortive

Power NI has argued consistently that the retention of a price control in a market that is demonstrably competitive compromises the proper operation of that market

and is counterproductive. A regulated tariff that acts as a market reference price but is based on an unrepresentative set of cost drivers distorts the market and lead to poor customer outcomes. These outcomes are clearly not in the best interests of customers generally, or those customers who are taking supply from a competing supplier, whose price offer is distorted upwards in line with the unrepresentative reference price. The UR is now faced with a situation whereby 9% of consumption⁷ is driving the offers for the remaining 91%.

As set out above, the European Commission is increasingly concerned about the distortive effect that the maintenance of price regulation can have on the development of competition in electricity supply markets.

- Disproportionate

The retention of price regulation in the non-domestic sector has a significant impact on the Power NI business. As you will be aware, linked to the price control requirements are additional licence conditions in relation to business separation, independence and the use of assets. These conditions prevent Power NI from realising efficiencies and economies of scale which would benefit consumers. The current standpoint of the UR has not been adequately justified, particularly in light of the UR's statutory duty to protect consumers, including by way of promoting competition within the electricity supply sector.

Power NI believes that by actively restricting its managerial and operational model, the UR is treating Power NI in a manner which is not consistent with its competitors, some of which are part of much larger organisations and are actively utilising the economies of scale their respective Groups can offer. The restrictions placed upon Power NI are increasing cost to consumers and restricting the further development of competition in Northern Ireland.

- Summary

In summary, Power NI strongly believes that the context and basis of the decision to retain price regulation in the non-domestic sector has changed; it would be unhelpful to cloud the price control agenda with this issue and the UR should publically consult on the removal of this unnecessary restriction without delay.

Q6. Do respondents agree with the UR proposal to review price regulation in the 73,200kWh to 732,000kWh (EUC 2) sector of the market? Please provide suitable evidence, including legal opinion if applicable, as to why price regulation should or should not remain in this sector.

A6. No response

Q7. Do respondents agree that it is reasonable to retain the scope of the price control for firmus at the under 732,000kWh sector of the market?

A7. No response

⁷ Price regulated demand as a percentage of non-domestic excluding LEUs who will seek bespoke tariffs

Q8. Do respondents feel that a duration of three years for the next price controls for electricity and gas is appropriate?

A8. The question of duration is inextricably linked to the development of the UR's strategic roadmap. As described above, Power NI believes that there is already a need for the UR to revisit the framework for price regulation as a matter of urgency.

In addition to the removal of price regulation in the non-domestic market Power NI believes that there is a clear need for a process that leads to a progressive removal of price controls and a properly functioning domestic retail market.

Should the UR determine that a full SPC17 process is required for Power NI, it should recognise that short term controls create a significant burden of regulation and remove efficiency incentives while long term controls do not adequately reflect the changing market.

A 3 year proposal is a reasonable mid point however should not be considered as a long term control. Longer term controls typically last between 5-7 years. Additionally, Power NI is concerned that a 3 year control may be interpreted as the timeframe for the conclusion of the URs effectiveness of competition market review. There is clear evidence that the Northern Ireland retail market is developing at a much faster rate than the UR acknowledges and that the regulatory framework lags significantly behind.

Q9. Do respondents think that a potential roll-over of the current Power NI price control is appropriate to help address the uncertainty in relation to the development of the new I-SEM?

A9. As described above, the development of the ISEM represents a fundamental redesign of the wholesale electricity market with a targeted implementation date part way through the first year of any potential new price control term. As the UR is aware, the ISEM will require suppliers, such as Power NI, to completely change their approach to the wholesale market, transitioning from being a passive real time taker of electricity to an active trading entity that is balance responsible for its metered volumes. This exposes Power NI to significantly greater risk and will require the implementation of specific ISEM trading and risk management functions.

While providing a sizeable implementation challenge, the ISEM project also has an impact on the detailed price control considerations. It is generally accepted that the ISEM will increase working capital and operating costs, however the precise nature of these are currently unknown. Full clarity is unlikely to be forthcoming until post ISEM go-live. This introduces a substantial degree of subjectivity into the forecast costs and renders an objective assessment impracticable. To progress a conventional new price control determination would require significant business model and cost estimation, exposing Power NI to risk and undermining the evidence based decision making regulatory principle.

If one accepts the premise that the current price control broadly represents the appropriate building blocks for an efficient supply business, the basis exists for a

continuation of the current price control which, in any event and because of uncertainty regarding the future course of supply market deregulation which continues to pertain, was set for a relatively short duration (three years, as opposed to a conventional five years). The question that remains is whether the new ISEM will so materially change the market and the cost base of Power NI operating in that market so as to require a more radical reappraisal of the price control building blocks, an outcome which will be more accurately determined once the new market has become operational and bedded in. The question arises for Power NI whether it is content to accept the risk of its operating cost base in the new market in the short term. This can only be the case if Power NI expects its efficiency performance under its current price control broadly to mitigate the foreseeable risks during an extension, an assumption we are prepared to make.

In addition to ISEM wholesale uncertainty the UR should be mindful of retail changes. Any price control review would also be set within an increasingly competitive and changing retail market. Market shares of participants are changing and new suppliers are entering all sectors of the market.

In parallel with the changing dynamics of the retail market, both the CMA in Great Britain and UR are reviewing aspects of energy retail market effectiveness. Unfortunately the CMA has recently announced a delay to the publication of their investigation findings and remedies. These recommendations are likely to influence the UR in developing the future direction of regulatory frameworks to be applied to the Northern Ireland retail market.

Whilst Power NI remains impatient at the slow pace at which a roadmap for deregulation is being developed, it is at least understandable that the UR will wish to take into account unfolding developments in GB. Accordingly, maintenance of the *status quo*, represented by the existing price control⁸, pending greater clarity on the future of regulation would be preferable to implementing a new price control while the regulatory future remains undefined.

In short therefore, Power NI believes a rollover is entirely appropriate.

Q10. Do respondents consider the approach outlined for assessing the Power NI opex is appropriate at this price review? If not, please explain what approach you consider the UR should take to assessing opex and the reasons why.

A10. As described above Power NI's current opex allowance reflects its position at the efficiency frontier.

Within the Consultation Paper the UR has stated a preference for an opex review which is a mix of both 'top down' and 'bottom up'. 'Bottom up' would appear to be a line by line assessment of the Business Efficiency Questionnaire (BEQ). This has been an approach that the UR has historically relied upon. As communicated throughout the previous price control process a 'line by line' approach while representing a reasonably transparent approach, is subject to significant error.

⁸ the short duration of which was partly influenced by the necessity for UR to advance its thinking on the future of retail market regulation in Northern Ireland.

Such an approach does not take a holistic view but rather subjectively disallows certain opex lines, using the lower of our submitted forecast figure or historic performance based upon the URs view of the supporting arguments.

The 'top down' approach appears to allow cost category movements if the overall allowance remains static. While this may deal with allocation issues, cost increases are again dependent solely upon the URs view of the supporting arguments.

Power NI believes this business as usual approach, which dates back to pre competition, should be replaced with a top down best new entrant approach. This reflects the broader business costs that Power NI should be allowed (including marketing), and is reflective of the costs that a new entrant would need to invest in a sustainable business model. Other models including those used by IPART in Australia to price regulate suppliers in competitive markets which have not reached full price deregulation, are also more relevant to the Northern Ireland electricity market than the 'line by line' proposal.

CEPA had explored the methodology question in more detail and a paper entitled 'Framework for setting retail operating costs in a liberalised market' was submitted to the UR during the last control. This should be revisited.

Any assessment methodology used must recognise that Power NI has and will continue to be faced with an unavoidable cost of competition. This has been seen in other markets and should be acknowledged within Power NI's cost allowances. As described above, in previous controls discussion has taken place in relation to the ability of Power NI to maintain sufficient communication channels and engagement with customers. This would undoubtedly become an ever increasingly relevant topic in a retail market that is clearly heating up. Announcements such as Electric Ireland's spend of circa. £5m in Northern Ireland, alongside an aggressive national marketing campaign by SSE Airtricity, represent a serious competitive threat to Power NI. Additionally, the activity on new entrants such as Go Power, Click Energy and Open Electric cannot be underestimated.

Historically the UR has not recognised marketing costs within its allowance decisions. In future Power NI will be highlighting that such a decision runs contrary to one of the important Cornwall Energy Competition Review and CMA observations, i.e. that customer engagement is a key market effectiveness enabler. A failure to allow Power NI to fund a reasonable "share of the voice" reduces the level of knowledge, competitiveness and engagement in the market.

An under allowance in this area is also contrary to the principle that a determination is a proxy for business decisions that would be made in a competitive reality. The UR's failure to recognise increasing competitor activity treats Power NI in a different manner to our competitors. Power NI is concerned that neither methodology suggested by the UR adequately deals with this issue and believes this is an area of increasingly undue discrimination which is contrary to the UR's statutory duties.

As also described above, ISEM will represent a potentially significant cost increase for Power NI. In summary, the implementation will lead to increased opex costs as current systems will have to remain in place to accommodate SEM resettlement while the ISEM is running in parallel. New systems will also undoubtedly be more

complex and deliver significantly greater functionality than current solutions. It is reasonable to assume that such systems will incur a greater on-going opex cost. The transformation to a trading entity will also require increased trading resources with real consideration given as to whether a 24/7 trading desk may be required.

Due to the timing of both the project and the potential price control review it will be difficult to accurately forecast the level of these cost increases. This introduces a substantial degree of subjectivity into the forecast costs and renders an objective assessment impracticable. To progress a conventional new price control determination would require significant business model and cost estimation, exposing Power NI to risk and undermining the evidence based decision making regulatory principle.

Q11. Do respondents consider the approach outlined for assessing the treatment of costs for the gas supply companies appropriate? If not please explain what approach you do consider to be appropriate and the reasons why.

A11. No response

Q12. What are respondents' views on the proposed approach to establishing a margin for Power NI?

A12. Consistent with Power NI's response to the existing price control determination, while a margin allowance of 2.2 per cent represented progress towards recognising the risks which Power NI face and the capital requirements of its regulated business, Power NI still believes that the UR's proposals, and ECA's supporting analysis, give limited weight to the impact that the changing retail landscape in Northern Ireland has for the ability of Power NI to finance its regulated activities. Power NI is clearly significantly less dominant than when a monopoly supplier and has transitioned to a position close to when comparable suppliers had price controls removed and were deemed to be no longer dominant. The relatively modest increase in margin in the last determination from 1.7 per cent when Power NI supplied 100 per cent of the domestic market, to 2.2 per cent when supplying 74 per cent, does not equate when market margins are at 60 per cent. As the Northern Ireland market becomes increasingly competitive Power NI's margin must transition to competitive levels.

Power NI believes that too much weight was placed by the UR on ECA's risk-based methodology particularly ECA's quantification of K risk and how investment/cost recovery risk is therefore accounted for in the UR's margin proposal. Power NI continues to believe that the CEPA method of calculating the margin, based on the forecast capital requirements of the business, cross-checked to practical evidence of financeability constraints retail electricity trading businesses face, provides a more reliable estimate of the required margin.

Power NI also continues to believe that the ECA's report underestimates the impact of this fundamental shift in capital and regulatory commitment as a result of the changing retail landscape in NI:

- Firstly, accepted ex ante principles of regulatory commitment to Power NI capital may not be perceived as reliable. As highlighted previously, the UR cannot ensure that Power NI will always retain a sufficient size of customer base, regulatory approval to recover costs and sufficient pricing power to always facilitate the full recovery of K. As the previous protections and regulatory commitment to the retail businesses capital can no longer be so strongly relied upon in the increasingly competitive market, this fundamentally alters the basis of investor risk and return in the context of the forthcoming price control period.

- Secondly, commercial protections against the risks of accumulating under-recoveries are based on theoretical inferences, not the practical circumstances of the market. The examples that ECA provide of how Power NI could manage K risk illustrate again how the state of world has changed. While fixed term supply contracts and hedging policies may provide a market based means, in certain circumstances, to manage aspects of risk, no evidence was provided by ECA that the practical circumstances exist to implement such strategies. As highlighted previously, there are significant practical constraints on the contract hedging market which may prevent Power NI from efficiently managing certain risks in a context where it is still subject to price controls.

Power NI therefore continues to believe the riskiness of the business was underestimated by ECA's analysis, particularly as a result of how key financeability issues, such as capital commitment, are treated within a largely theoretical analysis of the risks. On that basis, Power NI believes that the UR provided a low estimate of what is required in the given the risks that Power NI face. An ex ante supply margin (St) entitlement closer to 3 per cent (as supported by previous submissions) would be a more realistic estimate.

Notwithstanding the above position, it is Power NI's expectation that given the factors which the UR stated led to an increase in allowed margin have deepened; future controls would again recognise this and the allowed net margin would increase.

In addition it is generally accepted that the ISEM will increase Power NI's working capital costs. While the full extent of this is currently unknown and clarity is unlikely to be forthcoming until post ISEM go-live there are two key related assumptions that can be supported at present. The first is that suppliers will have to make significantly earlier payments i.e. next day has been mooted. Secondly, as all parties must be balance responsible, a supplier must be able to actively trade its way to balance through the market timeframes. Both of these changes require a significant change to the operational model of Power NI. The transition to a trading entity will be a fundamental shift from the current operational model, requiring increased working capital provisions and exposing the business to higher levels of risk.

Power NI is concerned that should the UR chose not to rollover the current control the ISEM factors will not be adequately reflected in the margin analysis.

Q13. What are respondents' views on the proposed approach to establishing a margin for the gas supply companies?

A13. No response

6. Conclusion

Any price control determination is of a business critical nature for Power NI. It is of fundamental importance that allowances are reasonable and the business can operate in its respective markets in an efficient and competitive manner.

As described above the context of a review at this point raises considerable uncertainty. There will undoubtedly be increased operating costs, financing requirements and risk associated with the changing wholesale and retail markets. Their unquantifiable nature renders any analysis at this time highly subjective.

The current control represents a sizeable challenge to the business. This is a challenge which Power NI has worked extremely hard to meet and efficiencies have been made. While the UR might potentially look to harvest those efficiencies through a new price control process (subject, amongst other things, to the appropriateness of doing so in the context of the relatively short period of the current price control) this would be inappropriate in the light of ISEM, increased competition and other operational challenges which give rise to an upward trajectory of costs and risks post 2017.

Power NI is concerned that with such uncertainty an appropriate balance may be impossible to reach. It is mindful of such risk that Power NI values the certainty that a 2 year rollover would provide.

The 2014-2017 control mandated that Power NI remains at the efficiency frontier and operates with a relatively low net margin. There is nothing to suggest that retaining the allowances would not maintain this position. A further 2 year retention period does not expose price regulated customers to additional costs.