Power NI
Woodchester House
50 Newforge Lane
Belfast
BT9 5NW

www.powerni.co.uk

Jody O'Boyle
The Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED

22 May 2014

Dear Jody,

<u>Re: Consultation on NIE's Payment Security Policy.</u>

Power NI welcomes the opportunity to respond to the Utility Regulator's (UR's) consultation on NIE's Payment Security Policy. The UR notes within the paper that NIE conducted this consultation between October and December 2013 with only two suppliers responding. Power NI was one of those respondents and I have included our response in Appendix A. Power NI's position and recommendation is relation to this issue has not changed.

As stated in our response to NIE, Power NI acknowledges that payment security is an important market issue as it reduces risk exposure. It does however come at a cost, either on an on-going basis or as a result of a market event. This cost is ultimately paid by consumers and therefore in any assessment or policy decision a balance must be struck between risk and cost exposure.

Power NI believes that it is important to strike a reasonable balance between risk and cost. It is clearly not in customers, the markets or NIE's interest to have no collateral in place. Equally however, it is not in customer's interest to put in place credit requirements which are excessive and highly improbable that they will be required.

Within the consultation paper the UR has posed a number of specific questions for respondees. Power NI has addressed each in turn -

Question 1. What is the realistic security cover shortfall that should be considered when reviewing the current Payment Security Cover policy?

The change to NIE's billing arrangements was as a result of the implementation of the Enduring Solution Project. The project facilitated the IT separation of NIE and Power NI and implemented the 'continuous billing' DUoS arrangement noted in the paper. It is important to recognise however that while the DUoS billing did change for most suppliers it did not change in relation to Power NI (as the legacy billing arrangement was 'continuous') nor did it change in relation to interval metered customers. Based upon the latest UR Quarterly Transparency Report therefore 72% of the DUoS market by consumption was unaffected by the implementation of the Enduring Solution.

Question 2. What is the likelihood of a Supplier/Suppliers defaulting and NIE being unable to recover the debt within 6 months or earlier?

Supplier default is a very unusual event. While not impossible, supply companies tend to be asset light with their value being directly linked to its customer book; therefore in most occurrences of financial difficulty, some form of trade sale takes place before any licence revocation and supplier of last resort direction. Once a supplier has lost all customers there is no residual value in the business.

Question 3. Do Suppliers consider that the 1% charge is a 'typical rate' for them to provide additional cover?

Power NI believes that 1% may be based upon a rate available to an asset heavy company prior to the recent economic downturn and banking sector difficulties. It is extremely unlikely that the quoted rates would be available to all suppliers in the market, especially those who are not investment grade and / or 'asset light'.

Power NI therefore believes that in the assessment the cost of additional cover should be increased significantly to appropriately reflect both the available rates and the relative size of suppliers.

Question 4. Will an increase in Supplier cover be seen as a barrier to entry to new Suppliers?

The electricity market requires significant lines of credit to be in place across the various functions i.e. wholesale cost with SEMO, any hedging with counterparties, TUoS with SONI and DUoS with NIE. This can be onerous on a supply company especially in the market entry stages when general expectation is that a loss will be made due to establishment, marketing and entry costs. Any increase in requirements therefore goes directly to the financeability of market participants and the likelihood that a bank will provide the credit facilities required. Clearly after the banking crisis securing finance is more difficult and therefore increase collateral requirements will act as a barrier to entry.

Question 5. Which of NIE's options strikes the best balance between the risk and the cost to the consumer?

Power NI believes the status quo (Option 1) is a reasonable position to maintain. Some risk of shortfall does exist at peak times due to the averaging nature of the requirement. The likelihood of this risk materialising however is small due to the nature and concentration of the supplier community in Northern Ireland. Coupled with an assumption that an appropriate recovery mechanism can be agreed between the UR and NIE is the event of such an unlikely event occurring; Power NI believes the status quo represents a reasonable risk position to adopt striking a balance between the short and long term costs to consumers.

Question 6. Should any other options/risk cost recovery mechanisms be investigated?

It would appear that should a default occur NIE would seek to recover all outstanding sums in one year. Power NI believes NIE and the UR could agree a recovery mechanism (and return on the working capital requirements) which would smear the recovery across a longer time frame. This proposal mirrors the recovery mechanism proposed following the delay in the recent NIE price control determination. Adopting this approach would reduce the impact on consumers of a default by increasing the recovery horizon.

As stated in our response to the NIE consultation; mindful of both the level of risk, the likelihood of occurrence and the cost to consumers; Power NI strongly recommends that the status quo is maintained in relation to the DUoS credit requirements placed upon suppliers.

Yours sincerely

William Steele
Power NI

Appendix A – Power NI's response to NIE's Consultation Paper published in October 2013

Power NI
Woodchester House
50 Newforge Lane
Belfast
BT9 5NW

www.powerni.co.uk

Roisin Ballentine
Northern Ireland Electricity Limited
Danesfort
120 Malone Road
Belfast
BT9 5HT

20 December 2013

Dear Roisin,

<u>Re: Proposal to increase payment security cover provided by suppliers under NIE's Payment Security Policy.</u>

Power NI welcomes the opportunity to respond to the above consultation. Payment security is an important market issue as it reduces risk exposure. It does however come at a cost, either on an on-going basis or as a result of a market event. This cost is ultimately paid by consumers and therefore in any assessment or policy decision a balance must be struck between risk and cost exposure.

The policy decision therefore should firstly deal with the question of risk and risk allocation.

A fully collateralised Distribution Use of System (DUoS) requirement ensures that if a supplier defaults, NIE can draw down the credit in place, recover the necessary funds and no additional charges will be passed onto consumers through DUoS charging. This fully collateralised position requires suppliers to have substantial lines of credit in place. This placement of credit incurs significant bank charges and is a cost which is ultimately passed on to consumers via end user tariffs on a continual basis.

At the opposite end of the spectrum, should no collateral be in place and a supplier defaults, NIE would have a shortfall in received funds. This shortfall could be significant dependent upon the relative size of the supplier. To address this, NIE would recover the shortfall through an increase in DUoS charges. This recovery would again ultimately be paid for by consumers and perhaps over a truncated timescale. It should be noted however, as no credit was initially posted, the day to day costs of having the credit in place would have been avoided. In addition, although NIE would ultimately recover all DUoS monies due there would be a time delay and associated working capital requirements to be met.

Assuming NIE and the Utility Regulator (UR) can agree a recovery process, timetable and return; the question when considering DUoS credit cover becomes – *what level of risk and cost should customers be exposed to?*

Power NI believes that it is important to strike a reasonable balance between risk and cost. It is clearly not in customers, the markets or NIE's interest to have no collateral in place. Equally however, it is not in customer's interest to put in place credit requirements which are excessive and highly improbable that they will be required.

Assessment

As you are aware the change to NIE's billing arrangements was as a result of the implementation of the Enduring Solution Project. The project facilitated the IT separation of NIE and Power NI and implemented the 'continuous billing' DUoS arrangement noted in the paper. It is important to recognise however that while the DUoS billing did change for most suppliers it did not change in relation to Power NI (as the legacy billing arrangement was 'continuous') nor did it change in relation to interval metered customers. Based upon the latest UR Quarterly Transparency Report therefore 79% of the DUoS market by consumption was unaffected. Equally the PSO billing arrangements were not changed and therefore should be excluded from consideration.

The consultation paper bases the assessment of shortfall on the "PSP levels for the 3 largest Suppliers". This suggests that the £50m quoted would only occur should the three largest suppliers (who supply 82.5% of consumption) default at the same time. This is highly improbable. The difference driven by the system changes may be more accurately quantified by reference to Section A7 of the paper as £17m. It is unclear how the £50m figure was calculated however it may be based upon the system changes and the comparison of peak exposure against an annual average posting.

Given that the assessment of £50m is based upon such an improbable scenario (i.e. the 3 largest suppliers all defaulting at the same time during the peak winter period) Power NI does not consider it as a relevant shortfall figure.

It would also appear that should a default occur NIE would seek to recover all outstanding sums in one year. Power NI believes NIE and the UR could agree a recovery mechanism (and return to reward the working capital requirements) which would smear the recovery across a longer time frame. This proposal mirrors the recovery mechanism proposed following the delay in the recent NIE price control determination. Adopting this approach would reduce the impact on consumers of a default by increasing the recovery horizon.

Finally in the assessment, NIE have quoted a typical bank charge of 1% per annum for the cover provided by a letter of credit. Power NI believes that this may be based upon a rate prior to the recent economic downturn and banking sector difficulties and this has increased significantly. It is extremely unlikely that the quoted rates would be available to all suppliers in the market, especially those who are not investment grade and / or 'asset light'. Power NI therefore believes that in the assessment the cost of additional cover should be increased significantly to appropriately reflect both the available rates and the relative size of suppliers.

Options

Option1: Status Quo

Power NI believes the status quo is a reasonable position to maintain. Some risk of shortfall does exist at peak times due to the averaging nature of the requirement. The likelihood of this risk materialising however is small due to the nature and concentration of the supplier community in Northern Ireland. Coupled with an assumption that an appropriate recovery mechanism can be agreed between the UR and NIE is the event of such an unlikely event occurring; Power NI believes the status quo represents a reasonable risk position to adopt striking a balance between the short and long term costs to consumers.

Option 2: Increase cover by £50m

As stated above Power NI believes that a £50m shortfall is highly improbable and therefore this option should not be considered.

Option 3: Increase in line with the Republic of Ireland

While the description of this option suggests harmonisation with the process in the Republic of Ireland the billing arrangements and tariffs are different in Northern Ireland. NIE acknowledge this in the consultation and have amended the requirement to 2 winter months applying for the entire year.

This proposal would cover the winter peak however it would also result in a significant over collateralisation of the rest of the year, in particular the summer months. This would incur an unnecessary cost for consumers. DUoS has an undoubted seasonality. Historically to strike a reasonable balance of exposure while not incurring the operational burden of frequent collateral changes, NIE has adopted a flat average calculation. Taking 2 winter months in isolation does not deal with the seasonality; it weights the requirement to cover the peaks in exposure while ignoring the valleys.

Option 4: 2 Month average

Increasing the average to 2 months reflect the timescale adopted in the Republic Of Ireland and acknowledges the seasonality issue with Option 3. NIE estimate that the increase by virtue of moving to this solution is circa £9m of increased security cover.

While there may be some merit in considering this approach as it closes some of the gap created by the Enduring Solution billing change its merits must again be judged and separately consulted upon, against the criteria of risk, likelihood and cost.

Conclusion and Recommendation

Power NI welcomes the review undertaken by NIE of the status of the DUoS security cover. A properly functioning market should identify risks and were appropriate take mitigating actions.

As discussed above, Power NI believes scenarios where there is a £50m shortfall in DUoS recovery are highly improbable. While acknowledging that the Enduring Solution did change the DUoS billing arrangements for a small proportion of the market, this was implemented in May 2012 and to date no issue has been encountered.

Power NI believes that increasing credit cover requirements for suppliers will increase costs to consumers to a significantly greater degree than quantified in the consultation paper and risks over collateralisation at periods throughout the year. It also places a burden on suppliers and will add to the entry considerations on new suppliers.

These considerations must be weighed against the likelihood of default and the method of remedy.

An appropriate remedy which dampens the cost impact to consumers while mitigating the working capital risk to NIE should be agreed with the UR as a matter of course and Power NI would welcome such discussions taking place.

Assuming such agreement can be reached and mindful of both the level of risk, the likelihood of occurrence and the cost to consumers; Power NI strongly recommends that the status quo is maintained in relation to the DUoS credit requirements placed upon suppliers.

Yours sincerely

William Steele
Power NI