Regulatory Approach to Energy Supply Competition in Northern Ireland

A Utility Regulator Position Paper

01 July 2011

1.0 Introduction

Introduction and summary

1. In recent times, the NIAUR (hereafter referred to as the Utility Regulator or UR) has actively pursued a policy centred on creating a fertile environment for greater levels of electricity supply competition to emerge, particularly in electricity retail market sectors where competition until very recently has been absent (households). This policy approach emanates from: previous consultations on delivering effective energy retail competition; our strategic policy drivers; our underlying legislative framework both locally and at an EU level; and wider national and EU-level policy frameworks.

2. However we feel that it would be appropriate to take stock and consult on next steps in terms of our monitoring of energy retail markets, customer protection arrangements in an increasingly competitive supply environment, and future regulatory approach. That is the purpose of this paper[1].

3. In theory, effective competition can achieve better outcomes for customers than regulation – which can only ever proxy the beneficial aspects of competition. We consider that these benefits might include:

    - Innovation – new suppliers, with experience in other markets, are likely to bring to market different products that extend consumer choice. This will likely include dual fuel options;
    - Service standards – Competitive pressures, combined with effective industry systems, should enable high service standards to be delivered flexibly and cost effectively;
    - Price benefits – in the short term, from creating competitive pressure to reduce costs in supply, and to be more efficient in the procurement of wholesale electricity. In the longer term, from dynamic efficiencies and improvements driven by competition at both the firm and sectoral levels.

4. However it is also a reality that competition may not be particularly effective and often if that is the case i.e. it is ineffective, may not provide the benefits talked about or provide them to a lesser extent. Furthermore the most important benefit to customers is reduced prices. It would be premature of the UR to take as definite that the initial reductions we have seen to the incumbents' tariffs for

[1] This paper covers both gas and electricity retail policy. However the paper also discusses wholesale matters and when doing so refers to the electricity market only, However the general retail policy and the future regulatory approach to the retail energy market discussed in this paper relates to both electricity and gas sectors.

domestic customers will endure indefinitely. Therefore for our present policy we see a competitive market that has an overlay of regulation to ensure that prices are no higher than they would be if incumbent price control was removed. This policy is set out in more detail in section 7. It is therefore important to emphasise that we are not 'blinkered' in our pursuit of enhanced supply competition. We are aware of the need to move forward pragmatically and with due regard to the complexity of issues involved with delivering competition in a relatively small market like NI. This paper seeks debate and feedback on important issues raised.

5. As a first guiding principle, to future policy development, we believe that regulatory frameworks should remain in place until we believe that customers in NI can realistically expect to benefit from competition and most importantly benefit in terms of price. As we go forward we need to try to ensure that all customers groups benefit from competition and switching opportunities. Where they do not, we need to ensure the regulatory structure continues to offer customer protection to the same level as it affords customers today.

6. In the GB market today Ofgem have concluded that those customers who have never switched from their incumbent supplier are charged considerably more than those who switch. Ofgem describe them as "in area" and "out of area" customers. Amongst other things it is this group of non-switchers that we are seeking to ensure protect as a competitive market develops. The figure for non –switchers in the GB market, after over a decade of a fully competitive market, is 42% of the domestic sector and the UR has no rationale to expect that Northern Ireland customers will not likely show similar levels of inertia. It is a fact however that the switching levels in the RoI have been seen at a much faster rate than in GB, so it is prudent that the UR continually monitors the situation and assess the market shares of each supplier as unexpected changes in these market shares may call for a review of UR policy.

7. It is also important to note that, in relation to electricity specifically, the GB incumbents were vertically integrated to a greater or lesser extent. Neither ESBCS nor NIEES were vertically integrated when they first faced competition in the domestic market. This <u>may</u> explain the reason for the high levels of switching in the RoI (although it could be for other reasons e.g. BGE already a strong brand customers affiliated to) and the UR will need to monitor customer migration from NIEES carefully.

8. However if we for the moment assume a reasonable level of non switching it is the UR view that this group of non-switchers often includes the vast majority of customers who can be described as vulnerable. Furthermore Ofgem in its recent Retail Market Review has suggested that around 40-60% of customers in the energy sector are what it describes as "sticky" and that vulnerable customers are likely to be disproportionately represented in this group. The UR has statutory duties to have special regard for the vulnerable. It would not be in

keeping with these duties if the UR were to allow the situation that has arisen in GB to emerge in Northern Ireland knowing that the inertia of non switchers would be used by the incumbent to finance the better deals and special offers it would use to attract more sophisticated customers back from competitors.

9. As a second guiding principle we believe that overall electricity retail competition can *potentially* deliver benefits for consumers, so long as it is developed efficiently, delivers truly contestable retail conditions in all market sectors and most importantly lower prices than regulation of the retail market would otherwise have achieved, and consumers are empowered to fully engage with these markets. Our future regulatory approach, and actions to the regulated supply market, will be driven by this principle. Later sections of the paper explain the work we intend to do to monitor competition and what it is or is not achieving.

10. A third principle is that the relationship between the wholesale and retail markets, which are inextricably linked, should be transparent, of benefit to customers as well as the companies, and facilitate retail competition. This is a wide statement but a principle worth having and it is discussed in more detail in section 2.

11. A fourth principle is that the UR will flex the existing systems concerning the setting of a maximum tariff in order that there is less build up of "K" factor over or under recoveries by the incumbent. This means that there is the possibility of tariff reviews outside the normal yearly cycle where a new incumbent tariff is set (i.e. from the 1st October in electricity and 1st April in gas). This should see the incumbent act more akin to an unregulated supplier and reduce the chances that the incumbent will be selling energy either significantly above or below prevailing market prices due to passing through significant under or over recoveries respectively. The UR is mindful that there is an ever changing environment in the retail (and wholesale) markets and this policy position is for the next three years at which point the policy will be reviewed. However as stated above should events, such as significant movement is supplier market shares, take place then the UR will be flexible and react quickly.

12. Finally a fifth principle is the UR will continue in the setting of a maximum tariff for domestic and small business customers for at least the next three years (for both gas and electricity). We are however cognisant of the fact that this may prove problematic in the context of a diminishing incumbent market share. It may be that we move to a maximum tariff for domestic customers only or a tariff set only for those domestic customers who have never switched from the incumbent and may require protection from being charged high prices. Again the UR is not going to set triggers for any future regulatory policy. Policy needs to be formulated in the context of not just market shares but also market behaviour or potential market behaviour.

13. In summary, the paper contains the following sections.

Section 2 presents a brief overview of the environment within which this policy is being formulated.

Section 3 sets out our future vision for customers' experience of competitive energy supply markets in NI and notes the need for a structured analytical basis for future market monitoring and decisions on regulatory policy.

Section 4 of the paper sets out our initial thinking on electricity supply market sub-sectors that need to be monitored going forward. We seek comments on these categories from respondents.

Section 5 of the paper sets out our initial thinking on the market monitoring framework going forward and separates our plans into the immediate/short-term, and the medium term. **We note the need for work on defining the appropriate supply market monitoring framework going forward.**

Section 6 of the paper sets out the relevant issues from the perspective of customers.

Section 7 of the paper sets out our thoughts on policy for the current Northern Ireland supply market in the short to intermediate term.

Section 8 of this paper presents conclusions, policy implications and way forward.

Consultation Details

14. If you wish to express a view on the issues raised in this paper, we would welcome your response by 23 September 2011.

15. Although we have asked some specific questions in this paper we welcome comments on areas considered important by individual respondents. For ease, it would be useful if respondents could group their comments in relation to the individual sections of the paper please.

Responses should be addressed to:

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Individual respondents may ask for their responses, in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.

As a public body and non-ministerial Government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in consultation responses can be put into the public domain. Hence, it is now possible that all responses made to consultations will be discoverable under FOIA – even if respondents ask the Utility Regulator to treat responses as confidential. It is therefore important that respondents note these developments and in particular, when marking responses as confidential or asking the Utility Regulator to treat responses as confidential, should specify why they consider the information in question to be confidential.

2.0 Strategic, Policy and Regulatory Environment

16. Effective competition that can deliver real consumer benefits has long been a goal of EU, UK and Northern Irish regulation. However competition and a regulatory framework are not mutually exclusive and can exist together.

17. The statutory remit given to the Utility Regulator places a high value on competition as a means to deliver consumer benefits. Competition is a key feature, particularly in electricity where it forms part of the Utility Regulator's primary statutory objective *'to protect the interests of consumers…wherever appropriate by promoting effective competition'*. In gas the term used is "*facilitating*" competition but its effect is the same. The words "wherever appropriate" are important and indicate that competition should not be seen as a panacea but rather the UR should assess its application and the circumstances of that application in the context of ensuring protection and benefits for customers as the first overriding principle.

18. EU law also points to competition as a possible means to deliver consumer benefit. Successive packages of energy legislation require Member States to achieve a 'competitive, secure and environmentally sustainable market'. The legislation is not prescriptive on how this should be achieved but rather gives member states the latitude to decide how best a competitive market can be achieved

19. Recent 2009 EU Directives[2] continue in the pursuit of effective competition as an EU-wide policy goal and focus also on consumer rights and roles within retail markets 'in order to allow consumers to take full advantage of the opportunities of a liberalised internal market in electricity'. There is however no specific legislation specifying whether or not the liberalised internal market the directives envisage should exist in the absence of or alongside a regulatory framework and or maximum tariffs set by the regulatory authority. Indeed the third EU package legislates for a more prescriptive regulatory regime that will ensure "a high level of customer protection" and mandates measures such as enhanced customer transparency provisions, cost reflectivity between payment systems and ensuring suppliers offer a wide range of payment methods. This illustrates that the legislation envisages regulation existing alongside a competitive market.

[2] Directive 2009/72/EC concerning common rules for the internal market in electricity available at : http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0055:01:EN:HTML and Directive 2009/73/EC concerning common rules for the internal market in natural gas available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0094:01:EN:HTML

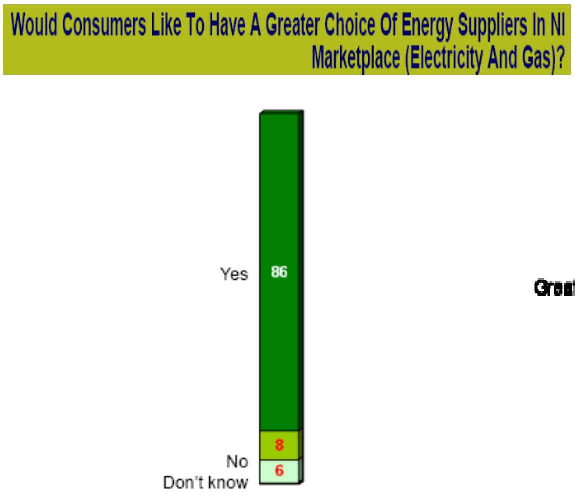
20. DETI’s 2004 Strategic Energy Framework set the primary objective of energy policy in Northern Ireland as ‘a competitive sustainable, reliable energy market, at the minimum cost necessary in an all-island, UK and European context’. It stated four main goals towards achieving this including building competitive energy markets. A review of the 2004 framework in 2008, prior to consultation on up-dating the strategy in 2009, concluded the four main goals remain the correct priorities to be addressed going forward. The Strategic Energy Framework 2010 stated that ‘the Department is committed to ensuring an efficient, diverse, competitive and sustainable energy market’.

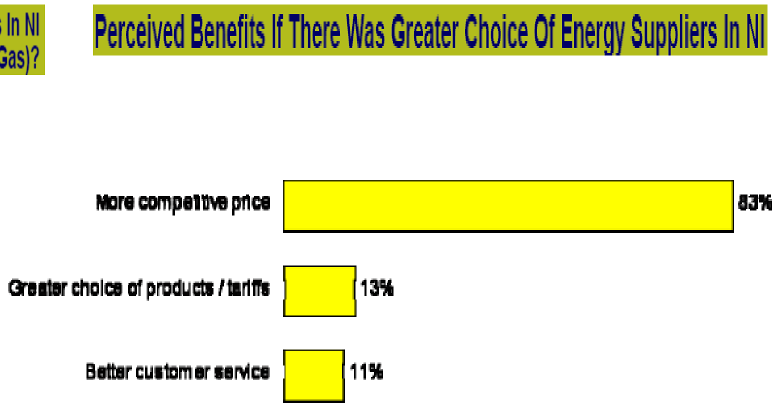
21. The UR view is that whilst the benefits of competition are potentially obtainable within Northern Ireland and the Republic of Ireland separately, we believe there may be enhanced opportunities (market scale, supplier business opportunities, efficiencies in operation, dual fuel potential) if energy retail developments were better harmonised between the two jurisdictions. To this end the RAs initiated the harmonisation project which will in the coming years see Ireland move to a single market schema with harmonised market messages and market processes with a few jurisdictional differences.

22. Revealed consumer preferences also drive our policy. The UR has abundant anecdotal evidence that Northern Ireland consumers would like to have more choice in their energy supplier based on complaints we frequently receive about limited or non-existing supply competition. In addition to the anecdotal evidence we also have quantitative evidence to this effect.

23. In February 2008 Millward Brown Ulster carried out a survey on behalf of the UR covering a range of questions about consumer awareness and attitudes - respondents were asked to rank five possible developments. New companies competing to provide electricity, gas or water services in Northern Ireland received the second highest level of support (behind reduced utility tariffs for vulnerable customers). A second survey was carried out by Ipsos Mori in 2009 when new competitors in the market ranked the same as reduced tariffs for vulnerable customers and expansion of renewable energy.

24. More recent research on consumer preferences on behalf of the Consumer Council for Northern Ireland (CCNI) (carried out by Millward Brown in August 2009) tends to confirm the above results. When asked about their desire to have choice of energy supplier (electricity and gas) 86% answered yes with just 8% saying no.





Source: CCNI/Millward Brown

25. Most importantly over eight in ten (83%) of people cited more competitive prices as a key perceived benefit of wider choice of supplier whilst 13% cited a greater choice of products/tariffs and 11% stated better customer service would be the result of greater competition.

26. The UR notes these customer views regarding choice and the benefits of choice (namely price) and notes that the overriding customer view is that the greatest benefit of competition is lower prices. The UR at this stage is not wholly convinced that removing maximum tariff regulation and relying on a competitive market to constrain the behaviour of suppliers will lead to lower prices. The danger for customers is that it could lead to increased prices (higher than what they would have been if tariff regulation had been retained) if the competition that emerges is not effective. This is a criticism that has been levelled at the GB market. In its recent Retail Market Review, Ofgem give a series of reasons including tariff complexity, market concentration, customer segmentation leading to higher tariffs for certain groups, lack of wholesale liquidity, evidence of companies pursuing similar pricing strategies and incumbent market power as to why the GB market (which is much larger and has more suppliers than the NI or indeed all island market) is not delivering effective competition to domestic customers. It is therefore prudent for the UR to allow competition to emerge but at this stage within a regulated market with suppliers competing against efficiently set regulated tariffs in defined regulated market sectors.

All-Island Context

27. The retail markets in electricity (and in the future in gas) in the North and South are moving closer together. All the suppliers purchase from the same wholesale market, the suppliers in the North and South are often one and the same i.e. they have the same shareholder but are separate legal entities (this is now true also of the network businesses in both jurisdictions) , the separate northern and southern companies share resources and strategies and the recent harmonisation project will see an all island retail market schema introduced that will see a very high level of harmonisation of the processes and systems of the retail markets north and south. This has been facilitated further by the fact the network businesses in NI and RoI now use common systems architecture, a development brought on by the purchasing of NIE by ESBN.

28. These developments show the UR that there will be a relationship between the retail markets of the two jurisdictions, but we have yet to fully determine how this will affect policy in the North. Whilst harmonisation does allow suppliers who operate in the north and south to use one single system for both, it does not imply that either jurisdiction has to fall in line behind the decisions of the other. Regulatory decisions regarding the retail market can have profound effects on customers and are also subject to political influence. A good case in point that shows how separate the jurisdictions can be is the issue of domestic disconnection which is permitted in the RoI but not in NI. However we will continue to monitor this situation for developments.

We would like to ask respondents what their views are on how NI retail policy should be influenced by RoI retail policy and vice versa and also provide justification of those views from the perspective of consumers north and south.

Relationship between Wholesale and Retail Markets

29. The UR holds the view that the wholesale and retail markets in electricity and gas are inextricably linked. The key issue for the UR here is to make sure competitors can access appropriate wholesale product to sustain their business competitiveness and manage wholesale risk issues. The UR accepts that retail competition will only deliver benefits if it is part of a wider competitive framework i.e. there is effective competition in the wholesale market also.

30. Also the importance of effective retail competition for fair wholesale markets is a point that is sometimes not emphasised enough. In the absence of retail

competition, wholesale investment decisions may be dictated by who is best able to pass costs to down-stream customers, rather than who can minimise costs overall. Moreover, the lack of competitive pressure on retailers means they may adopt a hedging strategy that aims not so much to minimise cost, but only to keep level with other companies. This could raise consumer costs, while at the same time contribute to a lack of wholesale liquidity. It is fundamental to have confidence that retail prices are set against a benchmark that truly reflects the clearing price for the whole market. This was a key factor leading to a gross mandatory pool structure for SEM, since this design maximises liquidity. Without a trustworthy marker for retail prices or investment decisions, entrants cannot buy on a level-playing field with vertically integrated groups.

31. Within the pool, it remains important to ensure competition is not distorted by anti-competitive behaviour or structures. The SEM is monitored on a daily basis by the regulators, who look at bidding patterns that could distort price or dispatch patterns. Since inception, the regulators are confident that the SEM price has been set by competitive pressures and we have also seen progress towards improving the competitive structure of the market, with divestiture of plant by ESB. We need to continue to work in this area to ensure retail competition is not hindered by aspects of the wholesale market operation and have committed in our forward work plan for 2010-2011 to review the SEM contracting and liquidity issues. Aside from the wholesale price and fair access to wholesale product however, supply economics is also dominated by risk management. Theory and experience elsewhere indicate that key risks for companies around wholesale prices and their relationship to downstream supply markets can be managed either by vertical integration, or through widespread availability and diversity of wholesale electricity product and of varied wholesale financial hedges. Liquidity and granularity in the secondary market for such hedges is key, but so far inadequate within the SEM context. The Regulatory Authorities continue to push for a more flexible approach to contract auctions and enhanced use of a trading screen platform to centralise offers and demand and allow for continuous trading.

32. Our concern is that, given the small size of our market (even at an all-island level), there is a real risk that it would only accommodate a very limited number of vertically integrated groups (perhaps as few as two). This has the associated potential detrimental effect on contestability and supplier entry, particularly from more niche non- (or limited-) wholesale integrated entities. Integrated firms have the potential to move margin between wholesale and retail – so-called margin shifting. Shifting margin from wholesale to retail can make life difficult for an Independent Power Producer in the wholesale arena and shifting margin from retail to wholesale can make life difficult for non-integrated independent suppliers. Widespread vertical integration can result

in a lack of liquidity for non-integrated players to manage risk and thus deter market entry.

33. Sometimes it is argued that electricity markets tend naturally towards vertical integration. This is because price risk is pervasive in these markets, and managing through internal "natural" hedges is efficient. However, if this tendency is allowed to run to its logical conclusion it can benefit companies more than consumers because it will damage the ability to enter into or expand within the electricity markets – vertical integration can hinder contestability in electricity markets.

34. However the risk is one of differential risk –i.e. prices do not move at the same rate along the value chain because wholesale prices are volatile and yet customers often purchase in a fixed term fixed price way. Managing the risks that arise from different levels of volatility across the value chain is one of the fundamental purposes of an energy supply business, and is why suppliers earn a profit.

35. In practice suppliers can manage the risk above in two ways. One is by owning generation and trying to match their customers' aggregate demand to the generation portfolio. This strategy includes purchasing fixed fuel hedges to service the generation and forecasting dispatch (in a pool market) and also forecasting any wind dispatch as accurately as possible although this element will be unreliable. The second is by buying contracts in the market (at prevailing market prices without large premiums applied due to scarcity of contracts) as a proxy for owning generation. A market with good liquidity will have not only a sufficient amount of contracts for non-integrated players but also a sufficient variety of base load, mid –merit and peak hedges that are divided into short, medium and longer time windows to allow the supplier to hedge their customers demand accurately and on a rolling basis.

36. To date SEM has been effective in ensuring competition and transparent pricing in the wholesale market, however achieving efficient levels of liquidity for suppliers in a small market with few players can often prove difficult. As mentioned earlier the liquidity within the SEM is currently inadequate and this will lead to market entry being more difficult and risky for entrants without generation and may lead ultimately to an oligopoly of two or three large vertically integrated players. The issue of wholesale liquidity will need to be addressed in some way if effective retail competition and a contestable market are to be achieved in the long term. A more immediate effect of this lack of liquidity concerns the incumbent electricity tariffs. It may well be the case that the incumbent tariff which is effectively setting the market price cap at present for tariff regulated customer groups is not being set at an efficient level. This particular issue is discussed further in section 7 of this paper.

3.0 Our policy goal

What destination are we pursuing?

37. Regulators in general pursue regulation as a proxy for effective competitive markets until they are confident that the market is in a position that it will deliver effective competition if tariff regulation is removed. Consumer benefits can potentially be maximised via effective competition but, where that is absent, by a regulatory framework which seeks to proxy the positive effects of competition.

38. International research on competitive markets and consumer engagement in those markets shows that, to maximise competitive potential and beneficial outcomes for consumers, regulators and energy policy makers should be concerned with delivering both effective supply and demand side market attributes. Thus regulators should and do seek to deliver a competitive supply market structure and non-competition-distorting activities (e.g. collusion); but also seek to promote and deliver effective engagement of informed customers in that supply market – both levers need to be pulled together.

39. The current regulation framework for the smaller SME and domestic energy supply markets in NI (and until recent times in the RoI) is predicated on insufficient competition offering opportunities for customer detriment from supplier market power. The essence of the policy approach we are developing is that essentially we are seeking to realise consumer benefits from competition within a regulatory framework whilst possibly in the future removing regulatory controls if appropriate. However we will retain the incumbent price controls in gas and electricity for the next three years whilst also continually monitoring the situation regarding market shares, liquidity in the electricity market and supplier behaviour. If there are significant movements in the market we will review the policy of retaining the price control sooner but our current plan is to review this policy in three years time. We explain later in the paper how that will impact on our future work.

40. The UR acknowledges that it is impossible for a Regulatory Authority in isolation to control the customer experience of a competitive market. However, as an ultimate goal, the “ideal” vision we have for a future electricity and gas supply customer environment is one where:

- Consumers benefit not just from competitive prices, but also from improved or differentiated service and tariff choices which better suit their requirements;
- Well-informed customers who have a clear knowledge and awareness of suppliers, products and tariff / service choices;
- Consumers can switch supplier quickly and simply and without undue cost or risk of error;
- There is transparency regarding price, product and service, resulting in uncomplicated, high-quality decision-making by consumers (the lack of this transparency has been cited by Ofgem as one of the reasons the market is not working effectively in GB);
- All sections of consumers either benefit from competition or are protected from **being significantly worse off than they would have been had competition not emerged** by ongoing regulatory action (the latter may involve price control of the incumbent supplier resulting in tariffs that new entrants can compete against or perhaps in the future price controls for non-switchers only; non-discrimination conditions, etc).
- There is confidence that prices were being set by the activities of competing suppliers;
- We achieve and leave open entry from more supply businesses offering a greater diversity of product and service bundles and who can find commercial space to grow;
- Successful entry and expansion of suppliers would not be necessarily dependent on vertical integration.

41. Our overall philosophy in developing retail competition is to develop, change or maintain and only where demonstrably appropriate reduce the regulatory framework in a way that seeks to crystallise and maximize consumer benefit from competition. We contend that this can be achieved through maximising the degree to which the electricity retail market is truly contestable and competitive – truly competitive supply markets with participants competing effectively firstly and most importantly on price as well as other areas such as innovation and service and effective customer engagement are the engines that can realise the benefits of competition.

4.0 Defining relevant retail market sub-sectors

42. A key pre-requirement in assessing current market openness to competition is to define the relevant market to be assessed. Our suggested framework for market monitoring (discussed in Section 5) can then separately focus on each of the identified market segments.

43. It is not always easy to strictly define markets and it is appropriate that any market definition exercise here does not unduly restrict the scope of any subsequent investigation under competition law. Competitive conditions will change over time - for example innovation may make substitution of a product easier. So market definition will also change over time and thus any relevant market must be identified according to the particular facts at that time. Our analysis below seeks to define market segmentation at this point in time - however we will monitor relevant changes over time and re-define the markets if necessary in the future.

44. Normally a market definition will have two dimensions; product and geography. The Office of Fair Trading (OFT) guidelines[3] outlines the process for defining markets under competition law, starting with the hypothetical monopolist test which:

> *'…seeks to establish the smallest product group (and geographical area) such that a hypothetical monopolist controlling that product group (in that area) could profitably sustain 'supra competitive' prices, i.e. prices that are at least a small but significant amount above competitive levels. That product group (and area) is usually the relevant market.'*

The Product Market

45. At an overall product level, we consider the product market to be electricity only for a number of reasons. Firstly, the vast majority of consumers use electricity for a specific purpose (light and power) for which there is no significant substitute. Where consumers use electricity for heating (5.2% of households[4] and less than 7% of electricity consumers overall) we could consider other home heating fuels to be part of the same market. However conversion to other heating fuels (oil, natural gas, LPG, coal, wood) from electrical systems requires substantial up-front investment i.e. high switching

[3] Office of Fair Trading: Market Definition: OFT 403: 2004 available at http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf
[4] NI House Condition Survey 2006: NIHE, available at http://www.nihe.gov.uk/index/foi_publications/research-3.htm?docid=13203

costs and is likely to be a longer-term decision for the household, (and thus may take more than the one year suggested by OFT). We would also consider the proportion of households not on the natural gas network to exclude gas from the relevant market. The guidelines state that 'it is not necessary for all customers, or even the majority, to switch but whether the volume of purchases that is likely to be switched in response to a sustained 5-10% (considered to be 'small but significant') price increase is large enough to prevent the increase. As less than 8% of total consumption in Northern Ireland is consumed for heating, we would argue that the market is electricity only.

46. Since future regulation policy and, in due course, the application of competition law, are wholly linked with levels of market power, dominance and potential for new entry, we would wish to break down the overall electricity supply market into smaller constituent sub-markets.

47. As a starting point for discussion, it is useful to consider electricity customers under separate sub-markets on the basis of how and when electricity is used at the premises, implications for system cost drivers and data availability to network companies i.e. the boundaries defined by the underlying Use of System tariff. In broad terms there are arguably four different categories of customer types:

    - Household, where the electricity is used for domestic purposes exclusively (or in premises comprising flats and places of worship).
    - Business premises with electrical demand below 70 kVA (smaller SMEs [SSME]).
    - Business premises with electrical demand above 70 kVA but under 1MW (larger SMEs [LSME])
    - Business premises with electrical demand above 1MW (large Energy Users [LEUs]).

48. We have developed the market sub sectors for gas and will be reporting on them in the quarterly transparency reports in the future showing the same information as is currently published for the electricity market.

Currently these sub sectors are:

- Domestic
- I&C < 2,500 Therms
- I&C > 2,500 and < 25,000 Therms

- I&C > 25,000 and < 75,000 Therms
- I&C > 75,000 Therms

49. These market sub-sectors are based on customer grid connection import parameters (MIC) and line up with current NI network charging frameworks which themselves are a pointer to separate market segments in terms of electricity demand profiles and customer connection requirements. In gas the are based on annual consumption.

50. Within the domestic/household sector, given different payment methods and the associated licence requirements on cost reflectivity, tariff structures and switching system capability in the coming period, it is also useful to consider Credit/Direct Debit and Prepayment as two sub-sectors within the overall household sector, one sub-sector being prepayment and the other non-prepayment (credit or direct debit).

51. These various recognised sub-sectors of the electricity and gas markets in Northern Ireland are at different stages of development with regard to contestability and competition due to: gradual opening under European legislation during the previous decade in NI; and revealed levels of competing supplier interest and activity in taking market share and customers from the previous supply incumbent. At a household level competition has only began to emerge in mid-2010.

52. The UR recently published market shares by consumption and connection in the five electricity sub-sectors discussed. This was to illustrate market shares to various stakeholders. However it is important to note that in monitoring these sectors the UR should take account of any combined market shares of affiliate supply businesses. This is the approach CER took when calculating the market share of ESB in the sectors of the market it defined. The share taken was the aggregate of ESBCS and ESBIE.

53. As regards justifying these sub-sectors for the purpose of supply market monitoring, in very practical terms the lack of significant evidenced competition, short-term switching system limitations and existence of regulated tariffs for domestic and smaller SMEs would support a definition of at least two markets. However, differing price elasticises of demand for electricity in the domestic and non-domestic markets5 would suggest that domestic and non-domestic sectors are different markets (the report

[5] See http://www.niaur.gov.uk/publications/view/an_economic_analysis_for_the_elasticity_of_demand_for_energy_in_northern_ir/

referenced concludes business consumption is more responsive to changes in price in both the short and the long run).

54. It is also arguable that the differing tariff structures, initial evidence of market switching and resultant market shares, and levels of complexity of tariffs between LEUs and LSMEs lead us to conclude that this market should be considered as two separate markets. With regard to the SSME and domestic sectors, we consider these to be separate in spite of the similarities in consumption levels as one is a sector of business customers and the other household customers. Hence the regulatory protection required is very different.

55. Our conclusion therefore, is that for the immediate short term going forward, we will monitor 5 electricity market segments: LEUs (>1MW), LSMEs (>70kva<1mw), SSMEs (<70kva) and households (spilt into Prepayment and Non-Prepayment sectors). Following these market category definitions, rather than one based on consumption for example, relates categories for monitoring to physical assets. A definition based on consumption on the other hand will be used for the gas market again with 5 segments: Domestic, I&C <2,500 Therms, I&C > 2,500 and < 25,000 Therms, I&C >25,000 and < 75,000 Therms and I&C > 75,000 Therms.

56. We note that current NIEES price control regulation methodology employs a threshold based on consumption, rather than MIC connection, of 150 mwh per year or in the absence of consumption data 100KvA to draw the boundary between the smaller I&C plus Household customers protected by NIEES regulated tariffs and the larger SME and above (LEU customers) not operating under a price-controlled maximum tariff regime. We note at this point therefore the difference between the current price control customer thresholds and the market sub-sectors set out above for monitoring purposes going forward. We intend to do work in the future on examining the appropriateness of the current threshold for formal tariff regulation. This work will include an analysis to determine if the reduction of the tariff regulation threshold from 1MW to 100KvA/150 Mwh consumption has in fact had a positive impact on consumers. By a positive impact we mean principally in terms of the prices offered by the incumbent (which when regulated were the backstop price customers could avail of).

5.0 Market monitoring future framework

57. To decide properly on future policy requires informed decision-making based on hard data. In order to provide the necessary analytical background for taking these future policy decisions, this section of this paper sets out our market monitoring intentions going forward.

58. A key driver of future regulatory approach will be the degree to which we view the above supply market sub-sectors as truly contestable (and thus able to secure for consumers the positive benefits of competitive forces). Contestability is a concept that describes the extent to which a given market is actually or potentially capable of being open to competitive forces. It is not just about evidenced competition in terms of active market participants, but more importantly describes the potential competitive effects that restrain current market participants from monopolistic behaviour.

59. One of the purposes of this paper is to begin a discussion on the potential indicators we might best use to monitor contestability and the state of "competitive health" of the identified electricity retail markets.

60. In making decisions about future regulatory actions, and in particular whether we may make any changes to the current regulation regime, there are a variety of factors that might need to be considered with regard to measuring progress towards contestability. Examples of the type of market monitoring necessary can be taken from regulated markets elsewhere in Europe and Australia for example. In addition, the European regulatory authorities are taking forward their own thinking and work in relation to indicators to be used for market monitoring (especially in the context of the EU 3rd package).

61. In preparing this consultation, our review of international regulatory best-practice suggests that supply market contestability should be monitored and evaluated in terms of both:

(a) a relatively small number of specific actual competition related indicators, such as:

- market shares,
- switching rates,
- number of competing suppliers,
- Price/tariffs information.

(b) a wider concept of contestability capturing a more rounded assessment of actual/potential competitiveness in markets as a driver of consumer benefits e.g.

examining barriers to entry, ease of access to required information, etc. In this area we will also need to look carefully at competing supplier behaviour. It may be that there is no market concentration per se (or as defined by the usual parameters) but a small number of suppliers could all display the behaviour of dominant players or there could be evidence of what Ofgem have described as tacit as opposed to explicit collusion. This is most likely in a market with few players.

Approach in the immediate short term

62. Our proposed approach is, in the short term to uniformly and regularly collect the key data for the individual market sectors in electricity identified in section 4 above (and indeed in gas supply markets as a sister-project). This data will relate to the primary short term indicators noted above: market shares, switching, number of competing suppliers, price/tariffs information. The data will be presented on a quarterly basis and the first quarterly report was published in March of this year. Structured collection and transparency of these key pieces of market information will allow industry, regulators and other stakeholders to have a more robust basis for discussions around regulatory approach to market sub-sectors, the timing and appropriateness of changes to regulatory approach/policy to sub-sectors, and specifically the appropriateness of considering further phases of tariff de-regulation and assessing the impact of recent tariff de-regulation.

Approach in the medium term

63. In the medium term, we intend to consult more fully in the coming months on the specific wider market monitoring regime and data collection framework we intend to put into place for the electricity and gas supply markets in NI. In all of this, we are keen to balance the need for monitoring and establishing a rigorous base for future policy, with the resource consequences of significant data collection and monitoring.

64. Based on a wide review of relevant literature, discussions ongoing at the European level in terms of market-monitoring best-practice, and in light of the contestability decision framework discussed above, we have started to identify a “long list” of possible indicators that are used to monitor energy retail market activity and competitiveness. This will be fully consulted on in due course.

6.0 Delivering effective competition: the Customer perspective

66. To this point, this paper has concentrated on our policy background, approach and monitoring regime. We are keen not to lose sight that at the end of the day the drive by policy makers for more competition is all about benefiting customers principally, but not exclusively, in terms of price and ensuring customers engage with, and are benefited by, the emerging competitive supply arena. We commented earlier in the paper that effective competition requires both the proper supplier engagement in the market, and also effective and informed consumer engagement. In that context we note in this section the need for a new vein of work by the UR to assess the extent to which our customer protection framework is fit for purpose as we move into an increasingly competitive energy supply environment, and to ensure consumers have the appropriate quality of information and protection to effectively engage. Above and beyond UR's own view on this, this work area is also driven out of the consumer aspects of the EU Third Package – see recent DETI consultation on IM3 implementation and our own current FWP draft.

67. Confident, informed and empowered consumers will improve the functioning of the market and drive innovation and efficiency and final outcomes for consumers will signal whether the market is failing or succeeding. The challenge will be in equipping consumers with the skills, knowledge and information they need to make good-quality decisions with regard to their electricity supply and not only benefit from a contestable market but drive competitiveness within the market.

68. The 2009 electricity Directive obliges Member States to:

> *'…ensure high levels of consumer protection, particularly with respect to transparency regarding contractual terms and conditions, general information and dispute settlement mechanisms. Member States shall ensure that the eligible customer is in fact able easily to switch to a new supplier'.*

69. Consumers are to be able to switch supplier within three weeks and are entitled to all relevant consumption data to facilitate comparison of offers from suppliers. Annex I of the Directive lays out requirements with regard to contracts, terms and conditions, complaints and information.

70. There are many obstacles to empowering consumers and encouraging their active participation in the electricity supply market and we recognise the transition will be challenging. In our recent research with CER, over one fifth

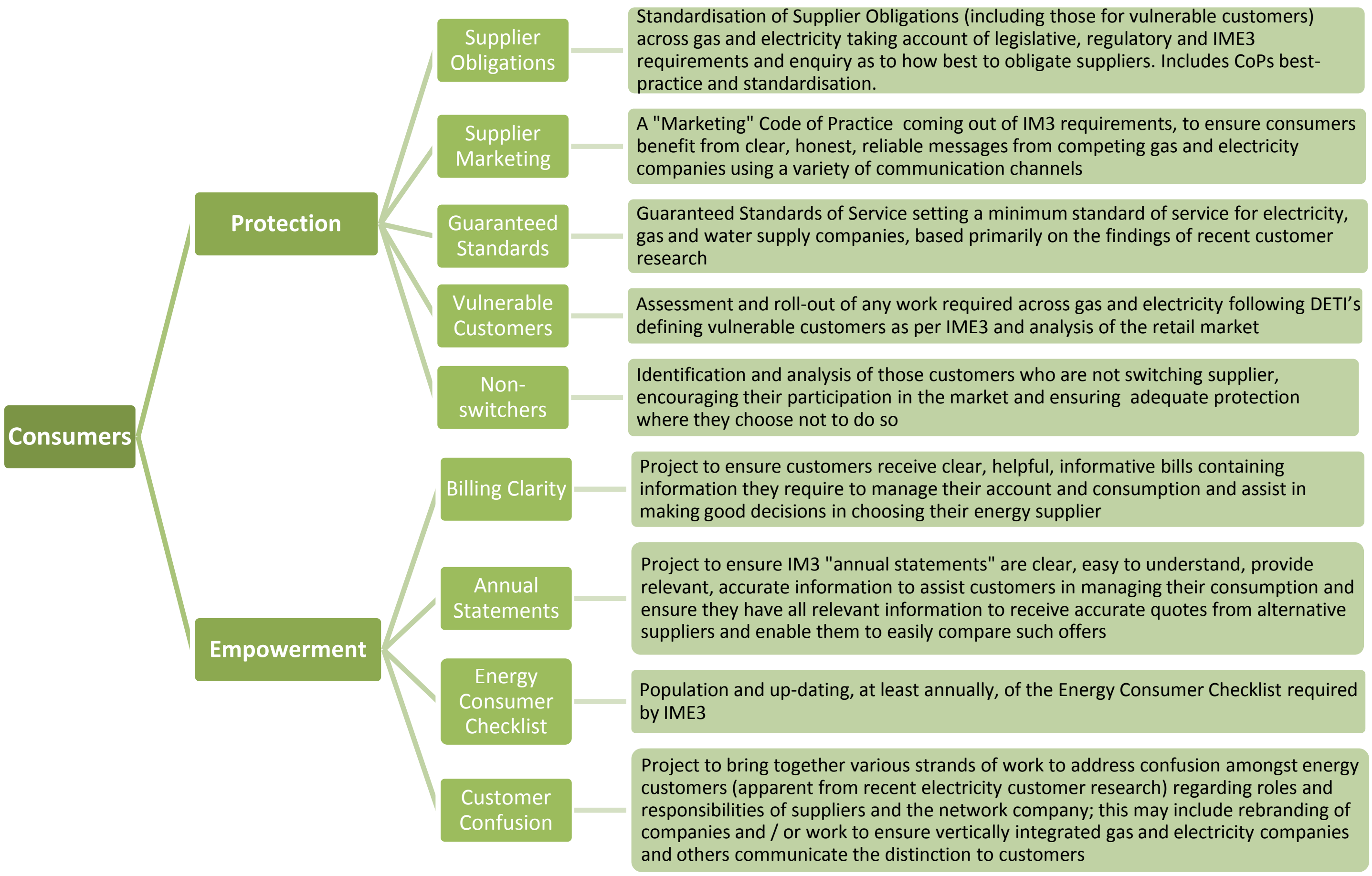
of domestic consumers said they were not interested in switching immediately if they had a choice of supplier; of this 22%, over half (52%) were not interested in switching within 12 months. Various reasons were given for this, mainly suggesting a lack of confidence in potential new suppliers; they may not be able to deal with outages sufficiently or they may not be reliable or they may claim to be offering bigger savings than customers would actually secure on switching.

71. The research also confirms domestic customers require easy access to comparable pricing information, reassurances on service levels, a clear understanding of the switching process including transitional billing arrangements and support from their new supplier to have confidence in the process. The view that access to these things will mean greater levels of switching than say has been seen in GB (where around 40% of all domestic customers have never switched away from their original incumbent supplier even after 10 years of full de-regulated competition) needs to be treated with some caution at this stage. It could be argued that a more realistic view is that only the more sophisticated customers will benefit from this transparency of information and regulators need to ensure that less capable or inert customers (Ofgem research suggests up to 60% of domestic customers will be "sticky" even if they have switched in the future) are not disadvantaged in terms of price in order that suppliers can offer attractive prices to those sophisticated customers without lowering their overall profit margins. In other words suppliers may seek to make bigger margins from non switchers in order to finance lower offers to acquire those customers who do switch often. This has been the case in GB as described in Ofgem's retail market review.

72. To allow this situation to arise would see the most vulnerable customers suffer at the expense of those more sophisticated. This is because a large proportion of the vulnerable will reside within the non switching 60% of customers. Whilst completion may benefit those customers who can engage effectively with the market it is the UR's duty to ensure that those that cannot will be protected by a full regulatory regime. The introduction of competition in domestic energy supply is welcome provided it benefits some within harming others. A "trade off" of outcomes between different customer groups where some benefit to the detriment of others is not a good outcome for customers as a whole.

73. Furthermore we recognise that the UR will not be capable of overcoming barriers and building confidence amongst consumers alone and we expect to work closely with CCNI and other stakeholders to ensure all consumers benefit.

74. To ensure we adequately address the issues we have completed a scoping exercise, and in light of the DETI consultation on IME3 we have defined a number of areas of customer-protection focused work to be co-ordinated across both gas and electricity sectors going forward. Priorities and timelines are under discussion in the context of our FWP and resource availability.



7.0 UR Regulatory Approach

75. As has been stated already in this paper the two most important issues for the UR regarding further emergence of energy supply competition in NI are that the principal benefit is one of reduced prices and that either customers benefit from competition or they are not demonstrably worse off due to its emergence.

76. We have also stated that competition is potentially a good thing for consumers and the policy to enhance competition is underway. This can be evidenced by further deregulation in 2009 and the harmonisation project. It would however be premature at this stage for the UR to see initial offers that are being made to customers in the NI domestic and SSME markets as firm indicators of future enduring price benefits that customers could enjoy. Indeed in electricity, some evidence has emerged that some customers in the SSME sector may be paying more than the regulated tariff for their customer grouping. This has been those customers experience following the first initial flush of competition which saw all suppliers offering prices lower than the regulated tariff.

77. Furthermore the UR wishes to attempt to avoid some of the GB experiences of competition that did not benefit customers as policy makers in GB had intended they would. Whilst some customers (likely more sophisticated ones) have seen benefits from competition it has also been observed that standard tariff rates have been closely aligned between suppliers and often move upwards and downwards largely in unison. The "big six" suppliers tend to increase and decrease standard tariff rates at the same time. Ofgem have also stated recently as part of the retail review that they now see clear evidence that suppliers are slower to lower tariffs after falls in wholesale prices than they are to raise tariffs after increases in wholesale costs. Furthermore with the plethora of tariffs on offer in GB at present it is very unclear which tariffs are in fact the best for any one customer. A recent Which? Investigation showed that an average household could choose from 89 different tariffs for dual fuel gas and electricity by direct debit and other information given to MPs suggest that the figure could be as high as 129. Ofgem has carried out research into this issue and the results showed that 70% of customers find the number of available tariffs confusing. In light of this Ofgem are consulting on new licence obligations to oblige suppliers to standardise all "evergreen" tariffs into three standard tariffs per supplier, one for each payment method so that customers can more easily compare prices.

78. Doorstep selling in GB over the years has also exhibited some problems of customer abuse and a proportion of those customers who switched after a door step call actually moved to a more expensive tariff. This unfair treatment

is facilitated by the complexity of tariff offerings already mentioned. However this is more an issue that can be dealt with by proper controls around marketing, especially doorstep marketing. In the medium term the UR intends to implement the measures concerning customer protection that are within IME 3 and this is where the UR will deal with these marketing issues.

79. This paper is more concerned with the more immediate UR strategy with regard to tariff offerings and incumbent tariff regulation. Our policy has two main strands discussed below.

1. Licence Conditions to prevent unfair treatment.

80. It does appear clear that in GB right up until very recently non-switchers have been disadvantaged. OFGEM as part of its 2008 probe and more recent Retail Market Review published in March 2011 found that margins were considerably higher for “in area” customers i.e. that group that will include those who have never switched away from their original incumbent supplier than “out of area” customers i.e. those who have switched. Following this OFGEM have re-introduced licence obligations in supply licences in September 2009 that require cost reflectivity between different payment methods and prohibiting undue discrimination in terms and conditions offered to customers.

81. Some suppliers - such as Scottish and Southern Energy and British Gas - backed Ofgem's proposals publicly. Scottish and Southern chief executive Ian Marchant told MPs that accepting the proposed remedy was vital to restore public confidence in the industry. He said "It is fair to say that over the past two to three years there have been some pricing practices among some of the six of us that would have breached that condition if it had been in place in the past. So there is an element of restoring confidence and also an element of keeping all six of us honest,"

(A) Requirement to Offer all Payment Types and Price Differentials between Payment Types to be Cost Reflective

82. The current licences in NI (for both electricity and gas) reflect the newly updated position in GB licences regarding cost reflectivity and indeed go further. Under the current NI licensing regime electricity suppliers who opt to supply domestic customers have an obligation to their domestic customer base that requires cost reflectivity between different payment methods. However there is also an obligation which requires that all suppliers must offer all three payment methods i.e. standard credit, direct debit and by prepayment meter to domestics. The electricity licences state:

The Licensee shall ensure that its standard terms and conditions provide Domestic Customers with a choice of payment methods, including as a minimum making payment:

(a) in arrears (at such frequency as is set out in the terms and conditions);

(b) by direct debit (at such frequency as is set out in the terms and conditions); and

(c) by prepayment meter.

Any difference in the charges for supply of electricity according to the choice of payment method shall be calculated by the Licensee on a reasonable basis to reflect the costs to the Licensee of such different payment methods.

83. The UR view is that the situation is GB after much analysis during the probe and the addition of new conditions by OFGEM has effectively come to the same position as is presently the case in Northern Ireland. It is our intention to keep and enforce this licence condition. Any supplier who wishes to supply the domestic market will need to be able to demonstrate to the UR that the differentials between its tariffs are cost reflective if it is called upon to do so. The UR will need to work with suppliers to understand the nuances of what cost reflective means but will carry out robust analysis if there is a potential licence breach. Assessing cost reflectivity between types may be done on a supplier basis or on a market basis with guidance issued pursuant to the licence condition on expected percentage differentials between payment methods within which suppliers differentials would be expected to fall. Those that come outside these parameters leave themselves open to investigation and would need robust evidence to prove that they were not in breach of the licence condition. It may however be more appropriate to use an ex-post licence enforcement regime and investigate those cases were there seems to be evidence of non compliance (most likely if a differential is much larger than those of other suppliers observed at present). The UR will consider how any guidance would need to be framed and whether or not that guidance should include actual parameters and will decide on the content of any guidance closer to the time it is issued. The overall principle however is that the tariffs for different payment methods must be cost reflective and a supplier will be in breach of its licence if it attempts to deviate from this. Any supplier expected to be in breach will need to provide robust evidence, potentially to outside experts, to prove their tariffs are cost reflective.

84. We intend also to retain the requirement that all suppliers offer a minimum of three types of payment method. By retaining these conditions and ensuring

they are adhered to the UR is attempting to ensure that all customers will be able to avail of fair offerings from those suppliers that enter the domestic market.

85. The UR notes that there is no obligation on suppliers to offer three payment types to those SSMEs that can still avail of a regulated incumbent tariff. The UR feels this condition is not appropriate for small business customers as firstly on the whole they do not use prepayment meters and all businesses can be expected to have a bank account and be familiar with direct debit as a means of payment. Cost reflectivity as it was discussed above is directly linked to different payment methods and hence that condition does not apply to small business customers either.

(B) Undue Discrimination

86. The UR is minded to investigate and consult on the issue of whether it is appropriate that new licence conditions should be included that suppliers do not show undue discrimination to any group or groups of customers within any sector where they are deemed to have significant market power. At present OFGEM have stated that undue discrimination will be deemed to have occurred:

(1) If a Supplier offers terms and conditions of supply to one group of customers which are materially different from the terms and conditions of supply offered to any other group of customers; and

(2) Ofgem considers that any such difference or differences in the terms and conditions offered cannot be objectively justified.

They go on to explain that the terms and conditions of the supply of an electricity or gas product…….include all the elements of that product, including price…..

There is a similar condition in the NIE Energy supply and Phoenix supply licences entitled "Prohibition in discrimination in supply". However these conditions only apply to a supplier who is in a dominant position in a market for the supply of electricity or gas. For example in the NIE Energy licence it states:

This Condition applies where the Licensee (taken together with its affiliates and related undertakings) is in a dominant position in a market for the supply of electricity to Customers.

Where this Condition applies the Licensee shall not supply or offer to supply electricity to Customers in any market in which it is dominant on terms which are predatory.

Where this Condition applies but subject to paragraph 4, the Licensee (taken together with its affiliates and related undertakings) shall not, in supplying or

offering terms for the supply of electricity to Customers in any market in which it is dominant:

> ***(a) show undue preference to any person (or class of persons) within such market;***
>
> ***(b) exercise undue discrimination between any persons (or classes of person) within such market; or***
>
> ***(c) set terms which are unduly onerous.***

The equivalent condition in the phoenix supply licence has the same effect of prohibiting undue discrimination or undue preference if the supplier is in a dominant position in a sector or sectors of the market.

Hence at present this condition applies only to the incumbent in the domestic and SSME sectors.

In condition 27 of the supply licence it states that:

"***The licensee shall determine standard terms and conditions for the supply of electricity to Domestic Customers and may determine different standard terms and conditions for different cases or classes of cases or for different areas. The Licensee shall not enter, or offer to enter, into a Contract for the supply of electricity with a Domestic Customer otherwise than on its standard terms and conditions".***

87. Hence suppliers without market power can determine different terms and conditions for different groups of customers within the domestic and indeed any market sector.

88. However in GB it appears that there are six suppliers all of whom do not have market power but yet all exhibit behaviour consistent with market power e.g. the treatment and prices charged to non switchers that Ofgem has identified. The UR may consult on future proofing conditions in the licence to include that if suppliers have "significant power" then certain non discriminatory obligations may be triggered. This policy is embryonic at this stage and will be investigated further. It may be the case that in NI with only one former incumbent the GB situation may not arise. There are 14 groups of non-switchers in GB resulting from the 14 regional electricity areas and hence the big 6 have acquired 6 different sets of "sticky" customers i.e. those 40% of customers who have never switched away from their former incumbent supplier despite change in ownership over the last 10 years.

2. Retention of Incumbent Price Control and a Maximum Tariff

89. The second strand to the UR current policy on electricity and gas market competition is the retention of the incumbent price control and the setting of a

maximum tariff for the domestic and SSME sections of the regulated energy markets. Apart from the fact that the NI incumbents in both electricity and gas still have high levels of market power (due to market share) in the domestic and SSME sectors, this has two positive effects.

90. The first is that any customers who do not switch will still be assured that they can avail of the regulated incumbent tariff which broadly speaking will be the price they would have paid in the absence of any emergence of competition hence we can be assured that they are no worse off.

91. Secondly the regulated maximum tariff sets an efficient benchmark or market cap under which all prices must be set in order that they are competitive. This removes the chance of a situation occurring where all competitors make margins that are higher than they would have made had the regulated tariff continued in existence and where an oligopoly of suppliers who compete only at high margin levels emerges. This may be especially likely in a market with few suppliers. This is not effective competition and in order to ensure that customers are not faced with this situation the UR is of the view that the safest way to ensure this in the near term is by retaining regulated maximum tariffs.

92. It is important also to remember that the incumbent has every right to price below the maximum tariff if it finds innovative ways to reduce costs below the maximum set. This enables the incumbent to compete and attempt to retain market share. In the round the UR is of the view that there is no “downside” to retaining a maximum tariff. If the argument is that suppliers need to price above it to compete or make what they see as appropriate margins then the competitive model being forwarded is not an effective one that works in the interest of customers but in fact delivers a price that for some customers (or potentially a majority of or all customers) is actually higher than what would have been the regulated maximum.

93. The UR welcomes to the market any supplier of electricity or gas who is prepared to price below this regulated tariff level and views the tariffs that that supplier would offer as a real benefit to customers. However two things need to be considered in the current context.

94. Firstly there is the question of whether the current discounts that we see against the incumbent domestic tariffs will endure. If we were to remove the maximum tariff these discounts could evaporate and customers could end up in the situation described above. It would be a leap of faith for the UR to decide that the emergent competition currently being experienced would be effective and put real downward pressure on prices. This could *potentially* always be the case even if we were to see an incumbent with a much reduced

market share. This is because even with a smaller share the incumbent tariff can *potentially* retain its role as a benchmark or market cap above which competing suppliers cannot price or customers who have switched (and who we can thus reasonably say are price aware) will move back to the incumbent. This scenario is in the context of the NI market which has only one incumbent in both electricity and gas, and would not have applied to GB where there were at one time 14 incumbents throughout England, Scotland and Wales. One issue that arises however is that we may see an incumbent tariff being at an inefficiently high level in the future following more competition due to customer migration factors e.g. leaving customers leaving behind under recovery; but the NI incumbent is far removed from that situation at present and the UR will assess that situation at a later date, if it arises.

95. Secondly, at least in electricity, the current NI incumbent tariffs at prersent may be higher than they would be in a more liquid market. This is not so much to do with incumbent business inefficiency as problems regarding liquidity the Single Electricity Market (SEM) secondary contracts market. The UR has analysed the supply costs of the incumbents to ensure they are efficient. Any issues with the level of costs being included in the tariffs will be dealt with as part of the price control allowances. However it appears to the UR that the electricity incumbent tariff is artificially high because it is unable to purchase energy through contracts as discussed in section 2 and hedge its exposure to pool price volatility on the same basis as its competitors. This is discussed briefly below.

96. NIEES (the incumbent supplier) do not own any generation assets which they can use to internally hedge their customer demand which is exposed to pool prices in the SEM which are different for every half hour of each day. In order to offer fixed tariffs ,which are the preference of domestic and SSME customers, a supply business needs to hedge its exposure i.e. buy energy at a fixed price for periods of time (this is done using financial instruments called contract for differences - CFDs). A supplier can enter into these CFDs with a generator and thus purchase energy at fixed amounts and prices and offer that energy at a fixed price to its customers. The SEM secondary market (the market where generators offer to sell CFDs to any supplier at agreed prices) has an inadequacy of CFDs being offered i.e. a lack of liquidity (in terms of both volume and shape) hence NIEES cannot buy sufficient hedges to cover their demand. The CFDs that are on offer often have premiums attached to them (due to scarcity of CFDs) and this in turn increases the price NIEES must pay for energy. There is also a distinct lack of CFDs to cover the “peak” period when electricity is at its most expensive. If NIEES competitors can cover their demand and also peak exposure with affiliate generators they can in effect purchase the energy more cheaply as there is much less risk involved. Furthermore they will not need to pay premiums for the hedges or

credit cover costs (apart from those amounts that they purchase from the secondary market).

97. The situation described above appears to be what NIEES is experiencing at present and it pushes up the level of the final regulated tariff. The UR is not aware of how much of other suppliers hedges come from affiliate generators, but is confident that the fact they have affiliate generation that they can utilise to internally hedge means they have a distinct advantage over NIEES. In the absence of affiliate generation or a sufficiently liquid market it could be argued that the incumbent has been rendered at a disadvantage in the market and the competitive offerings being produced seem more attractive as a result. If this situation was resolved then the incumbent tariff would likely be reduced (all other things remaining equal).

98. There is currently a work stream in the SEM to attempt to improve liquidity and the outcome of this may be important for the issue described above. However the situation will likely remain that it will require all island competitors of the incumbent (direct competitors and affiliates of competitors) to be the parties that sell the CFDs to the incumbent in order for it to hedge. The UR may need to assess this situation going forward and decide on appropriate remedies.

99. The problems of a lack of liquidity/vertical integration in the wholesale market discussed above are not evident in gas as they are in the electricity sector. Gas suppliers tend to purchase their wholesale gas from the same market and hence competitors of the incumbent do not have the advantage described above. Due to this the UR can be much more confident that the maximum tariff set in the gas market is in fact an efficient unit price.

100. The UR invites comments on the situation described above and more generally on the two strand regulatory approach outlined.

8.0 Conclusions and policy implications moving forward

Conclusions and policy implications

101. This paper sets out our view that electricity retail competition can potentially deliver benefits for consumers, so long as it is developed efficiently, delivers truly contestable retail conditions in all market sectors and lower prices more than regulation of the retail market would otherwise have achieved, and consumers can effectively engage with these markets with the proper protection.

102. As a first guiding principle, to future policy development, we believe that regulatory frameworks should remain in place until we believe that customers in NI can realistically expect to benefit from competition and most importantly benefit in terms of price. As we go forward we need to try to ensure that all customers groups benefit from competition and switching opportunities (or at least are not demonstrably worse off). Where they do not, we need to ensure the regulatory structure continues to offer customer protection to the same level as it affords customers today.

103. As a second guiding principle we believe that overall electricity retail competition can potentially deliver benefits for consumers, so long as it is developed efficiently, delivers truly contestable retail conditions in all market sectors and most importantly lower prices than regulation of the retail market would otherwise have achieved, and consumers are empowered to fully engage with these markets. Our future regulatory approach, and actions to the regulated supply market, will be driven by this principle.

104. A third principle is that the relationship between the wholesale and retail markets, which are inextricably linked, should be transparent, of benefit to customers as well as companies, and facilitate retail competition. This is a wide statement but a principle worth having and regulatory policy striving towards.

105. A fourth principle is that the UR will flex the existing systems concerning the setting of a maximum tariff in order that there is less build up of “K” factor over or under recoveries by the incumbent. This means that there is the possibility of tariff reviews outside the normal yearly cycle where a new incumbent tariff is set from the 1st October in electricity. This should see the incumbent act more akin to an unregulated supplier and reduce the chances that the incumbent will

be selling energy either significantly above or below prevailing market prices due to passing through significant under or over recoveries respectively. The UR is mindful that there is an ever changing environment in the retail (and wholesale) markets and this policy position is for the next three years at which point the policy will be reviewed. However as stated above should events, such as significant movement is supplier market shares, take place then the UR will be flexible and react quickly.

106. Finally a fifth principle is the UR will continue in the setting of a maximum tariff for domestic and small business customers (for both gas and electricity). We are however cognisant of the fact that this may prove problematic in the context of a diminishing incumbent market share. It may be that we may move to a maximum tariff for domestic customers only or a tariff set only for those domestic customers who have never switched from the incumbent and may require protection from being charged high prices. Again the UR is not going to set triggers for any future regulatory policy. Policy needs to be formulated in the context of not just market shares but also market behaviour or potential market behaviour.

107. If vigorous competition were established, we would possibly consider lifting price controls and maximum tariffs. However, we would wish to do that in a way that considered the interests of all consumers, including non-switchers. Almost all responses to our General Overview consultation[6] agreed with this stance. We would deregulate (in terms at least of tariff controls) only when contestability is evident, competition is effective and prices are being sustainably lowered by competition - thus making direct tariff control unnecessary; we do not yet believe that time has come in the current price-controlled sectors. However we will continue to review on an ongoing basis.

108. Coming out of our future planned work on retail markets monitoring, we will develop a set of key indicators that will inform future policy. At this point we have not attempted in this consultation to set out in stone exact "triggers" for future regulatory policy change. We feel it is too early for that in terms of supply market maturity (at the domestic and SSME level), the existence of structural barriers to switching (until mid 2012 in electricity and potentially further in gas), and the lack of structured regular market information for all stakeholders to have a common view on the competitive maturity of the markets and the data sets required to signal significant policy change. Obtaining and understanding key data sets will help significantly in shaping regulatory policy going forward.

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[6] http://www.niaur.gov.uk/news/view/utility_regulator_publishes_energy_retail_competition_work_programme/

109. In the meantime we have identified those key data indicators mentioned above that we will monitor closely going forward and report on regularly: market shares, switching rates, number of competing suppliers, demonstrated tariff choices, etc are all obvious data areas that need to be monitored for each market sub-sector.

110. In the body of the paper we have identified our views for consultation on: relevant market sub-sectors, key immediate data requirements, future projects on market monitoring framework development, customer protection requirements and regulatory approach. We have identified that in terms of household customers, existing data clearly shows very limited effective supply competition at this time. Given also the existence of structural constraints on switching activity and the lack of presence of a diverse set of suppliers, we see no need to begin changing existing regulatory frameworks prior to engaging in the further market monitoring and new work projects identified above.

111. That said, we note that our regulatory policy framework may however need to change as competition and supply markets mature. For the benefit of feeding this future policy discussion, we identify here for comment from respondents two related questions. In tandem with the work we are beginning to develop a more structured supply market monitoring regime going forward, we welcome comments and views from respondents on these matters as we enter the evolution of domestic energy competition in NI:

(1) **Does our current regulatory policy stance strike the correct balance between customer protection and allowing electricity supply market competition to exist?**

(2) **If we deem competition to be effective and working in consumers interests, how that might effect regulatory approach**?

112. For now, in the coming short-run period (three years) we will continue to regulate NIEES and Phoenix Supply Ltd, seeking to ensure efficient cost pass-through and an allowed return that reflects the risk profile faced by the incumbent in the remaining regulated sectors, thus ensuring customers can avail of a regulated tariff. We will seek to do so in a way that facilitates and fosters competition against the incumbent and ensures the market is working properly in systems and process terms so that those suppliers that can offer prices better than the regulated tariffs are not in any way prevented from doing so.

113. As we go forward, we will explicitly assess the competitive aspects in the remaining regulated sectors (including investigating the position of sub-

sectors of the domestic and SSME markets) and consult on potential implications for consumers and the industry. If we judge that customers can be adequately protected by competition (or the threat of entry/loss of market share) our approach may change and/or we will consider options to run alongside a regulatory approach. However one important aspect of any new policy would be the option to re-regulate and re-introduce a maximum tariff if the market were to become dysfunctional and customers were not being adequately protected.