Response to Price Control approach paper consultation

Utility Regulator consultation on electricity and gas retail supply price controls (SPC17)

December 2015

If you have any questions in relation to our response, please don't hesitate to contact me at
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Introduction

SSE AGSNI welcomes the opportunity to comment on the Utility Regulator's (UR) consultation on the approach to electricity and gas retail supply price controls. The paper sets out the regulatory approach to certain elements of the price controls for the three regulated retail supply companies; SSE Airtricity Gas Supply Northern Ireland (SSE AGSNI), firmus energy and Power NI. SSE AGSNI looks forward to working with the UR to put in place a price control to the benefit of its customers. Having worked during the last price control period to understand and raise standards of service to gas customers, SSE AGSNI will be submitting its business plan to the UR for consideration in January on this basis.

UR/Cornwall Energy's review of NI energy retail markets

The consultation paper refers to the findings of the Cornwall Energy review. In particular, the market limitations in terms of scale and stagnant nature of market share for incumbents

The paper seems to accept that significant change in switching levels or increase in competitions is unlikely in the NI gas market. Our view is that it is possible to develop a higher level of competition in the regulated NI gas markets, provided the correct market signals are provided and the structure of the market is appropriate. It is clear that competition has already been successful in some market segments, with deregulation of further customers segments being considered under this price control review. For example, there are six suppliers operating in the commercial sector where entry signals have been more attractive.

The geographical split in markets and networks within the NI gas market add an unnecessary layer of complexity for market entry and may contribute to higher levels of network costs being passed through to customers through duplication of systems and operations. SSE AGSNI urges the UR to consider establishing a single gas retail market for NI to reduce the barriers to entry for new suppliers and encourage a higher level of competition by building a larger customer base for new entrants to access. In addition, SSE AGSNI believes the UR needs to consider the return on investment needed for successful and sustained entry to the natural gas market in NI. The historical low margin allowed in the NI gas market has led to low levels of investment in customer services, system development and innovation in tariff offers for example dual fuel. We are happy to engage in discussion on this.

SSE AGSNI supports the URs proposal to extend its current control on a pro rata basis for a further 3 months to 31 March 2016 in order to align with the financial year which was amended in the SSE AGSNI licence by the UR in 2015.

Response

Structure and form of price control

SSE AGSNI accepts the proposal to continue to operate a maximum average price for the period of the next price control.. SSE AGSNI supports the treatment of network and wholesale gas costs remaining the same.

In terms of the approach to operating costs, SSE AGSNI believes these should be approved in the determination and feed into the price control as set out in section 2.16, however they should be considered separately for SSE AGSNI to firmus energy as the costs incurred and drivers may be different. We agree that some operating costs will provide for fixed allowances with others being retrospectively adjusted based on agreed cost drivers. Margin is addressed in the section below.

SSE AGSNI supports the modification of the license to allow the licensee to challenge the determination in advance of a tariff change. The change will provide clarity on the process for the regulator and supplier as well as minimising the risk of disruption to customers.

Scope

The UR has included proposals to review 3 market segments in the next price control process. These are :

- non – domestic 0-50MWh sector for Power NI;
- 73,200kWh to 732,000kWh (EUC 2) sector for SSE AGSNI; and
- the retention of price control for less than 732,000 kWh for the firmus Ten Towns area.

SSE AGSNI has provided comment on two of these proposals.

For both the Power NI and SSE AGSNI segments being reviewed, SSE AGSNI believes that in looking at customers who consume lower levels of energy it is important to use customer numbers rather than consumption as the driver of deregulation. We note that in the ROI electricity market, the CER used consumption rather than customer numbers as the driver of deregulation and in that market the incumbent has continued to hold approximately 60% of smaller customers while seeing consumption drop to lower percentage levels. Looking at consumption only can clearly lead to premature deregulation. It is likely that new entrants have sought higher consuming customers in the first instance when entering the market which means that if deregulated, the return of a smaller number of customers to the incumbent can see the market share tip back towards regulation more quickly.

Power NI

The question being asked is whether respondents agree to the UR proposal to review price regulation in the non – domestic 0-50MWh sector of the market for Power NI.

A roadmap for deregulation was included in the 2014 Power NI price control determination. The criteria to automatically trigger a consultation on further end-user price control deregulation of the 0-50MWh pa non-domestic sector were:

1. Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and

2. There is a minimum of 3 independent suppliers, each of which has at least 10% share of consumed units in the relevant market. For clarity, what this means in practice is Power NI/Energia plus two other independent suppliers.

According to the quarterly transparency reports[1], the criterion for deregulation using consumption as a driver has been reached this year. Power NI's market share by consumption in Q2 and Q3 2015 was 38.8% and 37.8% respectively.

SSE believes that market share for Power NI should be looked at in conjunction with that of its other brand Energia. In addition, as set out above, SSE believes that the driver of deregulation should be customer numbers and not consumption to more appropriately reflect competition developing. As such, SSE's view is that deregulation in this sector is premature. While the proposed trigger has been reached, we believe this should be reconsidered. In addition, there is ongoing difficulty with competition in this market sector. There is no industry database identifying these commercial customers which means Power NI has an information advantage over new entrants as the incumbent holder of all customer information.

We note action to develop a process to allow the confirmation of meter types before a switch is completed is being developed in the gas market. We would welcome a similar process to allow for confirmation of a 'tenure category' in the electricity market to support the deregulation of this market segment in the future. The provision of information such as property addresses and associated DUOS codes in NI electricity market would provide for continued competitive behaviour in this area and should be considered in parallel.

SSE Airtricity

SSE AGSNI is supportive of the proposal to review price regulation in the 73,200kWh to 732,000kWh (EUC 2) sector of the gas market. There is notable competition in this market segment with SSE AGSNIs market share reducing on a quarterly basis in 2015.

Had there been a roadmap to deregulation for gas based on the principals included for Power NI the trigger for deregulation has almost been met. SSE AGSNI believes that examining this market segment looking at customer numbers would show that it is appropriate to now deregulate this segment. In addition, the Cornwall Energy report

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[1] Quarterly transparency reports for 2015 available on the Utility Regulator website here

produced for the UR regards 50% market share as the trigger for deregulation. SSE AGSNI now holds less than 50% of this market segment based on customer numbers and consumption.

Market share for relevant supplier by % consumption in Q2& Q3 2015

Supplier	Q1 2015	Q2 2015	Q3 2015
SSE Airtricity	45.48%	42.15%	41.08%
Firmus	48.56%	44.83%	43.90%
Go Power (formerly LCC Power)	3.65%	9.09%	9.53%

Duration

SSE AGSNI supports the proposal for the next price control period to be 3 years. This will ensure that costs allowed will more closely reflect those the business faces. While the last price control was for a 5 year period, this was based on the market remaining stable for that duration. It has become clear that a higher level of competition, combined with increasing industry change has meant that costs have not remained stable over the 5 year period. Moving to a shorter price control is more reasonable given the level of industry change and possibility of further competition developing.

With respect to the possibility of rolling over some of Power NI's price control costs until clarity is forthcoming on ISEM costs, SSE AGSNI believes this could have a significant impact on suppliers trying to compete in the NI electricity market. Deferring these costs may not be possible for all suppliers, which would see competitors having to raise energy prices to reflect ISEM costs while the regulated entity would see continued lower prices. This would reduce switching and could see significant volumes of customers switch back to Power NI. The majority of ISEM scoping work should be completed by mid-2016 with a large proportion of work underway. At this stage suppliers should have a clear view on place holder costs for delivery. SSE believes the UR should include reasonable projected costs in its determination up front to be retrospectively adjusted based on actual costs. This will reduce the overall fluctuation in k factor and prices that deferral these costs could have.

License modification

SSE AGSNI is supportive of the proposed license changes with regard to the process to challenge a determination. The provision for review at the completion of the price control process will reduce the potential for disruption at the time of a tariff change and provide for any challenge to be referred to the CMA for resolution in a timely manner. SSE AGSNI has responded separately to the UR on the license modification consultation and urges the UR not to finalise the elements of the license modification which are being considered as part of the price control review in advance of substantive submissions being made on same.

Treatment of costs for SSE AGSNI

Network costs and wholesale gas

The UR is proposing to retain the pass through treatment of network costs and wholesale gas costs. SSE AGSNI is supportive of this approach as it ensures that costs directly incurred by the business are passed through in a cost reflective way. SSE AGSNI would like to note that the publication of forecast network costs is not always timely and this can have an impact on its tariffs. While outside the supply price control reviews, SSE AGSNI notes that the current practice with respect to transmission and distribution charges leads to an annual adjustment of these charges at the end of the year. This has an impact on forecasting and pricing to customers. SSE AGSNI believes the UR should consider introducing a k factor type approach to all postalised network charges to reduce the impact on the retail market.

Supply operating costs

The proposal to implement a combination of ‘bottom up’ and ‘top down’ analysis (with historical trend analysis) is welcomed in principle by SSE AGSNI. As referenced in the paper there is a difference in the operation of the business since acquisition and we welcome the UR’s recognition that a wider understanding of costs is needed for this first price control. A combined review of supply operating costs should provide a historic trend analysis of the business, as well as a more accurate forecast position. It should be noted however, that the historic costs directly allocated to the business may not show all required costs of the SSE AGSNI business due to the delays and changes made to the business following acquisition in the 2012-2014 period. SSE AGSNI will work with the UR to ensure a full understanding of costs is provided. We note that there has been a historical underinvestment in IT systems and processes which has led to the SSE AGSNI falling behind industry normal standards in terms of customer services and performance in some areas. This will form part of our discussion with the UR during the review.

Treatment of Variable Costs

The treatment of variable costs is essential in the overall treatment of costs under the price controls. In line with the objectives of the price control, to allow the business to recover efficiently incurred costs, it is important that where an actual cost is incurred by the business that it is allowed. In the case of variable costs, this is done retrospectively to ensure that the costs recovered represent the actual costs.

SSE AGSNI supports retaining the current approach of retrospectively adjusting variable items. This has become established practice and there are systems in place to ensure transparency in the presentation of information to the UR on this basis. Treating variable costs retrospectively is a more accurate and transparent approach than applying a fixed cost methodology.

In relation to cost drivers, there are a number of items in the price control which SSE AGSNI considers should be allocated in a manner more reflective of how SSE operates its gas business. It has become clear in operating to the PSL price control that the two businesses do not operate in the same way. Loss of market share should also be considered in this review. These will be addressed in detail in our overall submission.

Additional operating cost for SSE AGSNI

SSE AGNSI is broadly supportive of the UR approach to recognising that price control costs are not always apparent at the time of allowance determination. The list approach in the

Power NI license seems reasonable for known costs and industry changes, SSE AGSNI's view on what to include on a list will be discussed in its price control submission to the UR. This will reduce risk to the business as a whole.

While SSE AGSNI welcomes the clarity the inclusion of a list of items to be considered within the control will bring, it is important to include a provision for unforeseen costs. For instance, costs associated with satisfying new unforeseen license compliance requirements which have not been included in the assessment of costs that form the price control determination. While we note that some regulators have provided for a catch all approach in price control determinations, the size of the SSE AGSNI business, the low value and low margin of return set out in the price control does not allow scope for additional costs to be absorbed. The nature of the control should be that it will provide an allowance for these activities based on actual costs.

One known item for consideration at this point is the cost associated with the Supplier of Last Resort (SoLR) project. This project is focused on establishing emergency procedures in the event of a supplier exiting the market, triggering a Supplier of Last Resort (SOLR) event. While there has been a regulatory commitment for the associated costs to be recovered, the explicit inclusion of this cost item is needed given the expectation of up front investment.

The list should be recognised as not being exhaustive; the option for introducing additional items within the control period should be explored. This is of particular importance for items which could significantly increase the financial risk carried by SSE AGSNI and other price controlled businesses.

Treatment of over and under recovery

Over/under recovery is a normal occurrence in a price control. Making the customer whole through an agreed K factor is a well-established method of dealing with over/under recovery. Interest is paid on the amount based on an agreed rate (LIBOR in this case), and the over or under recovery is processed through the tariff.

However, the application of penal interest rates to both under-recovery and over-recovery in the current price control is unique to SSE AGSNI. Given the seasonal nature of gas and the direct impact that external factors such as weather conditions have on the ability to forecast gas, the current mechanism guarantees a penalty will be applied to the business as it is based on 100% accuracy of forecasting. The mechanism in the determination looks at the allowed expenditure (with the exception of gas costs) not incurred or exceeded because of inaccurate forecasts of volume etc. It is based on a two tier mechanism similar to that used by Ofgem in the 2007 Distribution Price Control. The two tier mechanism treats over/under recovery as follows:

Over recovery

- > 3% = interest rate of 3% higher than the base rate is applied;
- < 3% = interest rate of 1.5% higher than the base rate is applied.

Under recovery

- < 3% = interest at a rate of base rate + 1.5% can be recovered;
- > 3% = interest at base rate can be recovered.

The base rate used is the rate set by the Bank of England taken as the July figure in that year.

SSE AGSNI is of the view that a mechanism designed with respect to a distribution operator with significantly higher costs and more stable business is not appropriate for a supply business. SSE AGSNI will make a separate submission to the UR with respect to this mechanism.

Margin

At the outset, the UR's acknowledgement that different margins may be applicable to different business is encouraging. SSE AGSNI is of the view that the margin must be sufficient to allow an appropriate return on investment, while also ensuring that new entrants are not disincentivised from entering the competitive gas market. As recognised by the CMA, it is important to consider margin in relation to the costs of a standalone business. SSE AGSNI will be making its submission on this basis.

In addition, it is important to realise that setting a margin based on a percentage may not lead to appropriate return depending on the costs experienced by the business. While the methodology for calculation of the margin is addressed in the model, the underlining principal (i.e. margin as a % of allowed revenue) for setting the margin warrants more detailed examination. SSE AGSNI will be making a further submission in this regard.

Conclusion

SSE AGSNI has sought to address the relevant section of the consultation paper in its response. A more substantive response on the element of the price control as they relate to SSE AGSNI will be submitted in January as part of the Price Control review process.