

**A REVIEW OF K-FACTORS AND SUPPLY MARGINS IN THE SINGLE  
ELECTRICITY MARKET**

**RECOMMENDATION TO THE COMMISSION FOR ENERGY  
REGULATION AND THE UTILITY REGULATOR**

**SKYPLEX CONSULTING LIMITED**

**DECEMBER 2009**

## 1. Summary

In June 2009, Skyplex Consulting prepared a report (the “June 2009 Report”) for the Commission of Energy Regulation (CER) and the Northern Ireland Authority for Utility Regulation (NIAUR), jointly the Regulatory Authorities (RAs) on a Review of K-Factors and Supply Margins in the Single Electricity Market (SEM). This report formed the basis of a consultation paper published by the RAs on 22<sup>nd</sup> June 2009.

The June 2009 Report set out the issues identified in Skyplex’s review of k-factors and included three proposals for changes to k-factors with a view to promoting the development of supply competition in Ireland and Northern Ireland. The proposals comprised:

- *Proposal 1, Minimal Change*; in which k-factors are retained but a number of changes to the existing arrangements are made in order to address the detrimental impact that k-factors may have on competitor suppliers;
- *Proposal 2, Asymmetric K-factors*: whereby any over-recovery must be repaid with a premium whilst any under-recovery is subsequently not fully recovered; and
- *Proposal 3, No K-factor*: with maximum allowable revenue determined ex-post from out-turn pool prices and customer demand; whereby use of k-factors is discontinued completely and allowable revenues for the regulated suppliers would be set ex-post based on the pool purchase costs of the electricity actually used by their customers, not including hedging costs.

Eleven responses to the RAs’ consultation were received, one of which was confidential.

Many of the issues raised in response to the consultation highlighted the dichotomy between retaining high levels of regulation whilst at the same time seeking to introduce retail competition. New suppliers wishing to enter or expand their presence in the retail market typically called for an abolition of k-factors; greater access to information over the activities of the regulated suppliers; and higher margins, which they believe are necessary to support the development of competition.

Conversely, others expressed concern over the potential abolition of k-factors whilst retaining regulated tariffs and strong restrictions upon the regulated suppliers’ behaviour.

In light of the consultation responses, Skyplex remains of the view that it is likely that the existing k-factor regime is detrimental to the development of retail competition in both Ireland and Northern Ireland and recommends that the RAs consider adopting the following changes as part of their roadmaps to de-regulation.

#### *Northern Ireland*

In Northern Ireland, given the current state of retail competition, we do not advocate adopting either Proposal 2 (Asymmetric k-factors) or Proposal 3 (No k-factor with maximum revenue restraint determined ex-post). Instead, we recommend that Proposal 1 (Minimal Change) be considered for adoption at this stage. Essentially, the changes proposed include:

- ensuring that there is greater transparency and certainty associated with the application of k-factors;
- providing additional certainty to the processes followed by the RAs in approving any k-factor; and
- undertaking a legal review of the relevant existing licence conditions so as to ensure that they are robust against any under-pricing and any cross-subsidisation between tariffs.

#### *Ireland*

Given the more advanced state of retail competition in Ireland, we recommend that the RAs consider adopting Proposal 3 in this jurisdiction at some time in the near future.

Under this Proposal:

- the regulated supplier would be given additional freedom to revise tariffs;
- k-factors would be discontinued, and the maximum allowable revenue for the regulated suppliers set ex-ante equal to their customers' demand priced at outturn pool price;
- in the first year, the maximum allowable revenue would be adjusted to correct for any prior year over or under recovery;
- the costs of any contracts for differences would not be included in the allowable revenues, although regulated suppliers would be permitted to contract as they saw fit; and

- the regulated supplier would be afforded a small increase in supply margin set so as to ensure that they had a reasonable expectation of covering costs given that the regulated suppliers would have to set tariffs so as to recover an expected amount below their maximum allowable revenues in order to avoid breaching their maximum allowable revenue licence condition and to cover the costs of more frequent tariff changes.

Skyplex also notes that whilst taking steps to abolish or reduce the effects of k-factors is likely to assist in the development of retail competition, there may be other factors which serve to limit the rate of development of such competition in the two jurisdictions. Consequently, changing the k-factor regime may not in itself be sufficient to foster more competitive arrangements and we therefore acknowledge that it will be important for the proposals set out above to be considered in light of the RAs' more comprehensive roadmap proposals to introduce retail competition in the two jurisdictions.

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### **3. Introduction**

In June 2009, Skypex Consulting prepared a report (the “June 2009 Report”) for the Commission of Energy Regulation (CER) and the Northern Ireland Authority for Utility Regulation (NIAUR), jointly the Regulatory Authorities (RAs) on a Review of K-Factors and Supply Margins in the Single Electricity Market (SEM).

On 22<sup>nd</sup> June 2009, the RAs published a consultation paper<sup>1</sup> inviting interested parties to comment on the proposals set out in the June 2009 Report. In parallel, within the consultation paper, the RAs also invited comments on a report on a Review of Tariff Structures that had been prepared by Pöyry.

Eleven responses to the RAs’ consultation were received, one of which was confidential. This draft report summarises the proposals made in the June 2009 Report and the responses received, and, in light of these, makes initial recommendations as to how the RAs may wish to take forward the issue of k-factors in the SEM.

#### **June 2009 Report**

In the June 2009 Report, Skypex described how ESB Customer Supply (ESBCS) and NIE Energy (NIEES), respectively the Public Electricity Supplier (PES) in Ireland and the former PES in Northern Ireland, are subject to price or revenue restrictions. In any given year, the revenues that the licensees earn from tariffs that they have to set in advance may differ from the allowable revenues. The k-factor is a term in the price control formula that allows compensation for any under-recovery or over-recovery in any given year to be applied in the following year.

The June 2009 Report highlighted the fact that a number of concerns have increasingly been raised, both by NIAUR and CER and by industry, over the continued use of k-factors in the price/revenue restrictions for ESBCS and NIEES, suggesting that k-factors serve to undermine competition in supply.

The June 2009 Report went on to set out the issues identified in Skypex’s review of k-factors and included three proposals for changes to k-factors with a view to

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<sup>1</sup> See: Review of K factors & Supply Margins and Tariff Structure Review. Proposals for Consultation. 22nd June, 2009. CER/09/093. <http://www.cer.ie/en/electricity-retail-market-current-consultations.aspx?article=a695f970-307f-45f5-9d59-272c6d37b0f6>.

promoting the development of supply competition in Ireland and Northern Ireland. The proposals comprised:

- *Proposal 1, Minimal Change*; in which k-factors are retained, on the basis that hitherto developments in retail competition would continue to progress, but a number of changes to the existing arrangements would be made in order to address the detrimental impact that k-factors may have on competitor suppliers;
- *Proposal 2, Asymmetric K-factors*: whereby any over-recovery must be repaid with a premium or any under-recovery may not be subsequently fully recovered; and
- *Proposal 3, No K-factor*: with maximum allowable revenue determined ex-post from out-turn pool prices and customer demand; whereby use of k-factors is discontinued completely and allowable revenues for NIE Energy (NIEES) and ESB Customer Supply (ECBCS) (together the “regulated suppliers”) would be set ex-post based on the pool purchase costs of the electricity actually used by their customers, not including hedging costs.

In the case of Proposal 1, the principal changes proposed related to making available additional information as to the hedging position of the regulated suppliers within year and providing greater regulatory certainty over the subsequent application of k-factors. These changes were recommended as part of Proposal 2 also.

In the case of Proposals 2 and 3, additional freedom to change tariffs would be afforded the regulated suppliers. These proposals were intended thus to result in tariffs which more closely reflect costs and hence it is likely that tariffs would change more promptly to reflect changes - both increases and decreases - in underlying costs. In each of these two proposals the need for a small additional margin for the regulated suppliers was considered such that they were not expected to operate at a loss in order to meet their revenue restriction conditions.

The June 2009 Report also stated that, whilst taking steps to abolish or reduce the effects of k-factors was likely to assist in the development of retail competition, there may be other factors which serve to limit the rate of development of such competition in the two jurisdictions. Consequently, it was argued that changing the k-factor regime may not in itself be sufficient to foster more competitive arrangements. Nevertheless, subject to reviewing responses to a consultation on the proposals,

Skyplex stated that there did not appear to be any material disadvantages to introducing one of the reforms proposed.

The June 2009 Report recommended that the RAs should invite views, together with justification of those views, on the proposals set out therein and, in particular:

- (A) Do customers prefer a single tariff change per year, and are there any other matters that should be taken into account in considering the issues associated with reducing the effects of, or abolishing k-factors?

In respect of Proposal 1:

- (B1) What additional information should the regulated suppliers be required to make available in relation to their contract cover and forecasts of over/under recovery, and in what timescales?
- (B2) Are there any reasons why it would not be appropriate for additional information on such issues to be made available?
- (B3) What proportion of any over recovery should be returned in the following year to customer in general rather than only to customers of the regulated supplier?

In respect of Proposal 2:

- (C1) What level of asymmetry should be introduced into the k-factors and how should this vary over time?
- (C2) What level of additional margin should be afforded the regulated suppliers to give them a reasonable expectation of recovering their costs? Quantitatively, how should this vary with the level of asymmetry and the expected frequency with which tariffs can be changed?

In respect of Proposal 3:

- (D1) Is it feasible for regulated suppliers to apply ex-post tariffs corrections in order to avoid an over recovery of revenues?
- (D2) What level of additional margin should be afforded the regulated suppliers to give them a reasonable expectation of recovering their costs? How should this vary with the frequency with which tariffs can be changed?

Finally,



- (E) Which, if any, of the proposals put forward in this document should be adopted and why? What alternative proposals should also be considered?

## 4. Views of Respondents to the Consultation

Ten non-confidential responses to the RAs' June consultation were received, mostly including comments on both the June 2009 Report and Pöyry's parallel report on tariff structures. Non-confidential respondents included:

- Airtricity
- Bord Gáis Energy
- Endessa
- ESB Independent Energy
- ESB Customer Supply
- Gemserv
- The Consumer Council
- NIE Energy Supply
- NIE Energy Limited Power Procurement Business
- Northern Ireland Electricity

One confidential response was also received. Most respondents commented both upon the specific questions asked within the June 2009 Report as well as providing more general comments on the proposals<sup>2</sup>. These are discussed further below.

*(A) Do customers prefer a single tariff change per year, and are there any other matters that should be taken into account in considering the issues associated with reducing the effects of, or abolishing k-factors?*

Two respondents suggested that customers preferred a single tariff change per year, with one stating that within year changes were not welcome as customers preferred stability in tariffs for budgeting purposes. This respondent also suggested that more frequent changes would be costly for suppliers in terms of system changes, although suppliers would take this into account when deciding upon customer strategies and their competitive offerings.

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<sup>2</sup> Comments on the proposals set out in the Pöyry report on tariff structures are outside the scope of this report.

Another respondent stated that whilst some customers liked the surety of a single tariff change per year, if active competition exists then this will provide customers with the necessary price signals and ability to make informed choices.

One respondent stated that during August 2009, they had commissioned an independent omnibus survey of consumers' views on energy issues. Almost half (47 per cent) stated they would prefer their energy bills to be fixed for a defined period, rather than be variable to reflect fluctuations in international fuel prices. Over a third (35 per cent) preferred the idea of a variable energy bill. It should be noted however that Skyplex does not know whether customers were informed that having the surety of a fixed tariff carried with it a hedging premium included in the overall tariff that would be absent with variable tariffs.

### **Proposal 1**

*(B1) What additional information should the regulated suppliers be required to make available in relation to their contract cover and forecasts of over/under recovery, and in what timescales?*

One respondent stated that there must be clear transparency with regard to how tariff charges are constructed and the allocation of costs to particular tariff groups and how these costs are then allocated within each specific tariff group. It stated that the information should enable analysis of whether these costs are accurately reflected in PES tariffs. In its view, PESs should publish clear information on their hedging position and, whilst greater information on this was now provided, there remained the need to publish detailed data with respect to Directed and Non-Directed contract purchases, including prices, quantities, delivery profiles and delivery periods.

Another respondent suggested that if k-factors were retained, regulated suppliers should publish CfD volumes for all periods (baseload, peak, MM1 and MM2) and forecasts of over/under recovery on a quarterly basis.

A third respondent noted that since the drafting of the June 2009 Report, the RAs had agreed a format for enhanced disclosure of hedge positions by the PESs. In their view, there was a need to balance the transparency requirements for publication of PES-specific data with the potential opportunity for independents to exploit to their immediate advantage the arbitrage position that may become evident to the market. They were of the view that as there is now very robust competition for customers of

all categories in the ROI market, the need for such disclosure needed to be re-examined in that context.

Finally, one respondent stated that a balance must be struck between providing sufficient and timely information to enable potential competitors to assess the market and ensure that the incumbent is not placed at a disadvantage in a competitive environment.

<p><i>(B2) Are there any reasons why it would not be appropriate for additional information on such issues to be made available?</i></p>
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One respondent stated that the recent development of robust competition in all sectors of the ROI market had diluted the need for the PES to divulge more information, and that there was a risk that certain disclosures could result in the short-term exploitation of arbitrage possibilities by other market participants. This may result in an undermining of the PESs best efforts to minimise forecast over/under recovery. It also stated that the provision of contractual data could increase the likelihood of increasing tariffs as a result of the vicious cycle arising where under-recovery and switching away from PES occurs year after year.

This potential mechanism (i.e. the “vicious circle”) was also highlighted by a second respondent who suggested that if under recovery exists in a year, customers may switch away from the PES in the following year due to increases in the tariffs, potentially leading to further under recovery and higher prices again leading to further switching etc. They stated that customers that do not or cannot switch will find that they are picking up the costs of using K-Factors (these may be vulnerable customer types that are unattractive to new entrants or those with debt problems).

Another respondent stated that, as a regulated supplier, it would be reluctant to publish contract cover details to competitors and that there would be issues of counterparty confidentiality. It also suggested that details of contract cover may not be useful to competitors in making k-factor estimates because the k correction was complex and stemmed from a complex set of variations.

A fourth respondent stated that in the current fully regulated monopoly system there should full and timely disclosure.

(B3) What proportion of any over recovery should be returned in the following year to customer in general rather than only to customers of the regulated supplier?

One respondent did not believe that redistributing k-factors across all customers was appropriate, nor did they believe that it was in keeping with a competitive ethos. Instead, it should be the prerogative of competing suppliers to choose how and whether to account for under or over recoveries from the previous year.

A second respondent agreed that any over-recovery should be returned to the customers of the regulated suppliers and that any under-recovery should be collected only from their customers. It was concerned that as the regulated customer base shrank, there may be attempts to recover k-factors via network tariffs and that this must not be permitted.

A third suggested that if regulated suppliers had over-recovered, then independent suppliers were likely also to have over-recovered and to have banked the unexpected surplus. These gains could be used to fund pricing strategies aimed at maintaining or growing the customer base/market share. It noted that the CER had previously declared a very strong position against redistributing over-recoveries across all customers, stating that this would be a breach of legislation.

Another respondent believed that as a principle, over-recoveries should be passed back to those customers affected, but that tracking this was potentially complex and costly.

One respondent stated that it assumed that NIAUR would not endorse this approach as they had previously rejected the suggestion that the NIE Energy Customer Supply k-factor should interact with the PSO in the context of the October 2009 tariffs, even though there was a strong argument to do so on the basis of fairness and equity.

Finally, one respondent requested further clarity on this proposal.

## Proposal 2

*(C1) What level of asymmetry should be introduced into the k-factors and how should this vary over time?*

One respondent suggested that k-factors should permit a recovery of only 75% of any shortfall but that any over-recovery should be fully rebated to customers from the prior year via rebates rather than subsequent lower tariffs.

Another respondent stated that the asymmetrical proposals had not been considered in the context of the CER's statutory duties not to discriminate unfairly between licence holders and to secure that licence holders are capable of financing their activities and may therefore be inherently flawed. It stated that there was already a 'cost' imposed on the regulated supply business through a very low margin on sales and the unique and restrictive licence and regulatory conditions that do not apply to other suppliers. It believed that the proposal as presented meant that shortfalls were never fully recoverable, and that over recoveries were penalised through financial penalties. It also believed that the adoption of asymmetrical adjustments could give rise to perverse incentives for the PES to achieve a particular outcome (i.e. situations where over recovery is more favourable than under recovery or vice versa).

A third respondent stated that with asymmetric k-factors, the incentive effect would be for the PESs to adjust tariffs more frequently to minimise the error and that it was not clear that this was what customers preferred.

Finally, one respondent stated believed that this is a matter for the regulator to determine using their expertise of economic modelling and in consultation with stakeholders.

*(C2) What level of additional margin should be afforded the regulated suppliers to give them a reasonable expectation of recovering their costs? Quantitatively, how should this vary with the level of asymmetry and the expected frequency with which tariffs can be changed?*

One respondent suggested that a market risk assessment should be conducted to determine a reasonable rate of return for investing in the market. Another stated that substituting a higher margin for the k-factor would result only in higher tariffs for customers. They suggested that, as recent experience had demonstrated, the

potential financial exposure faced by ESB PES was of the order of €100m-€200m and that this was many multiples of the quantum of the margin.

A further respondent stated that if tariffs were too high, this would lead to customer switching and under-recovery leading to potentially greater variances in tariffs thus encouraging customers to look at price sensitivity rather than innovative services from suppliers.

Finally, one respondent stated that the current system provides the incumbent with a no risk business. It believed the margin should fairly reflect the risk to both the consumer and the supplier. Therefore, if the level of risk introduced remains low, the margin should remain low.

### **Proposal 3**

<p><i>(D1) Is it feasible for regulated suppliers to apply ex-post tariffs corrections in order to avoid an over recovery of revenues?</i></p>
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One respondent stated that it was not practical for the PES to apply this in a manner that was fair and transparent to all customers. Instead it was more practical to implement an approach whereby if forecast variances exceeded a threshold value a review would be undertaken. Given customers' preference for fixed tariffs and the absence of Time of Use metering and tariffs, the introduction of ex-post adjustments for outturn SEM pool prices and outturn customer demand without adjustment for contract costs would introduce an unacceptable level of risk, i.e. fixed tariffs and variable pool energy costs. Even if it was limited in application, it would be difficult to apply in practice as it may lead to customer confusion. If it is accepted that such adjustments could be made, then in theory, they could be made at each billing cycle e.g. a form of fuel variation tariff adjustment. However this would be an important change in concept and strategic direction without any guarantee of a positive benefit for customers and retail competition.

Another respondent stated that ex-post recovery was possible but that it was potentially costly and complex, for example how would such an approach apply if a customer had subsequently switched supplier away from the PES.

A final respondent stated that a consumer should pay a fair price for their energy and that they would therefore support this correction if it provided consumers with a better deal.

(D2) What level of additional margin should be afforded the regulated suppliers to give them a reasonable expectation of recovering their costs? How should this vary with the frequency with which tariffs can be changed?

One respondent reiterated their earlier arguments that, a higher margin on a regulated tariff would only lead to increased costs and that the substitution of a k-factor for a margin would not be in the customers' best interests. It stated that it was unlikely that ESB PES could achieve a reduction in un-hedged volume below 15%-20% and again, the financial exposure faced by ESB PES was of the order of €100m-€200m and that this was many multiples of the quantum of the margin.

Another respondent stated that unless there was full information to make a judgement on how much the PES actually requires, it would be difficult to know how much margin could be allowed. It would be better to allow competition to establish the price offerings that can be made so that the real price and minimum allowable margin could be quickly established using a competitive market mechanism.

Another suggested that it would be very difficult to set a price control where tariffs were determined in advance with no k-factor and that very high margins would be required. It stated that the gross margin in the GB competitive market was 2-3 times that of PESs in the All-Island market and that net margins were several times the size. The same respondent also suggested that in a market in which such risks were managed by suppliers, it was likely that customers would be offered a variety of tariffs with different risk balances – i.e. with varying degrees of exposure to pool price. Under such an approach, it would be difficult to set a price control with a fixed margin. It stated that the margin would need to be increased to allow for the expected value of any under-recovery shortfall and/or the over-recovery penalty and the increase in the cost of capital arising from the increased risk.

A third respondent stated that this is a matter to be determined by the Regulatory Authorities, but that it ultimately needs to be fair to the consumer, with the aim of reducing overall energy costs, and that it should reflect the level of risk that is introduced.

(E) Which, if any, of the proposals put forward in this document should be adopted and why? What alternative proposals should also be considered?

One respondent did not support solutions which retained k-factors. However they also stated that Proposal 3 seemed to equate to a situation whereby tariffs would be



set on the basis of pool price pass-through and did not believe that this is the answer as this would result in the price risk being passed to the customer. Instead, it believed that this risk should remain with suppliers who are best placed to mitigate price volatility. It noted that the proposal also proposed a tariff reduction that would be applied ex – post, and could not see how this was any different to the current application of a k – factor. It also believed that the level of freedom afforded to the PES in the tariff setting process was inappropriate given the developing nature of competition in the market. In its opinion, the premature removal of appropriate pricing controls would damage this developing competition and ultimately constrict consumer choice. It believed that, in the long term, it would be this competition that would deliver the best value to consumers. It believed that k-factors should be discontinued and that in a fully competitive market, the PESs would face the same risks as independent suppliers and would not be guaranteed full cost recovery.

Another respondent believed that Proposal 2 was overly complex for the purpose of removing the negative impact of k-factors and would not be a proportionate regulatory framework in the current market environment where competition is in its infancy but growing rapidly. It would also mimic the current issue of asymmetric information whereby the incumbent is at an advantage to other suppliers in the market. The incumbent would also have an advantage in determining when price changes would occur and be levied onto customers. It did not believe that there was sufficient transparency, liquidity or stability in the wholesale and retail electricity markets to support the relaxation of the current ex-ante regulatory framework. It believed that Proposal 3 as it is currently understood was a viable option only in the context of an overall change in the competitive environment and the regulatory framework. Therefore at this stage of the markets development, it supported the roll-out of Proposal 1 as an interim measure until such time as a regulatory framework to manage the transition towards full market liberalisation is finalised and approved.

Another respondent was of the view that in the short-term, k-factors should be eliminated and the regulated supply businesses should be allowed to set their own prices. It suggested that regulators should set a minimum tariff for all customer categories to ensure that the regulated businesses are not able to

undercut new market entrants. However, the final tariffs should be set by the regulated supply businesses without regulatory intervention.

A third respondent did not believe that it was appropriate at this point of evolution of the competitive retail market to introduce such radical changes in isolation of a review of the full scope of regulatory controls of the PES businesses.

A fourth, considered Proposal 3 to be the best solution presented as they believed that k-Factors create an artificial fallback position and distort actual costs from being established at /near real time. It stated that removing k-Factors and establishing level competitive market would be the best alternative - self regulation - and would also stop market distortions occurring due to a safety net being provided to the PES. Any predatory pricing concerns can still be dealt with under the regulators' competition provisions for investigation and auditing for market manipulation.

Another respondent stated that preservation of the status quo (in Proposal 1) had the attraction that it avoids the cost of change, particularly the accompanying significant rise in supply margin. Proposal 2 – penalising over-recovery and making under-recovery permanent - would probably lead to frequent tariff revision, which would be unpopular with customers, unless the margin increase was sufficiently large to turn the price control into a safety net or backstop control. The margin would, in any case, need to be increased substantially by the expected error times the asymmetric percentage plus perhaps as much again to cater for the considerably increased profit risk. It also stated that Proposal 3 was a particular example of a yardstick price control, one of many possible combinations, but in this case with 100% weight on the yardstick and a 100% asymmetric correction factor which was completely unfeasible and managed to combine the worst of both worlds. The absence of the correction factor would cause PESs to adjust tariffs more frequently to minimise error and require very significant increases in margins. The use of the pool price to determine allowed revenue would ensure that PESs would be unwilling to buy CfDs because this would increase the risk of their costs differing from their revenues. In its view, the level of analysis and range of options in the paper was inadequate and it discussed both tariff basket and yardstick price control alternatives, but suggested that the best alternative would be to adopt a backstop or safety net price control. This would be combined with a continuation of the phasing of the deregulation of tariffs in the non-domestic market, therefore reducing the overall scope for the price control. It went on to note that NIAUR had recently decided to reduce the scope of the NIEES price

control and thus the extent of NIEES's sales base to which "k" correction is relevant. The regulation threshold was now up to 150 MWh annual consumption (c 50% of total market) and they believed a further phase of deregulation in April 2010 is appropriate (i.e. 12 MWh threshold). This would result in "k" only being relevant for c 40% of the market. They viewed this phased approach with a backstop price control as the most practical, which followed a course that NIAUR had already embarked upon with respect to deregulation. Skyplex understands that NIEES has however subsequently agreed with NIAUR that a further phase of de-regulation down to a threshold of 12MW is not appropriate at this stage. They do however still support the overall approach of backstop controls coupled with phased de-regulation.

A further respondent did not consider Proposals 2 or 3 to be practical solutions and would either create additional risks or unintended consequences were they to be adopted. For example, it thought it likely that Proposal 2 would create a large disincentive to under-recover since recovery either retrospectively or in the subsequent tariff would be difficult. Therefore the result is that it would tend to incentivise the suppliers to set charges to over-recover through the year but to rebate any over-recovery just prior to year end to minimise any asymmetric penalty. Similarly, it felt that Proposal 3 would appear, particularly where no allowance is made for CfDs, to create a major exposure for suppliers that they could only manage through either vertical integration or through one-way CfDs or through spot price related contracts/tariffs with customers. Therefore it believed that the option would impose a major distortion on the functioning of both the contract and retail markets. Its view was that Proposal 1 was the most feasible option but suggested that it could be extended such that there is a progressive removal of price controls (and k-factors) for larger customer groupings that are currently covered by regulated tariffs and k-factors. In the longer term, it would remain difficult to remove k- factors while the incumbent supply businesses are restricted from using vertical integration as a tool to manage price and volume risk. It is clear from the recent CfD auctions that ESBCS and NIEES are the main purchasers in the contract market since nearly all of the other suppliers either already have access to, or are building, generation assets to provide internal hedges. Therefore if removal of k- factors is an objective in the medium term, there may be a requirement for longer term contractual relationships to be created by the former PESs with existing generation to create a proxy for vertical integration.

Another respondent stated that they recognised that the k-factor is incompatible with a fully competitive retail energy market. However, it believed that the k-factor, if operated correctly, can provide some level of protection to the consumer. The stability it provides for the incumbent supply allows for a relatively low margin to be set, in addition it provides an element of risk-smoothing for consumers, and is compatible with annual tariff setting. If the k-factor were removed, and any wholesale electricity purchases were not covered by hedges, this would expose the incumbent to variations in the wholesale generation price which more than likely would be passed directly through to the consumer. This could lead to more frequent and less predictable tariff revisions. It was concerned that, in the current climate of increasing energy costs, the potential impact of removing the k-factor without some mechanism for suppliers to mitigate their risk, would expose consumers to potentially higher and less stable prices. It stated that it was clear from this consultation, responses to previous consultations and from informal discussions with industry players that to remove the k-factor would mean the NIEES margin, and hence the final price to consumers, would have to increase. The argument is made that the increased margin will encourage new competitors into the market. Having achieved this, the cut and thrust of competition would eventually drive prices back down. However, it was concerned that there is no guarantee that competition will come, and even if it does that it will work effectively enough to deliver lower prices than consumers are currently paying.

One respondent did not believe that the current market environment is sufficiently robust, transparent and liquid to support the implementation of Proposal 3 at this time. Before transitioning to this phase of regulation, the RAs should firstly conduct an assessment of competition in the market, examining the remaining barriers to entry and outlining a framework to remove these barriers in the future. Only when these barriers are removed such that competition is more influential than regulation should Proposal 3 be considered for implementation.

Finally, one respondent stated that if Proposal 1 is to be taken forward, a greater degree of transparency and consistency would be helpful to encourage competitors into the market. Competition has started in the ROI market, with the k-factor retained. However, the inconsistent treatment of the k-factor in this year's ROI tariff review was unlikely to encourage competitors, and it would be interested to see how competitors will ultimately react. In relation to Proposal 2, it believed that as the k-

factor currently operates, it gave NIE Energy an unfair advantage over potential competitors. In passing through its costs to the consumer NIE Energy has virtually no risk on the regulated side of the business. The fact that the profit allowed is relatively small did not diminish this. NIE Energy should be allowed to lose money, as well as make it. Thus the idea of a k-factor with an incentive and penalty built in appeared to have merit whilst the transition to a fully de-regulated industry without any k-factor is made. Such a system would at least start the process of moving the incumbent to a competitive environment by creating a 'bottom line' incentive to purchase, forecast and generally run the supply business in as efficient a way as possible. Whilst it could be argued that this introduces an element of risk into the business, the respondent believed it is not high enough to justify an increased margin. It believed that Proposal 3 was worded in such a way that seems to assume that there was already competition in the market. It stated that clearly this is not the case in the domestic market, and that it believed that there still is no clear view that competition will appear in the market soon such that that the short term impact of removing the k-factor could be a price increase for customers with no guarantee that competition will follow. The challenge for policy makers was to introduce competition, without incurring additional costs to consumers. It believed that within the business sector, where competition currently exists, there is a stronger case for removing the k-factor where it still applies, as it would encourage competition and a more efficient market.

### **Other comments**

One respondent did not agree with the assumption which claimed that incumbents were indifferent to k-factors. In increasingly competitive and transition markets, incumbents can become more uncompetitive as a result of the application of k-factors and therefore lose market share.

Another respondent stated that the consultation came at a time when ESB Customer Supply is carrying over an €81m k-factor, which will have to be recovered from an ever-diminishing customer pool. This will result in ESBCS tariffs being less competitive, which in turn places risk on ESBCS and Irish taxpayers as any failure on the part of ESBCS will be borne by all Irish taxpayers. It stated that it was unsustainable to continue carrying forward this k-factor. If ESBCS is able to remain profitable without recovering these costs, it would seem that their allowable costs are

being set too high. If the deferred recovery is due to subsidisation by the parent company, this would seem to be contrary to ESB's licence requirements. It considered that the k-factor should be written off if ESBCS is able to remain profitable without it. If this is not the case, the RAs should require that the monies be recovered in full over the next tariff year.

One respondent stated that the view that k-factors distorted competition had some limited veracity when only taken in the context of one tariff period. The k-factor ensure PESs (eventually) recover all prudently incurred costs that they may otherwise have recouped if the regulatory mechanism didn't restrict it from acting in a fully commercial manner. It was of the view that it was the regulatory lag that gave rise to contentions of distortion of competition. It also noted that the paper did not address the issue of the costs of implementing and administering a shorter tariff period, or some process of mid-year tariff adjustment.

One respondent believed that it was obvious that the Skyplex and Pöyry reports had been written in isolation but that the choice between options in one would affect the conclusions of the other. Consequently, it was of the view that there did not appear to be a coherent overarching strategy. The first respondent also suggested that more generally, Skyplex paper did not examine the risks that suppliers generally are exposed to within retail markets, under SEM;

- Demand forecasting errors, for example, the impact of weather, and changing economic conditions; and
- Costs forecasting errors, resulting from poor liquidity in the SEM CfD contract market, the limited range of CfD products, unhedgeable capacity charging regime etc

More importantly, it was of the view that there was no examination of the risks PESs are uniquely exposed to in their respective retail markets:-

- Settlement errors, as a result of wholesale volumes being determined by differencing,
- No natural hedge from vertical integration (and related credit risks), and
- Other situations where PESs are treated differently than other suppliers. A recent example of this is the impact of the legacy currency hedging prohibition which impacted NIEES costs significantly during the 2008/09 tariff year.

Several respondents noted the RAs' intentions to develop "roadmaps" towards retail competition and were of the view that it was important that any proposal for change was taken forward either as part of these roadmaps or against a background of understanding of what this would entail.

## 5. Skyplex Views

Skyplex would like to thank respondents for the comments on the proposals set out in the June 2009 Report. Skyplex understands that following the publication of the June 2009 consultation paper, NIAUR and CER have held further discussions with a number of stakeholders to discuss the roll-out of retail competition in Ireland and Northern Ireland, and that it is the intention of the RAs to develop “roadmaps” for de-regulation of the retail markets.

For example, in CER’s August 2009 consultation paper on the proposed tariffs for ESB PES<sup>3</sup> the CER stated that:

*“... the Commission intends to move towards deregulation and a fully competitive market, and will consult in the autumn on a ‘roadmap’ for de-regulation. This consultation will explore the criteria for decision points in the removal of relevant regulatory controls on ESB businesses in a fully competitive environment, including price regulation in all sectors and the appropriate transitional mechanisms to a fully de-regulated market. In parallel the Commission has already jointly published two consultation papers with the Northern Ireland Authority for Utility Regulation (NIAUR); A Review of K-factors and Supply Margins and Tariff Structure Review<sup>2</sup>. While the appropriate circumstances for the full implementation of the roadmap are outstanding, these two consultations will inform the Commission on more flexible retail market models which could be implemented in the short term. “*

In addition, on 18<sup>th</sup> August 2009, NIAUR published the responses to its April 2009 consultation on Energy Retail Competition and stated that:

*“We are now considering the responses made and the way forward in terms of future actions and implications for our Retail Work Programme.”*

Skyplex understands that the recommendations from this draft report will be taken into account by the RAs in developing their respective roadmaps for de-regulation and the introduction of full retail competition in Ireland and Northern Ireland and we trust that the recommendations will contribute to this process. We also recognise that our review and report forms only part of a wider review process being undertaken by the RAs and there may be considerations and interactions outside the

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<sup>3</sup> ESB PES (Public Electricity Supplier) Proposed Tariffs for the Period 1<sup>st</sup> October 2009 to 30<sup>th</sup> September 2010. Consultation Paper. CER/09/125.



scope of this report that need to be taken into account by the RAs in their overall decision making process.

In reaching the recommendations set out in this draft report, Skyplex has reviewed the responses to the RAs' June 2009 consultation which relate to the proposals set out in the June 2009 Report.

In general, we recognise that the current levels of retail competition in Ireland and Northern Ireland differ significantly, with that in Ireland being significantly greater. We also believe that, to a certain extent, it may be necessary to take a "leap of faith" in moving from a highly regulated market in which there may be limited competition but in which consumers are protected primarily through regulation to one in which there is a healthier degree of competition and in which customers are protected through competition between suppliers. Many of the issues raised in response to the consultation highlight the dichotomy between retaining relatively high levels of regulation whilst at the same time seeking to introduce retail competition. New suppliers wishing to enter or expand their presence in the retail market have typically called for an abolition of k-factors; greater access to information over the activities of the regulated suppliers; and higher margins, which they believe are necessary to support the development of competition.

Conversely, others have expressed concern over the potential abolition of k-factors whilst retaining regulated tariffs and strong restrictions upon the regulated suppliers' behaviour. Specific concerns include the potential increase in risk that regulated suppliers may face as part of de-regulation, without being given the freedom afforded other suppliers to manage these risks; and the potential for their supply base to be eroded without they themselves being given a reasonable chance to compete to retain or re-gain customers.

There is also a significant risk from a regulatory perspective that, in moving to a more competitive regime, consumers may no longer be protected by regulated tariffs whilst initially levels of competition may not be sufficient to afford them protection.

Furthermore, even in markets where a healthy degree of competition exists, consideration must be given to the most vulnerable customers who, with de-regulation may no longer have the protection of regulated tariffs but who at the same time may be unable, for a variety of reasons, to benefit from a more competitive retail market. Whilst initiatives such as social tariffs and requirements on all suppliers to

offer terms to all customers, perhaps on a non-discriminatory basis, may assist in protecting such customers, we would expect that these matters would be considered by the RAs as part of their roadmaps to de-regulation.

In light of the consultation responses, Skyplex remains of the view that it is likely that the existing k-factor regime is detrimental to the development of retail competition in both Ireland and Northern Ireland. Even in Ireland, we understand, from our earlier discussions with stakeholders, that the mode of competition currently in place is largely one of independent suppliers discounting against regulated tariffs, rather than one in which they compete by developing alternative, more innovative offerings. Precisely why this is the case is not wholly clear. It may simply be because, on average, regulated margins are too low for new entrant suppliers to be able to develop a substantial range of innovative products that are attractive to customers and/or are generally too low to fund the new entrant costs associated with establishing a material supply business and attracting a sufficient number of new customers.

Alternatively it may be that k factors result in more risk to competing suppliers to the extent that their demand profiles are different to those of the regulated supplier. If demand profiles of competing suppliers were the same as the regulated supplier, in principle the hedge provided by k factors to the incumbent supplier would also provide a hedge also to rival suppliers. Because the demand profile of competing suppliers is not necessarily the same as that of the regulated suppliers, the hedge provided by a k-factor does not benefit rival suppliers to the same extent that it does a regulated supplier. Furthermore, the usefulness of the k-factor as a hedge for competing suppliers may be undermined due to a combination of lack of information relating to the k-factor and uncertainty over their future application.

### **Making Available Information**

Insofar as the specific proposals contained within the June 2009 Report are concerned, if it is considered that in either or both of the retail markets in the All-Island Market there is insufficient competition to warrant a move to a much more de-regulated market, and a k-factor regime is retained, then we remain of the view that there are strong arguments in favour of requiring additional information to be made available. Whilst, from the perspective of the regulated supplier, making such information available might be seen as assisting competitor suppliers, perhaps

permitting them to “arbitrage” by attracting new customers and supplying them at spot price below that of the (published) hedged position of the regulated supplier, or being able to attract new customers with the confidence that their own hedge prices were below those of the regulated supplier, such arrangements would be likely to increase the activity of new entrant suppliers and hence help to promote competition. Furthermore, rather than conveying a material advantage on competitor suppliers, the provision of such information may be regarded as establishing a more level playing field where more detailed information relating to likely k-factors is available to all suppliers and not just the regulated supplier. If such information is not published, even where a new entrant supplier could, in principle compete against the regulated supplier by buying spot or by underpinning its own offerings with a more competitive hedge price, under present conditions, rival suppliers may simply believe that any prevailing higher regulated tariffs might arise as a consequence of some artefact of the k-factor regime. More relevant still is the fact that, in principle, if an historic under-recovery is being levied on the customers of a regulated supplier or regulated tariffs have failed to respond quickly enough to a falling market, it might be expected that the regulated supplier would lose customers to competitors. Whilst there has been some evidence of this in Ireland, in any market where a k-factor regime and regulated tariffs remains sustainable to any material degree, implies that there is a lack of competition. Arguments that suggest that information should be with-held in order to create uncertainty for rival suppliers even though in principle the regulated supplier should be losing market share appear to be perverse.

Balanced against this, Skyplex accepts that such an arrangement may give rise to a “vicious circle” whereby rival suppliers are presented with sufficient information to benefit from inflated prices arising from past under-recoveries, and consequently the regulated suppliers lose customers and thus must seek to recover past under-recoveries from an increasingly small customer base, thus exacerbating the vicious circle into the future. Such a situation would, however, exist even if k-factors were retained in a market in which a reasonable degree of competition existed and in moving to Proposal 3, we would suggest that any under or over-recovery should simply be added (or deducted) from the allowed revenues in the first year of operation.

Skyplex is of the view that if k-factors are retained in one or both of the retail markets, the regulated supplier should be required to make available substantial additional

information over contracting levels, predictions of future k-factors and any other reasonable information that rival suppliers might wish to have access to in order to allow them to gauge with confidence whether any particular regulated tariff is, or is likely to be, affected by k-factors. This should be backed up by additional regulatory certainty over the future application of k-factors. If such a regime does result in a substantial number of customers switching supplier, then this should be considered to be a positive result.

Consideration should also be given to protecting vulnerable customers who may otherwise pay for the historic under-recovery from other customers who have subsequently switched from the regulated supplier.

Skyplex also notes that on 29<sup>th</sup> May 2009, in their Information Note on the Retail Tariff Timetable for 2009<sup>4</sup>, the RA's committed to providing additional information as part of the 2009/10 Retail Tariff process. In this note, the RAs' stated that:

*"The RAs consider that transparency represents a key founding principle for any effective competitive market and is essential in relation to the contracting process to foster retail competition to the benefit of all customers. Therefore the RAs intend to publish the following information on contracting levels; 3 contracting updates, two during the contracting window and one after it has completed. The updates will be consistent for both ESBCS and NIEES, giving a summary of both total aggregated volume of hedges purchased throughout the main contracting window, broken down into those applicable to; the first six months of the tariff year, the second six months of the tariff year, and beyond the tariff year if relevant. The specific dates for publication are set out in the detailed timetable in Annex I. As charges are approved for each of the individual components throughout the process, these will also be published. In addition, 'K' factor information will be published; by mid August in the context of the draft tariff submission for NIEES and by end June as part of the supply revenue review for ESBCS."*

Responses to the June 2009 consultation, which were provided in light of the RAs' proposals to publish the additional information set out above, called for still more information. This included the following information from regulated suppliers:

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<sup>4</sup> Retail Tariff Timetable 2009. Information Note. 29 May, 2009. CER 09/085

- detailed data with respect to Directed and Non-Directed contract purchases, including prices, quantities, delivery profiles and delivery periods;
- CfD volumes for all periods (baseload, peak, MM1 and MM2) and forecasts of over/under recovery on a quarterly basis; and
- demand forecasts and assumptions by tariff class, treatment of bad debt provisions, customer switching assumptions, level of hedging targeted and how the under/over recovery of k from the previous year is treated.

Skypex believes that independent suppliers are in the best position to determine what data would be of most use to them in managing their businesses and suggests that, as a starting point, any information that may reasonably be requested by competing suppliers should be made available in order to allow them to predict future k-factors. On this basis, we suggest that the above information should be made available where a k-factor is retained. One exception to this may be the individual prices of CfDs. From the perspective of predicting k-factors, we believe that competing suppliers may wish to know the total contract cover (in GWh) and weighted average price, rather than necessarily the individual prices and quantities of specific CfDs. Whether or not individual contract specific information should be made available may be considered to be more of an issue about the operation of the CfD market, rather than an issue permitting competing suppliers to forecast k-factors. The RAs may also wish to keep the information published under review with a view to requiring additional information to be published should independent suppliers reasonably request this in order to assist them in predicting the level of any future k-factor.

### **Asymmetric k-factors and Abolition of k-factors**

Skypex acknowledges that the proposal to introduce asymmetric k-factors did not receive widespread support from respondents to the June 2009 consultation. Whilst we still consider that there may be some merits in this proposal as part of a gradual glide path to reducing the effects of k-factors, we are of the view that, if possible, in preference, k-factors should be abolished completely.

Skypex is of the view that, in Ireland at least, as part of the roadmap to retail competition, it would be appropriate for the RAs to consider introducing an arrangement broadly along the lines of Proposal 3.

In summary Proposal 3 as set out in the June 2009 Report was as follows:

**Proposal 3 – No K Factors with Maximum Revenue Restraint**

Under Proposal 3, there is no compensation in year t for under or over recovery in year t-1 (or t-2). MAR is determined after the end of the tariff year in accordance with the revenue restriction formula in the licence or direction, as the case may be. MAR is determined to be the cost of energy purchases, priced at actual pool prices and known demands, plus a margin and an allowance (as now) for internal supply business costs. No allowance is made for contracts for differences, although the supplier is free to enter into CfDs if it believes these are favourably priced or should it consider that it is worth sacrificing margin for some reason. The time at which MAR must be determined is not critical. It should be late enough such that the required information is known to acceptable accuracy but not so late that there remains uncertainty for the supplier as to whether it is deemed to have complied with its obligations.

Any under-recovery against MAR through pricing too low is lost to the supplier. Over-recovery is breach of the MAR, and hence breach of licence or the direction. However this may be avoided by an ex-post discount to the supplier's customers in their final bills for the relevant year.

As under Proposal 2, the regulated suppliers would be given freedom to set its tariffs without recourse to regulatory approval.

An adjustment would be made to the allowed margin so such that the supplier would continue to be expected to recover its **allowable revenues over the long term notwithstanding the fact that it is not permitted to collect under-recoveries through k-factor adjustments.**

The additional allowed margin afforded the regulated supplier in this case would be an amount which compensated for any reasonable expectation of an increase in the frequency of tariff changes, plus an adjustment for the fact that, in order to avoid a licence breach, the regulated supplier would typically wish to slightly under-price relative to its allowable revenues. It would not receive any additional margin to cover the expected costs of entering into CfDs.

The principal arguments raised against Proposal 3 in responses to the RAs' June 2009 consultation were:

- it would result in price risk being passed to customers;
- the level of freedom afforded to the PES was inappropriate given the developing nature of the market;
- there is insufficient transparency, liquidity and stability in the wholesale and retail markets to support relaxation of the current ex-ante regulatory

framework and that Proposal 3 was only viable in the context of an overall change in the competitive environment;

- it was not appropriate to introduce radical changes in isolation of a full scope review of the regulatory controls on the PES business;
- Proposal 3 was a particular example of a yardstick control with 100% weight on the yardstick and a 100% asymmetric correction factor which was completely infeasible and managed to combine the worst of both worlds. The absence of the correction factor would cause PESs to adjust tariffs more frequently to minimise error and require very significant increases in margins;
- the use of the pool price to determine allowed revenue would ensure that PESs will be unwilling to buy CfDs because this would increase the risk of their costs differing from their revenues;
- the option is not practical and will either create additional risks or unintended consequences were it to be adopted. Particularly where no allowance is made for CfDs, a major exposure for suppliers would be created that they could only manage through either vertical integration or through one-way CfDs or through spot price related contracts/tariffs with customers. Therefore they believed that the option imposes a major distortion on the functioning of both the contract and retail markets;
- the arrangements could lead to more frequent and less predictable tariff revisions.
- the current market environment is not sufficiently robust, transparent and liquid to support the implementation of Proposal 3 at this time. The RAs should firstly conduct an assessment of competition in the market, examining the remaining barriers to entry and outlining a framework to remove these barriers in the future. Only when these barriers are removed such that competition is more influential than regulation should Proposal 3 be considered for implementation.
- the Proposal (in relation to Northern Ireland) seemed to assume that there was already competition in the market. This is not the case in the domestic market, and there still is no clear view that competition will appear in the market soon such that that the short term impact of removing the K-factor

could be a price increase for customers with no guarantee that competition will follow.

Skyplex accepts that under Proposal 3, there would potentially be a strong incentive for the regulated supplier not to enter into CfDs, to change tariffs relatively frequently and to simply pass through the price risk to consumers. Whilst consumers may, in general, prefer fixed ex-ante tariffs and infrequent price changes, by definition, without any appreciable degree of competition, they would have no alternative but to accept this position. We do not, however, believe that this arrangement would mean that consumers would, on average, pay more for their electricity than under the current prevailing arrangements. In fact, given that it is not proposed to include allowable revenues for any additional hedging costs, for customers of the regulated supplier, the long-term average difference prices should in fact be lower than current arrangements. Nor do we understand why the proposed approach would require a very significant increase in margins for the regulated supplier.

Without competition, however, there would be the possibility that the consequences of Proposal 3 would result in additional price uncertainty for consumers with no alternative choice to move to another supplier offering greater price certainty. In light of this, we accept that, given the current status of competition in Northern Ireland and, what we understand to be limitations on the amount of supplier switching that can be accommodated, it may be premature to introduce such arrangements in Northern Ireland.

In Ireland however, the current state of competition is more developed and, as a consequence we see no similar impediment to implementing Proposal 3 in Ireland in the near future. Given that there are competitors operating in the retail and wholesale sectors of the Irish market, and the reported customer preference for ex-ante pricing, if ESBCS simply adopted an approach of supplying customers on pool price pass through tariffs or on frequently changing tariffs, there would be an opportunity for new entrant suppliers to attract customers who preferred greater price stability. To the extent that such suppliers could hedge prices (either through vertical integration or in the bilateral contracts market) in order to be able to manage the risks associated with offering fixed price contracts, at a premium less than or equal to that which reflected the willingness of customers to pay for such certainty, then they would be able to compete against the regulated supplier to offer such products to consumers.



As suggested above, the regulated supplier would be granted a small increase in margin to cover the additional costs associated with more frequent tariff changes plus an adjustment for the fact that, in order to avoid a licence breach, the regulated supplier would typically wish to slightly under-price relative to its allowable revenues. The regulated supplier may still wish to enter into CfDs if contract prices were less than its own forecasts of pool price; or the costs of funding any margin in the CfD price was less than the savings arising from a reduced frequency of tariff changes.

There would be no reason, in such a market, for the regulated supplier to fail to have any substantial expectation of failing to recover its costs as it would, in principle be free to change tariffs at any time throughout the year in order to do so.

With reference to the comment that the Skyplex proposals did not adequately examine the risks faced by suppliers, under Proposal 1 (Minimal Change) there would be no material change in the level of the risks identified as the k-factor arrangements would be retained. Insofar as Proposal 3 is concerned, in general, the regulated suppliers would have only limited exposure to demand and cost forecasting errors to the extent that they entered into CfDs, or to the extent that there was a material restriction on their ability to change tariffs. Similar considerations apply to settlement errors and to the lack of natural hedges.

In the first instance, where for example metering failures occur which, depending upon the nature of the failure, would overstate or understate the regulated suppliers' demand any reduction in allowed revenue would be accompanied by a reduction in customer charges and vice versa. Insofar as the lack of natural hedges arising from vertical integration is concerned, again such issues may be managed by more frequent within year tariff changes rather than through the current inter-year k-factor process.

Addressing the principal arguments raised against Proposal 3 in responses to the RAs' June 2009 consultation in turn:

- Skyplex accepts that Proposal 3 would potentially result in price risk being passed to customers. However consumers currently pay a considerable premium for this price stability. Furthermore, to the extent that consumers value price stability, it is anticipated that competitive offerings (in Ireland at least) from rival suppliers will be forthcoming to offer price stability to customers;

- Given that under Proposal 3, the PES would still be subject to a revenue restriction it is not clear that the level of freedom afforded to the PES to change tariffs more frequently is inappropriate.
- Whilst it is accepted that there may continue to be some lack of transparency, liquidity and stability in the wholesale and retail markets, it is anticipated that Proposal 3 will go some way to addressing these issues. First, k-factors themselves are cited by many suppliers as giving rise to a lack of transparency. Their discontinuation should therefore help in improving transparency. By changing the form of the price control to operate based on outturn pool prices and quantities, it is possible that a reduced demand for CfDs from the PESs will improve the availability of such contracts for other suppliers. Finally, recent instabilities in the wholesale market have been caused primarily by material changes in underlying costs which would be expected to give rise to price changes in any market and it is not clear why this should be seen as a barrier to abolition of k-factors. In fact, the material underlying price changes may be considered to have exacerbated the problems with the k-factor regime from the perspective of both the incumbent PESs and competitor suppliers.
- Whilst Skyplex acknowledges that the RAs are each introducing road maps towards the introduction of full retail competition, it is not clear why, at this stage, it is necessary to undertake a full scope review of the regulatory controls on the PES business prior to discontinuing the use of k-factors;
- As discussed previously, whilst it is acknowledged that under Proposal 3 the PESs are likely to wish to adjust tariffs more frequently to minimise error it is far from clear why this would require very significant increases in margins;
- Skyplex also agrees that the use of the pool price to determine allowed revenue may result in a reduced demand for CfDs from the PESs. It is not however clear that this is an undesirable situation. A reduced demand for CfDs from the PESs should result in more CfDs being available to other suppliers who may wish to enter into them to the extent that customers value price certainty sufficiently highly to be prepared to pay any additional premium that this price certainty brings.

- Skyplex accepts that it would be necessary to consider any detailed practical issues associated with the implementation of Proposal 3, but it is not clear why there should be any major barriers to implementation nor have any specific unforeseen consequences been identified by respondents. Insofar as managing the risks is concerned, it is envisaged that regulated suppliers may need to offer spot price related contracts and that customers who valued certainty would seek such offers from rival suppliers. Whilst it is recognised that this is likely to reduce the demand for CfDs, this should, in turn, increase the availability of such contracts to other suppliers wishing to offer certainty to customers;
- Given that Proposal 3 does retain a price control on the PES, in general it is not clear why discontinuing k-factors should mean that customers will no longer remain protected. Whilst it is likely that the RAs will wish to consider the position of vulnerable customers in their roadmaps to retail competition it is again not clear why it is necessary to remove all barriers to competition prior to introducing Proposal 3, which itself should go some way to removing such barriers.
- As is discussed further in Section 6 below, Skyplex accepts that in the case of Northern Ireland, it may be premature to introduce Proposal 3 as the lack of any effective competition for domestic consumers would mean that under Proposal 3, such customers may be placed in the position of having to accept more frequent price changes without the option of seeking fixed tariffs from competing suppliers.

### **Discussion of Alternatives**

The alternative to implementing Proposal 3 that was put forward by a number of respondents was simply to abolish k-factors whilst retaining some form of price control/tariff regulation on the regulated suppliers with an increased margin. In Skyplex's view, this is essentially what Proposal 3 achieves, although the current ex-ante price control and regulated tariffs under Proposal 3 would, in the case of ESB Customer Supply, be replaced by a maximum allowable revenue restriction which limited revenues in any particular year to an amount determined from outturn (ex-post) pool prices and outturn demand (adjusted by network charges, PSO costs and any other relevant amounts).

The additional benefit of adopting Proposal 3 is that it retains a degree of regulatory control (in the maximum average charge is limited by the price control formula) whilst avoiding the need for either k-factors or a high ex-ante margin to reflect the additional risk faced by suppliers in a market where full hedging of pool revenues is considered to be difficult.

The asymmetric k-factor approach set out in the June 2009 Report would, in principle help to give regulated suppliers incentives to manage k-factors within a certain tolerance. Whilst a small increase in margin may be required, additional tariff setting flexibility would be afforded the regulated suppliers in order to assist them in managing the additional risks. Skyplex is of the view however, that whilst the asymmetric k-factor regime might be considered as part of a glide-path to abolition of k-factors, where there is at least some degree of competition in the retail market, this Proposal does not appear to have any particular advantages over Proposal 3 (abolition of k-factors) and does require the retention of some degree of k-factor. Consequently we do not advocate the adoption of this Proposal.

One respondent to the RAs' June consultation paper also suggested that it might be appropriate to consider implementing a minimum tariff below which the regulated suppliers are not permitted to set charges. Whilst this Proposal relates to the promotion of competition more generally, rather than specifically to the removal of k-factors, we do not believe that in a market which lacks competition it would be appropriate to introduce a minimum tariff for consumers.

## 6. Conclusions and Recommendation

There are a number of features of the existing regulatory arrangements relating to the treatment of k-factors and associated supply margins that may operate so as to stifle the development of retail competition in Ireland and Northern Ireland.

In light of the comments received relating to the June 2009 Report in the responses to the RAs' June 2009 consultation, Skyplex recommends that the RAs consider adopting the following changes as part of their roadmaps to de-regulation.

### *Northern Ireland*

In Northern Ireland, given the current state of retail competition, we do not advocate adopting Proposal 2 (asymmetric k-factors) or Proposal 3 (No k-factor with maximum revenue restraint determined ex-post). Instead, we recommend that Proposal 1 (Minimal Change) be considered for adoption at this stage.

Under Proposal 1 (Minimal Change), the form of regulation and tariff setting processes would remain broadly unchanged, although a number of changes would be introduced with the intention of addressing some of the issues associated with the existing k-factor regime. These would include:

- ensuring that there is greater transparency and certainty associated with the application of k-factors, more specifically publishing the following additional information:
  - detailed data with respect to Directed and Non-Directed contract purchases, including weighted average prices, total contract quantities and associated, delivery profiles/periods;
  - CfD volumes for all periods (baseload, peak, MM1 and MM2) and forecasts of over/under recovery on a quarterly basis; and
  - demand forecasts and assumptions by tariff class, treatment of bad debt provisions, customer switching assumptions, level of hedging targeted and how the under/over recovery of k from the previous year is treated.
- providing additional certainty to the processes followed by the RAs in approving any k-factor; and

- undertaking a legal review of the relevant existing licence conditions so as to ensure that they are robust against any under-pricing and any cross-subsidisation between tariffs.

### *Ireland*

Give the more advanced state of retail competition in Ireland, we recommend that the RAs consider adopting Proposal 3 in this jurisdiction at some time in the near future.

Under this Proposal:

- the regulated supplier would be given additional freedom to revise tariffs;
- k-factors would be discontinued, and the maximum allowable revenue for the regulated suppliers set ex-ante equal to their customers' demand priced at outturn pool price;
- in the first year, the maximum allowable revenue would be adjusted to correct for any prior year over or under recovery;
- the costs of any contracts for differences would not be included in the allowable revenues, although regulated suppliers would be permitted to contract as they saw fit; and
- the regulated supplier would be afforded a small increase in supply margin set so as to ensure that they had a reasonable expectation of covering costs given that the regulated suppliers would have to set tariffs so as to recover an expected amount below their maximum allowable revenues in order to avoid breaching their maximum allowable revenue licence condition and to cover the costs of more frequent tariff changes.

Because additional risks would be passed on to customers of the regulated supplier through potentially more frequent within-year tariff changes, the demand for contracts for differences from the regulated suppliers would be expected to reduce. The contracts for differences market is generally reported to be undersupplied and this change could be beneficial in lessening the supply/demand imbalance.

Skyplex notes that whilst taking steps to abolish or reduce the effects of k-factors is likely to assist in the development of retail competition, there may be other factors which serve to limit the rate of development of such competition in the two jurisdictions. Consequently, changing the k-factor regime may not in itself be

sufficient to foster more competitive arrangements and we therefore acknowledge that it will be important for the proposals set out above to be considered in light of the RAs' more comprehensive roadmap proposals to introduce retail competition in the two jurisdictions.