Douglas McIldoon

11 February 2009

Dear Douglas

We were grateful for the breadth and richness of the report on electricity tariffs you made to us last November. Your statements that the September tariff review had been carried out properly (within the existing policy and process), and that the resulting prices were justified (same caveat), clarified matters of public concern.

The clarification has helped to turn minds to future-focused questions about better outcomes for energy consumers. Those questions are very close to our own heart and, in that spirit, I am writing to let you know what we are doing with your various recommendations.

Overview

As an introduction, I might say that we perceive some contradictions within your comments about wholesale markets. On the one hand, you strongly endorsed the creation of a single electricity market. On the other, you made proposals that would effectively signal the replacement of a market by a fully administered system where governments make all key choices. A decision to abandon the market principle is clearly one for Ministers, not regulators. If and when Ministers ask for our views on this question, we are likely to argue in favour of transparent markets, supervised by independent and consumer-oriented regulation.

This is not, to use your word, a "mantra" – but a hard-headed and pragmatic conclusion based on international and NI experience about the limits of governments. That experience suggests that politicisation of investment decisions is likely to produce outcomes that are short-termist, subject to lobbying, tolerant of inefficiency, and prone to making irrationally "big bets" based on fashionable thinking. We appreciate, however, the need to ensure that efficiency gains from competitive markets are not offset by transaction costs or over-payments to market participants for risks that are actually borne by customers.

We have some concern that your proposals for revising overall electricity policy are being misinterpreted by some as indications that the SEM is currently mal-functioning. This is not the case; the SEM is proving extremely successful at delivering its goals. The SEM Committee published last July a report on the market's first 6 months, which showed that prices are being set competitively, and correlate to fuel costs and demand/margin movements as would be expected from a well-functioning market. The report also reported early signs that the SEM is triggering the market entry and investment that was hoped. These trends have continued over recent months, as will be shown by a forthcoming first SEM Annual Report.

Of course, the SEM could not shield consumers from recent wholesale volatility. No market could do that. The SEM aims to set a stable framework within which inefficient, older plant can be competed out by new entry which will lead over time to sustainable price reductions and a greener energy system.

Policy-level recommendations
A number of your proposals are more appropriately tackled by Ministers than by unelected regulators. We have written to DETI asking them to take up and consult in their Strategic Energy Framework consultation on:

- The single-buyer model, and consequences that flow from it (e.g., closing down the CFD market, collective purchasing of fuel);
- Engagement with the Irish Republic;
- The extent of support for renewables, and the means of providing that support (e.g., the proposed Renewables Gateways Levy);
- "Customer ownership"; and
- The role of CCNI. We note your own comments on this role, but also your recommendation that clarification is required.

On these issues we are not yet, therefore, setting out a developed view – although the direction of our thinking is as set out above. We will respond to any Ministerial consultation, and will also be happy to offer views to other stakeholders such as the ETI Committee at that juncture.

The only other thing I would say at this point is to reiterate my view that policy on these wider questions should be developed on an empirical basis, grounded in a hard analysis of costs, risks and capabilities.

SEM recommendations
You made a number of recommendations about regulation of the Single Electricity Market (SEM) (paragraph 137 of your report). You know that decisions on these will be taken not by the Utility Regulator alone, but by the SEM Committee on which we have a vote, as do the

CER and an Independent Member (Prof. Ignacio Perez Arriaga, currently of the Massachusetts Institute of Technology). We have therefore referred your report to the Committee, which discussed it in November (in draft) and again in January.

Capacity mechanism
The Committee has some concerns that opening up too many matters of SEM policy very early in the market's life might destabilise investment and damage consumer outcomes. Nevertheless, we consider that your report raises a number of important issues. The Committee will discuss at its next meeting a full paper setting out possible scope, pros and cons of a review of the capacity mechanism.

This paper will cover:

- Your proposal that capacity payments should not be made to fully depreciated stations. We recognise that this proposal would substantially reduce the size of the capacity pot, and so reduce bills in the short-term. However, we see some risks that paying some stations and not others for the same unit of capacity might lead to inefficient outcomes – for example, that older plant which could be kept running with a small level of investment might be retired and replaced with newer plant requiring much more investment. This could produce a perverse outcome which could, overall, increase consumer bills. That said, we will keep under review the distribution of the capacity pot so as to ensure that, where it is good for customers, old and inefficient plant has incentives to exit the market, being replaced by new and more efficient plant;
- Your proposal that the size of the capacity pot should be based on the actual costs of power stations. We see possible downsides in a general commitment to underwrite whatever generators might choose to build (particularly without the overall government control of generation-build that you call for). However, we do see merit in reducing the volatility of capacity payments and the consequent cost of capital. We are preparing to publish alternative proposals along those lines, which could be implemented quickly, while we consider whether to take forward your proposal;
- Your proposal that the capacity pot should internally hedge currency fluctuations; and
- Your proposal that capacity payments should be sculpted to increase rewards for providing capacity when it is most needed.

Constraints
You also made proposals that we should alter the patterns of constraint payments, so that these payments would take into account the implications of planning delay, and the relative flexibility of various plants. The SEM Committee considers that it would be inappropriate to open up the constraint payments system at this time and that this issue can be best addressed by encouraging SONI and Eirgrid to make transmission planning decisions on an all–island basis.

The issue of treatment of the rewards for inflexible plant is, however, an issue which the SEM Committee wishes to address and this may be covered in the first instance by the work on capacity payments mentioned above.

Tariff recommendations
You further made a number of recommendations about retail tariffs (paragraph 149 of your report).

Buy-side
A number of your recommendations related to creating more flexibility in the way that NIE (PPB) or NIEES purchase or hedge, so as to reduce the chance for future years of buying at the peak of the market. We have taken this goal on board, and currently have under way a review of how best to organise hedging processes in future. This will bear fruit in decisions over the next few months about the forthcoming directed contracts, non-directed contracts and Efficient Purchasing Obligation rules, along with encouragement by the SEM Committee of active participation by the incumbents in a multilateral trading platform.

We consider that our approach can further be improved by considering who bears what risk in relation to wholesale purchasing. Your report commends the approach we have used for a number of years: that the incumbent buys according to a regulated methodology, and almost all associated risks are borne by customers. We agree with you that this approach has served well in the past, but are less convinced that it is fully appropriate in the more volatile market conditions that currently apply. We are therefore also reviewing the mechanisms by which risk is passed to consumers (e.g., carry-overs between years), and the linked question of how much margin is allowed to the supply company.

I would also mention for completeness that we are further reviewing in detail the models by which costs are allocated and tariffs set in Northern Ireland and RoI. Customers do not always understand why similar wholesale movements produce differential tariff outcomes in the two jurisdictions, and we aim to eliminate avoidable differences.

Sell-side
You further recommend that we should require NIEES to provide several tariffs that you consider might be welcomed by customers (a tracker tariff, a "deep green" tariff, and a "right to buy" tariff). We are not going to take up this recommendation at this time – let me explain why.

We have legal obligations to ensure consumer choice of supplier, and customers want to be able to choose. A competitive supply market will create a more direct route for suppliers to respond to consumers revealed preferences than regulatory action. You will no doubt be aware that we have recently consulted on an action plan to accelerate the development of competition in the household sector. This is not a blind statement of trust in markets, and as part of this work programme we will publish an analysis document that highlights some of the more likely potential market failures, areas that we will monitor closely to ensure good outcomes for consumers. Nevertheless, our contacts with CCNI and indeed directly with consumers leave us convinced that there is a strong desire to see more competition, and we consider that this general consumer orientation is rationally based.

Stimulating effective competition will require some regulatory forbearance. If regulators always act to fill any possible demand niche, we will crowd out potential competitors. As part of our action plan for promoting retail competition, we intend to monitor closely the development of the market. If we do not see the development of innovative products of the kind you describe over the next few years, we could choose to step in at a later date.

I will close by thanking you once again for your most stimulating and seminal report.

In the light of the widespread stakeholder interest aroused by your report, I am copying this letter to Mark Durkan, Jenny Pyper and Eleanor Gill, and also intend to place it on the Utility Regulator's website.

Yours sincerely

Iain Osborne
Chief Executive

cc: Mark Durkan, MP, MLA, Chairman, ETI Committee
Jenny Pyper, Head of Energy Division, DETI
Eleanor Gill, Chief Executive, Consumer Council for Northern Ireland