

Date: December 2015

**Review of the Effectiveness of Competition in the  
Northern Ireland Retail Market – Phase II  
Options Paper**

Prepared by: Ed Reed, Colin Magee  
Cornwall Energy

## About Cornwall Energy

Cornwall Energy's team of independent specialists have experience of liberalised energy markets and their regulation since their inception in Great Britain and elsewhere in the late 1980s. We provide consultancy, intelligence and training, and are a trusted and reliable partner whether you are a new entrant or a large, established player.

Specific areas of our expertise include:

- wholesale and retail energy market competition and change;
- regulation and public policy within both electricity and gas markets;
- electricity and gas market design, governance and business processes; and
- market entry.

2 Millennium Plain  
Bethel Street  
Norwich  
NR2 1TF

T +44 (0) 1603 604400  
F +44 (0) 1603 568829  
E [info@cornwallenergy.com](mailto:info@cornwallenergy.com)  
W [www.cornwallenergy.com](http://www.cornwallenergy.com)

## Disclaimer

*While Cornwall Energy considers the information and opinions given in this report and all other documentation are sound, all parties must rely upon their own skill and judgement when making use of it. Cornwall Energy will not assume any liability to anyone for any loss or damage arising out of the provision of this report howsoever caused.*

*The report makes use of information gathered from a variety of sources in the public domain and from confidential research that has not been subject to independent verification. No representation or warranty is given by Cornwall Energy as to the accuracy or completeness of the information contained in this report.*

*Cornwall Energy makes no warranties, whether express, implied, or statutory regarding or relating to the contents of this report and specifically disclaims all implied warranties, including, but not limited to, the implied warranties of merchantable quality and fitness for a particular purpose.*

*Numbers may not add up due to rounding.*

## Contents

1	Executive summary.....	5
1.1	Purpose .....	5
1.2	Approach .....	5
2	Context.....	7
2.1	Phase I review.....	7
2.2	Stakeholder engagement.....	8
3	Rationale for options .....	9
4	CMA’s energy market investigation in GB.....	10
4.1	Initial findings.....	10
4.2	Proposed remedies.....	12
4.3	Implications for NI.....	13
4.4	Reaction to the CMAs provisional findings and possible measures.....	14
5	Options .....	16
5.1	Identification of Significant Market Power and consequent licence conditions .....	17
5.1.1	Description .....	17
5.1.2	Application.....	17
5.1.3	Verification.....	17
5.2	“Inactive customer” price controls for Power NI, Firmus and SSE Airtricity Gas Supply .....	18
5.2.1	Description .....	18
5.2.2	Application.....	18
5.2.3	Verification.....	19
5.3	“Default” tariff .....	19
5.3.1	Description .....	19
5.3.2	Application.....	20
5.3.3	Verification.....	22
5.4	Tariff cap spread.....	23
5.4.1	Description .....	23
5.4.2	Application.....	24
5.4.3	Verification.....	26
5.5	Dominance thresholds.....	26
5.5.1	Description .....	26
5.5.2	Application.....	27
5.5.3	Potential intervention options.....	29
5.5.4	Verification.....	29
5.6	Gross margin cap.....	29
5.6.1	Description .....	29
5.6.2	Application.....	30
5.6.3	Verification.....	32

5.7	Price-to-beat tariff .....	32
5.7.1	Description .....	32
5.7.2	Application.....	32
5.7.3	Verification.....	34

## I Executive summary

### I.1 Purpose

This paper sets out for consultation a series of retail market regulatory options that could be introduced, in isolation or combination, to the Northern Ireland (NI) gas and electricity retail markets if and when the current retail price controls are no longer required. The timing of when any of the options might be implemented following any removal of the current retail price controls is yet to be decided.

The options are designed to address retail market issues that may be present if and when retail price controls lapse. The Utility Regulator (UR) issued in November 2014 the *Review of the Effectiveness of Competition in the Northern Ireland Retail Market – Phase I* that concluded, among other findings, given the inherent oligopolistic tendencies of the supply markets “the NI experience strongly suggests that regulation and competition can successfully coexist. Some form of direct price regulation is often necessary to deliver and sustain competitive entry until it is well-established”.

This paper forms part of the UR’s programme of work to ensure the regulatory framework is fit for purpose if and when retail price controls, in their current form, are removed. Seven options are set out in this paper that, to varying degrees, look to provide regulatory protection where market conditions at the time suggest that consumers generally are not adequately protected through competition alone—or that specifically disengaged customers that could experience material detriment through supplier pricing practices.

The consultation will run in parallel with the ongoing Competition Markets Authority (CMA) investigation, with the initial findings published on 7 July 2015. Despite being open for 17 years and the GB market being considerably larger in NI, the CMA found that weak consumer response was giving suppliers, especially former incumbent suppliers, a position of unilateral market power over their inactive customer base. The report noted that suppliers had the “ability to exploit such a position through pricing their SVTs [Standard Variable Tariffs] materially above a level that can be justified by cost differences from their non-standard tariffs”.

In the SME market, where the highest profit margins were observed by the CMA, average revenues were substantially higher on the default tariff types that were often used by less engaged micro-business customers. In order to combat a perceived lack of competitive pressure on prices, the CMA proposed a number of remedies including safeguards for disengaged customers and relaxing tariff restrictions.

### I.2 Approach

The options presented in this paper (which the UR will consult on) have been drawn from desk-based research conducted by Cornwall Energy of energy retail market regulatory approaches in other jurisdictions that have been introduced to provide protection to some or all customers where competition is judged to be insufficient to deliver effective outcomes. These include Australian, US and European markets where initiatives have been introduced with a view to allowing competition and regulation to coexist.

This assessment of approaches in other markets forms the basis of the options presented in this paper. The seven options are a blend of initiatives seen elsewhere but considered in our view to be applicable in the NI context. In our view the options represent a credible range of potential interventions that could be made by a regulatory authority in a market where it was judged that competition of itself was not fully delivering the desired outcomes and/or that physical factors (such as the size of the market and its contestability) would not permit in full the realisation of the benefits of vigorous and effective competition.

This paper sets out a series of options that the UR could utilise as and when the current price controls lapse—it does not make a judgement on when this could or should be, or how the UR reaches its decision.

## 2 Context

This paper sets out a series of regulatory options that could be adopted (singly or in combination) by the UR in the energy retail market at a point where incumbents are no longer subject to price controls and conditions indicate the measure(s) would benefit consumers and the market.

Cornwall Energy has been commissioned by the UR to:

- research energy retail market regulatory frameworks in other jurisdictions where incumbents are no longer subject to retail price regulation but where interventions are made to benefit consumers and address concerns associated with limited competition or where competition is not fully effective, due to market scale, or other characteristics relevant to NI;
- detail regulatory options, including high level methodologies for design and operation, that should be considered for the NI market in the event that incumbent supplier market share drops to a position where they are no longer dominant and the existing price control regime on them alone is lifted;
- have particular regard to potential implications for the treatment of disengaged customers of former incumbent suppliers in relation to the development of the regulatory options;
- engage with NI stakeholders to discuss the options;
- consider the rationale for differences between options for domestic customers and for small industrial and commercial customers (small I&C); and
- consider the preliminary findings of the Competition and Markets Authority (CMA) review of the GB energy market, and the potential regulatory impacts and lessons for NI.

### 2.1 Phase I review

In November 2014, the UR published its *Review of Effectiveness of Competition in the Northern Ireland Energy Retail Market*<sup>1</sup>. This represented a completion of Phase I of a project that was one of the UR's 'flagship' projects highlighted in its Forward Workplan 2014-15. The report laid out the findings in relation to the state of retail competition in the NI electricity and gas retail markets. The report also made a number of secondary recommendations (e.g. around measures to improve customer switching rates), which will be dealt with separately by the UR outside of this consultation.

The primary findings of the Phase I report were:

- the NI market had achieved reasonable levels of switching given the context of the market and its maturity, and this has resulted in limited competition in the market;
- Power NI (former electricity supply incumbent) share of the domestic and small I&C market remains high, with a lot of the pricing strategies of competitors focused on discounting of the Power NI price;
- gas incumbent market shares remain similarly high, with similar pricing strategies as above;

<sup>1</sup> [http://www.uregni.gov.uk/news/competition\\_in\\_retail\\_energy\\_markets\\_in\\_northern\\_ireland\\_report\\_published](http://www.uregni.gov.uk/news/competition_in_retail_energy_markets_in_northern_ireland_report_published)

- there are limited players in the energy supply market;
- given the small size of the NI market in both an absolute and a relative sense, this situation is unlikely to change materially and the number of ‘players’ in the market is unlikely to increase; and
- whilst competition has been reasonably effective (up to November 2014), given the characteristics of the market and the lack of sufficient critical mass to attract a larger number of suppliers, relying on competition to protect customers is not enough on its own to effectively protect customers.

The report concluded that the requirement for some form of price regulation is likely to continue for the foreseeable future; and that this form of regulation should coexist with a competitive market. The report stated “the NI experience strongly suggests that regulation and competition can successfully coexist. Some form of direct price regulation is often necessary to deliver and sustain competitive entry until it is well established”. Indeed the current CMA proposals in GB for a “temporary safeguard tariff” indicate that regulatory protection may well be needed irrespective of the “maturity” of established competition.

However, at present the UR’s control of prices currently remains only on the former incumbent suppliers and is justified by their ongoing dominance in the price controlled sectors. This dominance may erode gradually. This could potentially lead to a situation where an incumbent’s market share falls to a level where they can no longer automatically be deemed to be dominant in either the domestic or small I&C market. At that point, it may no longer be tenable or desirable in terms of customer protection to automatically retain price regulation on only the incumbent supplier in isolation, as is the situation currently. Given the inherent oligopolistic tendencies of the supply markets described in the Phase I report, the UR is keen to examine its regulatory options in such circumstances.

## 2.2 Stakeholder engagement

During the development of this paper Cornwall Energy has met with a number of NI stakeholders. This has been primarily to provide suppliers and consumer representatives with an early view of the work stream and options that are considered in this paper.

The stakeholders were introduced to a high level design of each option, on which they provided feedback. Concerns and positive views regarding the various options were noted at this early stage, and the interviews helped shape the final design of the options.

We would like to thank stakeholders for their time and the useful comments we received during the drafting of this paper. These have helped us better understand not only stakeholders’ early views, but also a range of practical issues that implementation would need to address.

### 3 Rationale for options

The primary purpose of this paper is to present a series of regulatory options the UR could pursue at the point the current retail price controls are no longer deemed appropriate or at some later stage following the removal of the current price controls. Market conditions at that point in time would need to be such that intervention is judged, by the UR, to be proportionate and in the best interests of consumers and suppliers.

Research by Cornwall Energy, summarised in Appendix A, has reviewed regulatory approaches in other jurisdictions that have been introduced to provide protection to some or all customers where competition is judged to be insufficient to deliver effective outcomes. These include Australian, US and European markets where initiatives have been introduced with a view to allowing competition and regulation to coexist. Measures include interventions on price, such as a “price-to-beat” or “retailer of last resort”, that attempt to trigger a competitive response while ensuring disengaged consumers benefit from reasonably priced offers. Other interventions are aimed at vulnerable consumers and/ or provision of social tariffs.

This assessment of approaches in other markets forms the basis of the options presented in this paper. The seven options are a blend of initiatives seen elsewhere but considered in our view to be applicable in the NI context. In our view the options represent a credible range of interventions that could be made by a regulatory authority in a market where it was judged that competition of itself was not fully delivering the desired outcomes or that physical factors (such as size of market and its contestability) would not permit in full the realisation of the benefits of vigorous effective competition.

## 4 CMA's energy market investigation in GB

On 26 June 2014 Ofgem announced that it would refer the GB energy market for an investigation by the Competition and Markets Authority (CMA). The decision followed a market assessment, conducted by sector regulator the Office of Gas and Electricity Markets (Ofgem), which concluded that a number of features of the market were preventing, restricting, or distorting competition.

As part of its investigation, the CMA was required to examine whether “any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom”. If this were the case, it would represent an Adverse Effect on Competition (AEC).

The CMA focussed its market assessment on the GB market and did not consider the NI energy markets. Despite this the review is important in the context of this consultation for a number of reasons.

Firstly, the GB retail market has been deregulated for much longer than the NI markets (17 years in GB) and as such experience of market conditions and regulation provides valuable lessons for NI.

Secondly, notwithstanding important physical differences between the GB and NI market (such as market size and the relatively low (but growing) customer access to gas in NI), the assessment and proposed remedies in GB have a bearing on the options set out in this paper in terms of their probable effectiveness and impacts on competition.

### 4.1 Initial findings

The CMA published<sup>2</sup> its provisional findings and proposed remedies on 7 July 2015. The report has found AECs in a number of areas of the market.

The report said, over the period 2011-14, average revenue per kilowatt hour earned by the large six energy companies from customers on standard variable tariffs (SVTs) was around 10% higher for electricity and 13% higher for gas than average revenues earned from other tariffs. Despite this, around 70% of the large six energy companies' customers remained on the SVT, with these customers also more likely to be with their historical incumbent suppliers.

The CMA said it was “particularly striking” that there had been a wide variation in the prices that different domestic customers paid for energy given that it was a homogenous product. The dual fuel customers of the large six energy companies could have saved on average £160/yr by switching, though gains varied significantly between customers.

Over the last year the disparity between the SVT and the cheapest non-standard product has increased substantially. More generally the CMA observed that over the past three years the SVT had risen despite the fact that forward looking measures of direct costs had on average fallen; by contrast, the changes in non-standard tariffs had more closely tracked changes in anticipated direct costs.

---

<sup>2</sup> <https://www.gov.uk/cma-cases/energy-market-investigation>

Between 20%-30% of the domestic electricity customers of the large six energy companies have been with their suppliers for more than 10 years, and in gas the range is between 10%-40%. The CMA said incumbents appeared to benefit from a higher proportion of these customers—in electricity, around 35%-45% of domestic customers of incumbents within each region have been with their suppliers for 10 years or more.

EBIT margins were said to be generally higher in the SME market than in others—8% compared to 3% in the domestic market and 2% in the I&C market—and that these differences could not be justified by costs. The CMA saw that average revenues were substantially higher on the default tariff types that were often used by less engaged micro-business customers, and that these customers were not exerting sufficient competitive constraint on suppliers.

The CMA suggested two issues in particular might be inhibiting engagement: the lack of quality differentiation in energy reduced consumers' enthusiasm for the sector, and the lack of information readily available to consumers on their consumption.

The CMA concluded that weak consumer response was giving suppliers, especially former incumbent suppliers, a position of unilateral market power over their inactive customer base, and that suppliers had the ability to exploit this position and consequent market power by pricing their SVTs materially above a level that could be justified by cost differences.

The result of a survey commissioned by the CMA suggested that customers in Scotland and Wales were less engaged than the GB average and that customers in these areas were generally more satisfied with their current supplier and to trust it.

A higher proportion of Scottish and Welsh household consumers had been with their supplier for more than ten years and that 65% and 61%, respectively, of survey respondents were with an incumbent supplier (for at least one fuel) compared with 53% in England. The two regions where the electricity incumbent has a market share above 50% are in North Scotland and South Wales.

The report suggests that the results may be partially down to higher degrees of incumbent brand loyalty in Scotland and Wales and due to a high proportion of off-gas customers having Dynamic Tele-Switch (DTS) meters (for Economy 7 tariffs) where market engagement is relatively low.

The report was also critical of the impact in this area of some of Ofgem's Retail Market Review (RMR) measures, which were introduced during 2013-14 to reduce consumer confusion and increase engagement. Some of the RMR measures had, it said, restricted the behaviour of suppliers and constrained the choices of consumers in a manner that distorted competition. The measure had also seen suppliers withdrawing some of their discounted tariffs and making some consumers worse off.

The CMA said that, since liberalisation, there had been only a "limited" level of customer engagement in the market, with customers failing to respond to price differentials by switching suppliers.

The CMA was similarly concerned about the limited engagement of a significant proportion of micro-businesses<sup>3</sup>. It said there was a lack of transparency regarding the prices that were available to these customers, which could result from micro-business tariffs not being published and a substantial number being individually negotiated.

The authority concluded that a lack of robustness and transparency in regulatory decision making has increased the risk of poor quality decisions, in turn causing an adverse effect on competition.

## 4.2 Proposed remedies

The CMA's proposed remedies are guided by three key principles:

- provide a framework for effective competition—market forces should be allowed to work in order to maximise benefits to consumers;
- facilitate widespread customer engagement—customers must make choices between rival offerings of suppliers in order for competition to function; and
- ensure transitional safeguards for disengaged customers—while the markets have been open for 17 years a lack of customer engagement remains a significant issue.

The CMA set out a number of proposed remedies. The proposals relevant to this consultation are:

- the introduction of a transitional “safeguard regulated tariff” for inactive household and microbusiness consumers, imposed until other measures to improve competition are implemented;
- relaxing restrictions, introduced following Ofgem’s RMR programme, on the number of tariffs that suppliers can offer;
- the introduction of rules governing the information that third party intermediaries (TPIs) are required to provide to micro-business customers;
- a prohibition on terms that allow the auto-rollover of micro-business customers onto new contracts with a narrow window for switching suppliers or tariffs;
- extra measures to provide customers with additional information to reduce perceived barriers to accessing and assessing information;

### The CMA’s proposed “Safeguard tariff”

To provide “direct protection to disengaged customers” a maximum default tariff would be set by the CMA or Ofgem. It would be introduced on a transitional basis until other remedies improved competition.

Household and microbusiness customers that did not actively choose a new tariff at the end of a fixed term contract would be rolled onto the safeguard tariff. No other variable tariffs would be permitted.

The safeguard tariff price would be set on a cost-plus basis by making reference to an assessment of costs and a “headroom” element. The latter would need to be set such that less costly tariffs would still be offered and ensure effective competition (i.e. the price difference being sufficient to encourage switching) but not too high that it will not provide protection to disengaged consumers and provide a “focal point for default prices to settle”.

<sup>3</sup> In GB energy markets micro-businesses are defined as: electricity business consumers not exceeding 100MWh/ yr consumption; gas business consumers not exceeding 293MWh/yr consumption; and having 10 or fewer employees and an annual and an annual turnover less than €2mn/yr.

- measures to prompt customers on default tariffs to engage in the market;
- Ofgem to operate an independent price comparison website;
- improvements in the regulatory framework for financial reporting including Ofgem to develop a comprehensive “market oriented” regulatory accounting framework under which generators and suppliers should report; and
- revising Ofgem’s statutory objectives and duties in order to increase its ability to promote effective competition.

The deadline for responses on the provisional findings was July 2015 and the CMA is scheduled to publish its final recommendations by April 2016.

### 4.3 Implications for NI

The CMA’s provisional findings<sup>4</sup> and possible measures provide a timely assessment of the neighbouring GB market and the challenges facing suppliers, consumers, and regulators.

Tellingly, the majority of smaller consumers (households and micro-businesses) in GB are, to varying degrees, classed as being disengaged from the market despite full retail competition being introduced 17 years ago. A consequence of this, concludes the CMA, is that many of the disengaged consumers are likely to face much higher prices and in many cases prices that cannot be justified on cost grounds. Evidence from the first stage of this review indicates that is likely the case in NI also as it is reasonable to suggest that customers here will act in a similar way to those in GB and suppliers will have similar business models as their supplier counterparts in GB.

The report also notes that disengagement does not necessarily equate to dissatisfaction. Similarly in NI, the omnibus survey performed last year found that despite a degree of disengagement, there was a high level of consumer satisfaction and trust in the sector. However, this echoes the findings from GB for Scotland and Wales, concerning high degree of customer inactivity and therefore potential supplier market power.

In terms of the proposed remedies for disengagement the CMA suggests that disengaged consumers would benefit from a “transitional” retail price intervention. Therefore although regulatory bodies with a duty to promote effective competition generally see such interventions as anathema the CMA recognises that such tools have a place where competition—as a means to deliver a desired outcome—is failing.

In the NI context four key of the possible measures stand out. They are:

- the safeguard tariff;
- measures to provide customers with additional information to reduce perceived barriers to accessing and assessing offers;
- measures to prompt customers on default or evergreen tariffs to engage in the market; and
- Ofgem to operate an independent price comparison website.

<sup>4</sup> [https://assets.digital.cabinet-office.gov.uk/media/559fc933ed915d1592000050/EMI\\_provisional\\_findings\\_report.pdf](https://assets.digital.cabinet-office.gov.uk/media/559fc933ed915d1592000050/EMI_provisional_findings_report.pdf)

As noted in the *Review of Effectiveness of Competition in the Northern Ireland Energy Retail Market* report the NI market is relatively immature and (at the time of the report) there was no online price comparison service that also had the capacity to allow customers to complete a switch. The majority of interviewees for phase I suggested that the introduction of comparison sites (for tariff comparison and switching at the household/small I&C end of the market) would be beneficial, provided consumers were presented with all offers and any commission clearly displayed. The CMA found that price comparison and switching providers offer a valuable service, albeit only just over half (55%) of respondents to a survey it commissioned stated they were confident that they would be able to get the right energy deal from a price comparison website.

The UR's Retail Energy Market Monitoring<sup>5</sup> (REMM) initiative has already been established and is more sophisticated than anything currently present in the GB market in terms of depth of data reported and published. This should provide the UR with the level of data, provided in a consistent basis to highlight trends, that ensures regulatory and policy choices and decisions are based on robust information. The options presented in this paper heavily rely on the REMM framework for that reason—to ensure any option that is taken forward is based on the best available information on market conditions and to give certainty to stakeholders that the UR has robust information on which to reach its conclusions. Using the REMM framework also keeps to a minimum any additional reporting requirements on suppliers.

#### 4.4 Reaction to the CMAs provisional findings and possible measures

Unsurprisingly the CMA's report has received much interest and reaction. For the purposes of this paper we draw on three critiques from respected academics and ex-regulators that have a bearing on the UR's proposed approach to the regulatory framework following the removal of the current retail price controls.

Professor Catherine Waddams in a Centre for Competition Policy blog<sup>6</sup> noted that a safeguard tariff could lead to further consumer disengagement as many “will feel that the authorities are looking after them” but notes that the CMA is “clearly overall taking a longterm view in a market which has resisted many previous attempts to improve its functioning”.

A submission<sup>7</sup> to the CMA on 16 July 2015 by five former regulators (Professor Stephen Littlechild, Sir Callum McCarthy, Eileen Marshall CBE, Stephen Smith, Clare Spottiswoode CBE) urged the CMA to make use of trials before implementing any of the significant remedies and that efforts to facilitate access of vulnerable consumers to the benefits of a competitive market should have been given priority.

---

<sup>5</sup> The UR is working to introduce a new Retail Energy Market Monitoring framework (REMM) for Northern Ireland. This will involve improved data flows between the regulated companies and the UR. On 30 June 2015, the UR [published](#) its final decision paper which provides information on our final decisions with regard to the REMM indicators, arrangements for implementation and timelines. <http://www.uregni.gov.uk/retail/reports/>

<sup>6</sup> <https://competitionpolicy.wordpress.com/2015/07/07/cma-provisional-energy-market-findings-does-protecting-the-weak-even-temporarily-make-them-stronger/>

<sup>7</sup> [https://assets.digital.cabinet-office.gov.uk/media/55a908c3e5274a6fea000013/Stephen\\_Littlechild\\_-\\_Submission\\_to\\_PFs\\_and\\_notice\\_of\\_possible\\_remedies.pdf](https://assets.digital.cabinet-office.gov.uk/media/55a908c3e5274a6fea000013/Stephen_Littlechild_-_Submission_to_PFs_and_notice_of_possible_remedies.pdf)

The group questioned the CMA's conclusion that a well-functioning market would exhibit greater levels of customer engagement as "an ideal that is not obviously realistic". They argue that the introduction of a safeguard tariff will increase regulatory uncertainty and in turn the cost of capital which would result in higher costs for consumers. Moreover the former regulators noted the practical and political considerations associated with determining the "right level" for prices and that regulators, under external pressure, would tend to set the control toughly to show short-term or immediate benefit to consumers despite the potential for longer term detriment from reduced innovation, choice, new entry and demand response.

Professor Dieter Helm published<sup>8</sup> a critique on 20 July 2015. He noted that the CMA found gross margins in electricity and gas retail to be 17% and 19% respectively and asked "does the regulated Northern Ireland supplier earn these sorts of margins?" Helm also questioned the notion that a characteristic of an effective retail market necessarily requires high levels of switching activity, particularly given the activity incurs costs for the industry and consumers.

Turning to the proposed safeguard tariff Helm echoed the concerns made in the two previous critiques. If the tariff is set at cost plus a fair margin it would "kill" competition as consumers would have no incentive to switch. Moreover the CMA's notion of "headroom" in the safeguard tariff would, in Helm's view, embed in rates a penalty for non-switchers' disengagement with the market.

An alternative proposal put forward by Helm is to introduce a default tariff for non-switchers that would be unregulated and see suppliers differ their tariff rates only on the margin they required to operate and manage their non-discretionary pass through costs (identified as being wholesale purchases, network charges and policy levies). The margins would be published by Ofgem separate from the non-discretionary costs. Although the margins would not be regulated they would be "subject to scrutiny for evidence of abuse". Customers would also see on their bill the explicit margin, network charge and policy costs associated with the tariff.

Helm argues that this approach would result in maximising competition for the margin and customers would actively switch to variable tariffs—on the premise, as stated by the CMA, that price is the most important characteristic for consumers and the wholesale markets are competitive.

---

<sup>8</sup> <http://www.dieterhelm.co.uk/sites/default/files/Penalty%20tariffs,%20open-ended%20regulation%20and%20embedding%20overcharging%2020.07.15.pdf>

## 5 Options

This section describes seven options that could be implemented to monitor prices, maintain competition and protect consumers should the current form of retail price controls be removed in the NI retail energy markets. In some form they all are “real” options that already exist in other jurisdictions’ retail market regulatory regimes

For each of the options we set out its high level design, how it would be given effect (e.g. licence or change in law) and summarise a high level methodology to implement the option.

Considerations around Appraisal of the options, together with potential evaluation criteria, are then provided in section 6 of this report.

The purpose of this section is to review options that might strike the correct balance between allowing the competitive market to operate efficiently and in the best interests of consumers that are (or become) engaged with the retail markets, and to provide a framework that protects the interests of consumers that are not (or become) unable to proficiently benefit from engaging with the market given the specific NI context.

To varying degrees the options presented have the purpose of ensuring that disengaged customers are provided reasonable terms for supply and that, in a small market, suppliers with a large proportion of disengaged customers do not have the opportunity to exert market power that they might have to the detriment of other suppliers and customers. This market power is the same as the unilateral market power over disengaged customers that the CMA has identified in GB.

As we have explained, the options take account of and make wide reference to the UR’s REMM framework, especially its methodology for assessing retail margins. To minimise regulatory burden and resource the data to be collected under REMM will be used where possible.

The potential options are:

- identification of Significant Market Power and new consequent licence conditions;
- an “inactive customer” tariff for former incumbent supplier’s disengaged customers;
- introducing a “default tariff” for those consumers unwilling or unable to engage with the market;
  - CMA is proposing something similar for GB,
  - Illinois has Percentage Income Payment Plans (PIPP), that provides financial assistance to customer paying more than 6% of household income on energy,
- a cap on price differentials between the cheapest and most expensive tariffs to limit the rates disengaged customer face compared to proficient and active consumers;
- mechanisms for determining where a supplier or suppliers are deemed sufficiently dominant to be able to exert market power and possible regulatory solutions;
  - whilst deregulating the gas market in RoI, the CER identified specific criteria that it felt described a dominant supplier.
- a gross margin cap where suppliers would only be permitted to put rates into the market with a maximum level of gross margin;

- this is in place in several Australian states including New South Wales; and
- a price-to-beat offer determined by the UR that suppliers would have to match or better;
  - this had been in place in Texas although it was framed as a minimum allowed price, rather than a maximum.

There may be potential for options to be considered in combination as well as stand-alone. Each of the identified options is discussed below.

## 5.1 Identification of Significant Market Power and consequent licence conditions

### 5.1.1 Description

The starting point to this option is in the current licence conditions (condition 14 in current electricity supply licences and condition 2.5.5 in firmus's gas supply licence for the Ten Towns) which state where a supplier is deemed dominant in any market it must not show undue discrimination or undue preference to any customers in that market where it is deemed to be dominant, or set prices that are unduly onerous or predatory in that market where it is deemed to be dominant.

Terms in respect of particular consumers shall be taken to be “unduly onerous” if the revenue from supply on those terms: significantly exceeds costs in respect of those consumers; and exceeds such costs by significantly more than in the case of the generality of consumers supplied in the same market. However (unless the converse is manifestly the case) terms shall not be taken to be unduly onerous if other suppliers have more onerous terms.

### 5.1.2 Application

The trigger point for the implementation or “switching on” of new licence obligations which would be enshrined in all supply licences and would be reworked versions of the conditions described above would not be a determination of dominance, but instead of significant market power. Significant market power (or SMP), is a position similar to, but falling short of, dominance. As defined in the context of communications regulation<sup>9</sup>, a supplier will be deemed to have significant market power “if, either individually or jointly with others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.”

Upon determination by the UR that a supplier had SMP it would be required to refrain from undue discrimination, undue preference, predatory pricing and unduly onerous terms. If, through its monitoring activities, it came to the UR's attention that a supplier was behaving in such a manner then it could intervene.

### 5.1.3 Verification

The UR would determine whether suppliers have SMP using the information gathered via the REMM.

<sup>9</sup> Article 14(2), Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (Electronic Communications Framework Directive)

## 5.2 “Inactive customer” price controls for Power NI, Firmus and SSE Airtricity Gas Supply

### 5.2.1 Description

This option would apply only to former incumbent suppliers at the point the UR determined that current retail price controls were no longer tenable. In its place Power NI, Firmus and SSE Airtricity Gas Supply would be subject to a price control for their customers that had never switched i.e. “inactive customers”.

As the suppliers in the market with by far the highest number of customers that have never switched, the incumbent suppliers would be in a position where, compared to their competitors, in a future where current price controls lapse, they could raise their disengaged customer prices to fund cheaper offers to more engaged customers. This could potentially result in the following detriment:

- disengaged/inactive customers pay significantly more for their energy, with the potential that an element of their bill is used to offer engaged customers “loss leading” tariffs; and
- other suppliers without a large rump of customers that have never engaged with the market are unable to compete against the lower tariffs offered by incumbents.

This type of concern is real, and this behaviour has been highlighted by the CMA in its *Energy market investigation—Summary of provisional findings report* where it states “weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies”.

The incumbent supplier would be allowed to offer any tariffs and offerings it liked to customers in the market, except those identified as disengaged. For the disengaged customers it would have to supply under a tariff agreed with the UR. The setting of this tariff would mirror the tariff setting process of today.

In effect this would divide the incumbent suppliers’ retail businesses into price regulated and price unregulated parts, as is the case today for NI price regulated suppliers who have price regulated and unregulated I&C sections within the one business. The change would be that the domestic sectors within these incumbent businesses would be split into price regulated and unregulated following removal of the current form of price control frameworks whereby now the domestic sectors of these businesses are totally price regulated.

### 5.2.2 Application

The process for implementing the “inactive customer” tariff would be similar to that used currently for deriving tariffs. Incumbent suppliers would submit to the UR information on wholesale, network, policy and operating costs and margin and a total allowed revenue (for disengaged customers only) would be derived from this. This figure would be divided by forecast demand for the disengaged customer base to give the maximum average charge for the disengaged customer tariff.

Disengaged customers could be identified from REMM submissions, specifically the “sticky customers” metric. For the purposes of this option only “connections that have never switched from the incumbent supplier” would be deemed to be disengaged. This though does not cover instances where a meter may not have switched but the occupants had changed, or whether the customer had negotiated another tariff option with the supplier.

In addition it is proposed that the incumbent suppliers would be prohibited from marketing to customers on the inactive tariff (as customers could be opted into a shorter term cheaper tariff - without having to actively engage the supplier or go through a switching process in any way - that then reverted to a higher priced tariff on the expectation the customer remained disengaged thereafter), but would be permitted to offer an inactive customer new terms for an alternative tariff if the suppliers can demonstrate that the customer proactively approached the company without prompting.

Any inactive customers who become active and switch to another supplier cannot go back and avail of the inactive customer tariff.

We suggest that the UR would set out a route map that would indicate when the inactive customer tariff would no longer be necessary, probably based on an assessment of the fraction (or number) of customers that have never switched away from the incumbent supplier.

### 5.2.3 Verification

The UR would verify compliance with this option in a similar manner to that employed for the current price control regime. Incumbent suppliers would be bound by licence conditions to provide regular data and information to the UR to ensure revenues and costs aligned.

## 5.3 “Default” tariff

### 5.3.1 Description

Suppliers would be obliged to offer a “default” tariff that would be open to all customers. The purpose of the tariff would be to provide fairly priced rates for consumers that cannot or choose not to engage with the competitive market. Customers that were not being supplied through a tariff that was cheaper than the default tariff would be migrated to the tariff either at the end of their fixed term offer (unless they chose a cheaper tariff or to switch to another provider). Also where customers are supplied via a variable tariff they would be switched to the default tariff unless they were being supplied through a cheaper alternative variable tariff.

The tariff would be set by the supplier with the company moving customers to it in the circumstances outlined above. It is envisaged that the tariff would be a variable tariff and not fixed term. This would ensure that prices can be changed as the supplier’s cost base moves and that customers are not exposed to a termination fee typically associated with a fixed term tariff. In addition, practical difficulties could emerge for fixed term default tariffs: for example, multiple tariffs may need to be offered and there could be equity problems if customers became stranded on high priced fixed default tariffs.

The default tariff would be offered by meter type (to take account of the different costs associated with credit and prepayment meters) and open to all payment options. A key difference in the small I&C market is that customers could end up on the default tariff in the event that they were unable to secure a negotiated contract from a supplier. As small I&C customers have a more varied consumption profile the supplier would need to take account of the risks it faced in terms of credit, trading and payment.

The terms of the tariff would be such that it would ensure that disengaged customers would not be exposed to tariffs with high margins that could be used to offset that supplier's other offers to attract engaged consumers—e.g. prevent the possibility of disproportionate cross subsidy between sections of a supplier's customer base.

It is important to note that while the UR would oblige the creation of default tariffs, it would be for the individual supplier to set the price. The UR would monitor the tariff rates after they have been levied (ex-post) and expect all suppliers to justify their cost elements. The rationale for ex-post is discussed further in 5.3.2. The UR would pay particular attention to the cost elements under the direct control of the supplier: wholesale trading, operating costs and profit margin. The margin reporting requirements under REMM should aid it in this task.

### 5.3.2 Application

To give effect to this option the UR would direct suppliers to offer a default tariff through licence condition obligations. The licence condition could be introduced prior to current retail price controls being removed by stating the obligation would only commence at the point no supplier is formally price controlled. This would be the case for gas and electricity, albeit the price controls may lapse at different times.

Enshrined in the licence would be the requirement for suppliers to offer a default tariff that was reflective of the costs and a reasonable profit to provide those customers with energy and that the supplier would need to have in place management and system processes to justify its charges. The UR would have the right to commission a third party assessment of any supplier's charges and their justification of them.

Care would need to be taken to understand how tariffs should be constructed, especially if they contain a standing charge and a unit rate. A low unit rate and high standing charge would benefit high consumers, whilst a low standing charge and high unit rate would be to the benefit low consumers. Currently there are no tariffs with a standing charge for domestic customers in NI, although this situation may change in the future.

The UR would need to assess if a supplier's default tariffs are fairly priced including their profit margins. In so doing it would need to have regard to how the default rates are set by suppliers themselves. Tariffs could be set either before (ex-ante) or after (ex-post) they have been levied.

If the UR were to take an ex-ante approach in monitoring default tariffs, it would need to assess the views taken by suppliers on factors including future commodity, taxes and network costs, as well as their operational costs and sales volume. Hedging and their own skills in managing their businesses would most likely enable suppliers to derive a more accurate view than any third party including the UR.

The UR will need to be mindful of how it undertakes and reports on its default tariff monitoring if this ex-ante approach is adopted. Any information or commentary set out by the UR runs the risk of being seen as informal guidance by suppliers in setting their default tariffs. Furthermore, by setting out anything that might be interpreted as a forward looking view of fairly-priced tariffs the regulator would risk becoming the de-facto price setter instead of the supplier.

Another alternative option for ex-ante monitoring could have default tariffs set with actual data (for example from REMM market indicators, published network charges and wholesale market cost indicators) from one period applied in formulas to calculate default tariffs for the next period. This approach has the advantage of being independently verifiable once the formulas have been defined, although this in itself could prove a complicating factor if the tariffs are defined explicitly by the UR or even seen as implicitly set by the UR by any acceptance of default rates applied by suppliers. It also risks lack of timeliness. For example higher priced winter wholesale energy costs might end up being used to calculate summer bills for consumers and, probably worse from the supplier point of view, lower summer wholesale prices applying for the higher demand time of winter. Moreover, a fundamental shift up or down in markets might not be passed through in to consumer bills through on a formula driven tariff as quickly as it might for those on other terms, which may create equity problems should competitive market prices fall.

One way to avoid the risks of lagging outlined above would be to use forecast or expected values for the formula parameters. However it may be necessary to reconcile actual values against the forecast values applied in the formulas leading to potential catch-ups in default tariff rates in periods after consumption has occurred.

An ex-post approach would appear to be the most effective method to validate that default tariffs as set independently by suppliers were justifiable. The UR could undertake benchmarks using REMM submissions on, for example, diversity of tariffs and final prices to assess the reasonableness of default tariffs.

Another consideration is whether the default tariff should be priced the same across the entire market (by fuel, meter/ payment type, and customer type) such that disengaged customers would have an identical rate regardless of supplier. This approach is akin to the price-to-beat tariff discussed in section 5.7. While there may be benefits to this approach in terms of consistent pricing it would have very different impacts for suppliers given their size, credit rating, trading approach and own costs. The additional benefit with all suppliers pricing their own default tariff is that this itself could drive increased consumer engagement as prices will be different. It is also for decision whether the default tariff should include any other services (energy efficiency, advice, enhanced customer service etc.).

New entrant suppliers might be subject to the obligation immediately or exempted until they reached a predefined number of customers or percentage of the market. In practice it is unlikely that a new supplier would seek to offer tariffs higher than default tariffs as it would find it difficult to attract customers. The obligation would be necessary once the new entrant had reached a threshold or customer number as defined by UR, as its customer base would include consumers for which circumstances had changed and therefore might benefit from the tariff.

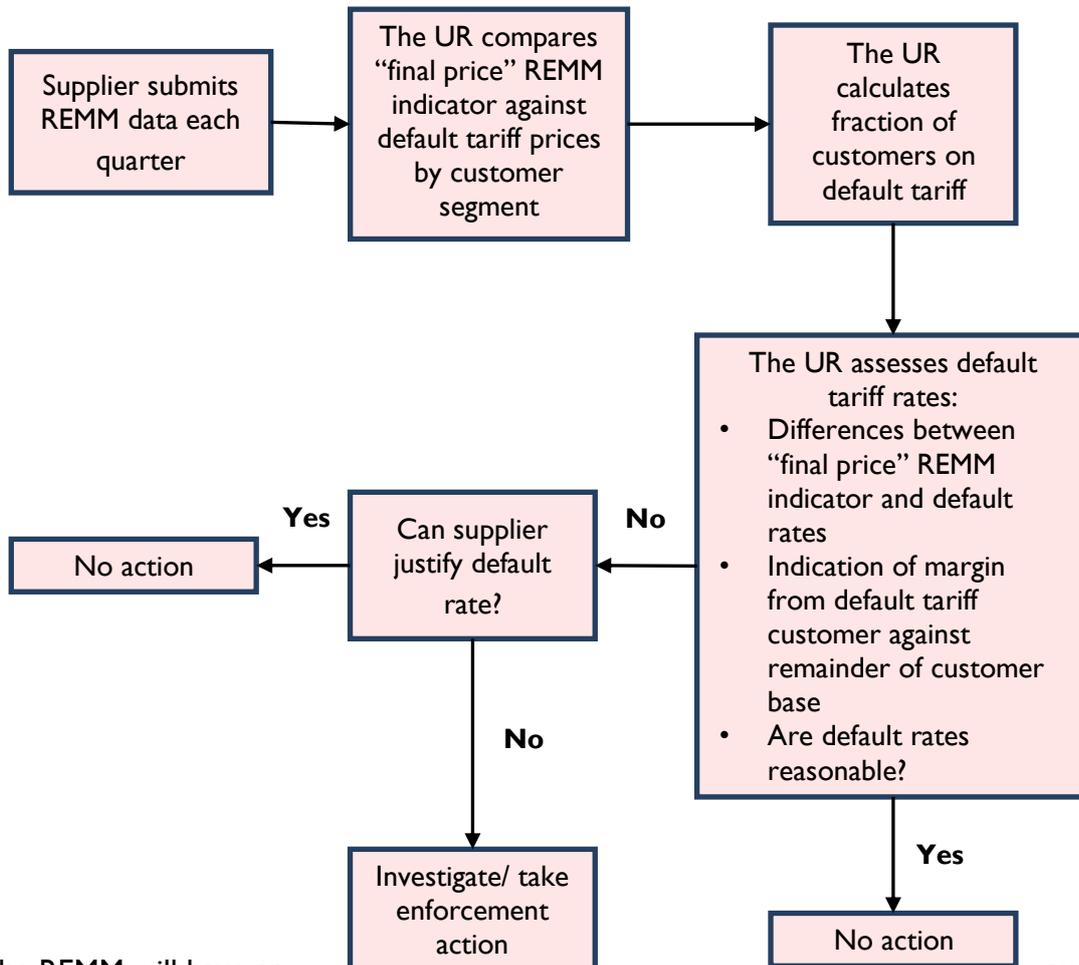
5.3.3 Verification

The REMM framework is expected to be implemented in full before the current retail price controls lapse. All suppliers will be required to provide detailed information to the UR on a quarterly basis. Submissions would be used by the UR to assess each supplier’s default tariff by taking account of REMM statements that provide data on:

- final prices;
- diversity of tariffs;
- disaggregation of customer groups;
- operating costs;
- wholesale costs (this includes commodity and credit costs); and
- margin.

The flow chart below sets out the high level approach to assessing the tariffs each quarter.

**Figure 5:1: Possible audit process for a default tariff**



The REMM will have an

audit framework

that ensures accuracy of submissions from suppliers. In addition the UR would need to have data on the number of customers supplied under a default tariff. Furthermore the UR would have the right to commission a third party assessment of any supplier's charges for their default tariff and their justification of them. Should the default tariff be implemented, the REMM margin data requirement could be expanded to include margin data on the default tariff. In doing this each supplier's tariff could be checked to determine if the final price is reasonable.

To undertake whether default tariff rates were justified the UR would need to take account of the following characteristics:

- the number of vulnerable consumers taking a default tariff;
- customers on default tariffs are expected to be less likely to switch and therefore this should be reflected in the risk profile attached to the customers in terms of wholesale hedging, unless evidence can be provided that churn rates are higher than industry average;
- less engaged customers on any given tariff typically incur lower costs per account as by their nature they tend to be disengaged from switching and general contact with their supplier and incur little or no marketing costs;
- customer account debt levels compared to overall customer base;
- changes in operational costs, such as expansion, new systems, change of business model etc.;
- significant changes in consumption levels;
- significant change in number and/ or percentage of customers on a default tariff; and
- indicative margins from default tariffs. The UR would not set out that margins should necessarily be at a particular level, but would seek justification for observed or implied differences between customers on default tariffs and those on alternative tariffs.

The UR may publish guidance on what is reasonable but not set out explicitly what the margins should be for a default tariff or how much the default tariff price should vary from the average of prices of other tariffs the supplier offers. The UR's objective is to ensure that default tariff customers are not subject to unreasonably non-cost reflective rates—particularly for vulnerable consumers. It would be incumbent on all suppliers to be in a position to robustly justify the level of their default tariff to the UR.

The UR would also take into account that the REMM data provides an instantaneous snapshot over a quarter of revenues and costs and in reality suppliers will not be able to adjust prices (which include providing customers notice of changes) immediately.

Using existing powers, or explicitly enshrined in licence, the UR would reserve the right to commission a full audit of any supplier's default tariff at any time to see if it is justifiable.

## 5.4 Tariff cap spread

### 5.4.1 Description

Licence conditions would require all suppliers (including new entrants) to price offers within a defined spread to ensure that disengaged customers are not subject to charges that are not cost-reflective and could enable a supplier to offer a “loss leading” cheaper tariff to consumers that can

and/ or choose to interact with the retail market. The licence condition would take effect the moment current price controls were removed and would apply to all new offers from that point forward. It would also be necessary for the licence condition to give the UR the ability to alter the spread in response to changing evidence and market conditions.

The rules would apply to tariffs a consumer could avail of by meter and payment type. The tariff cap spread would need to be defined as a maximum price difference between cheapest and most expensive expressed as a percentage of a typical annual bill. This would be for *all* tariffs types and so the spread would be comparable for variable rate tariffs and standard rate tariffs.

**Table 5.4: Example of spreads for different electricity tariff types by consumption**

Consumption level	Fixed rate tariff 1yr	Fixed rate tariff 2yr	Variable rate tariff 1	Variable rate tariff 2	Spread (expensive: cheapest)
	15p/day + 16.5p/kWh	25p/day + 15.5p/kWh	19p/kWh	20p/day + 17p/kWh	
1,000kWh/yr	£219.75	<b>£246.25</b>	£190	£243	1:1.296 (29.6%)
2,500kWh/yr	£467.25	£478.75	£475	<b>£498</b>	1:1.025 (2.5%)
5,000kWh/yr	£879.75	£866.25	<b>£950</b>	£923	1:1.097 (9.7%)
15,000kWh/yr	£2,529.75	£2,416.25	<b>£2,850</b>	£2,623	1:1.180 (18%)

Provisions could be introduced for “green” tariffs where a supplier could justify additional costs as a consequence of the customer willing to pay a premium for an additional environmental benefit.

The situation in the I&C market would be complicated where some customers would take a bespoke contract rather than tariff.

#### 5.4.2 Application

Prior to the introduction of the option the UR would analyse pricing trends in the market and set out the allowable percentage spread for tariffs by typical consumption levels, meter and payment type. The analysis would also need to take account of discounts and other financial benefits that may not form part of the final price to the consumer. For example the final annual bill for a customer with a tariff that includes a discount/ reward/ inducement would need to be converted into a cash equivalent where possible. It would also be necessary to understand if discounts were automatically applied or required the consumer to actively apply for them. Moreover oversight would be needed to ascertain the customer type (vulnerable, proactive switcher, disengaged etc.) that could or are benefiting from such offers.

The specific REMM indicators that would be used in the analysis are:

- sticky customers;
- renegotiated contracts;
- debt recovery;
- diversity of tariffs;
- final prices; and
- retail margins.

Suppliers are also required to inform the UR of all new tariffs in the market; this would allow an immediate analysis of spreads to be undertaken.

To determine the appropriate spread between cheapest and most expensive offer the UR would assess in particular the tariff structure (unit rates, standing charges (where applicable), and any discounts/ rewards) to calculate the annual bill for a customer based on defined consumption profiles—such as those proposed in the recent REMM consultation (using the bottom end of each band).

**Table 5.4.1: Consumption bands**

Electricity	Gas
<b>Household</b>	
1,000kWh/yr	5,557kWh/yr
2,500kWh/yr	55,556kWh/yr
5,000kWh/yr	
15,000kWh/yr	
<b>Small I&amp;C</b>	
20MWh/yr	278MWh/yr
50MWh/yr	732MWh/yr

This analysis would show the tariff spreads in the market by consumption band. From this further analysis would be conducted to assign the reasonable costs differences (for each meter and payment type) to serve customers. It is assumed that network costs would not be different for the majority of consumers within each consumption band over the course of a year. The costs that are within the control of the supplier are: wholesale trading, customer service, offer of discounts/ additionality and operational costs.

**Table 5.4.2: Cost differences between tariffs to determine reasonable spread**

Contract type	Payment method	Consumption	Discounts/ additionality
Different hedging strategies for fixed and variable tariffs, including trading and credit costs.	Account for processing different payment methods including metering type.  Bad debt levels by tariff/ meter type.	Recognition that fixed costs comprise a higher fraction of a low consuming customer.	Quantify discounts (e.g. vouchers) and additional costs for delivering additional environmental benefits.

The material difference in actual costs incurred is likely to be wholesale prices where the supplier offers a fixed and variable tariff as these carry differing degrees of certainty regarding customer churn. It is also probable that where different contracting terms are offered they will attract

customers with (on average) different annual consumption and debt levels. These too would be considered in reaching a decision for a reasonable spread between tariffs that an individual consumer can avail themselves of.

In terms of implementing the spread limit, it may be simpler for the UR to stipulate a percentage that is the same for all suppliers, although it would also be possible to determine spreads for individual suppliers to take account of real differences in costs and customer base size and profile. Moreover the UR would take account of the composition of a supplier's customer base when analysing differences in the tariff prices. If, for example, a supplier with a high proportion of disengaged customers offered tariffs with wide spreads the regulator could seek to stipulate a reduction in differences if analysis showed sticky customers were predominantly paying towards the more expensive end of the market compared to more proficient and active consumers that took advantage of lower (potentially loss leading) tariffs. A wider spread of tariff prices may be permissible for suppliers with a proven engaged customer base, such as new entrant suppliers, provided the costs are still justifiable.

Importantly it may be necessary to define different spreads for different consumption bands. This would be in recognition that standing charges (where applicable) represent a higher fraction of low consuming customers' bills, and should be set (where applicable) to recover fixed costs incurred by the supplier. This assumes suppliers seek to make net margin on their trading activity and cost savings on their fixed costs.

A market wide spread would enable less chance of consumer confusion—although messaging would have to be clear as the spread does not relate to absolute prices for annual bills.

### 5.4.3 Verification

Once the spread had been determined and introduced the UR would verify that suppliers are compliant with the rules on an ongoing basis. As new offers are put into the market the UR would check, or ask suppliers to verify, that they fell within the allowable price difference for all consumption bands. It would be expected that suppliers would withdraw tariffs where necessary when new products breach the spread limit.

As part of its ongoing monitoring of the market via the REMM framework the UR would be required to monitor market conditions to ensure the tariff spread remained fit for purpose. It would formally commit to reviewing the spread annually and setting out its reasons for retaining or updating the spread. Suppliers would be provided with a reasonable notice period where it was changed.

## 5.5 Dominance thresholds

### 5.5.1 Description

Where a supplier or suppliers hold in isolation or combination a high proportion of the overall market share the UR would take action to ensure that the supplier(s) could not use dominance to exert market power.

This option differs from others presented here insofar as regulatory action would only be invoked once a predefined threshold had been crossed. It is worthy of inclusion though as it could work in conjunction or isolation with other proposals and is framed to ensure consumers are protected where the market tends to monopoly/ oligopoly.

The fact that dominance reappears in a market (on the assumption that the transition to retail competition has been successful insofar as original incumbents have had their market share competed away to a point the retail price controls are no longer deemed necessary to protect consumers and facilitate competition) presents a challenge for regulators.

On the basis that the newly dominant supplier(s) has reached a position through fair means in an effective market it suggests that its prices and services are the most attractive to consumers and so preventing it from offering the same to a greater number of consumers could be seen as resulting in detriment. Moreover these concerns with dominance would differ from those related to a previously public entity operating in a newly created market as all (as opposed to some in the case of an original incumbent) consumers would have, at some point, actively engaged in the market.

Nonetheless market dominance in any market could give rise to outcomes that are to the detriment of consumers, other competitors, other markets (i.e. wholesale markets) and wider socio-economic considerations.

It is important to note that, where a supplier is dominant it will be subject to Chapter II of the Competition Act 1998 and will be precluded from abusing its dominant position. Under Articles 42(5A) and (5B) of the Energy Order, before taking licence enforcement action against a supplier for abusing a dominant position, the UR is required to consider whether it is more appropriate to use its concurrent powers under the Competition Act. It would only be after this consideration that the licence conditions required to implement this option would be put in place.

### 5.5.2 Application

In the first instance the UR would set out to the market its approach to monitoring the market and how it would determine when a supplier or suppliers became dominant and so subject to regulatory intervention.

The determination of dominance would need to take account of the number of suppliers active in each market, market share held by all suppliers, switching rates, and market share held by the largest suppliers. Tolerances would also be included to mitigate the risk that suppliers moved in or out of dominant positions in a short period of time.

**Table 5:5: Indicative approach to determining supplier dominance**

Metric	Characteristic	Note
Number of active suppliers	A higher number suggests greater choice for consumers.	The number of suppliers and particularly new entrants indicates greater customer choice and that participants believe there is a profitable and contestable market.

Concentration	With above data the HHI <sup>10</sup> can be calculated to take a view on market concentration.	An index above 2,500 is considered to be a highly concentrated market; and an index between 1,500 and 2,500 a moderately concentrated market. The domestic and small I&C markets are currently deemed highly concentrated.
Combined market share of largest suppliers	To ascertain market concentration in a market where market shares differ significantly between suppliers	The metric to be applied would be: $S \geq 2^n$ and $< 2^{n+1}$ Where S is number of suppliers in the relevant market. The combined market share would be calculated for n suppliers.  E.g. in a market with 10 suppliers the largest 3 suppliers market share would be considered; in a market with 6 the largest 2 suppliers market share would be measured etc.
Switching rates	Indicative of consumer engagement	A higher rate of switching indicates greater consumer engagement and a greater likelihood that market shares could change.

As an example, dominance could be determined using the following assessment:

- where HHI is above a threshold (say 2,500 as used by the US Department of Justice in evaluating takeovers<sup>11</sup>) for two consecutive quarters; or
- the combined market share of the largest suppliers is above two thirds of all accounts in the market. Regulatory intervention would only apply where a supplier market share exceed half of all accounts in the market; or
- switching rates fall below 5% for four consecutive quarters; or
- indicative margins are deemed to exceed 10% for six consecutive quarters; or
- a combination of the above.

Ongoing monitoring would provide some foresight of when suppliers are reaching the threshold, but the nature of the intervention itself would need to be taken into account in determining the practicality of implementing an intervention.

<sup>10</sup> The Herfindahl-Hirschman Index (HHI) is a widely used measure of market concentration. The index is calculated by finding the sum of the squares of the market shares of companies active in the market. An index of 10,000 denotes a monopoly market; an index above 2,500 is considered (by the US Department of Justice) to be a highly concentrated market; and an index between 1,500 and 2,500 a moderately concentrated market. An index below 1,000 represents a highly unconcentrated market with many participants, of which none holds large market share.

<sup>11</sup> <http://www.justice.gov/atr/herfindahl-hirschman-index>

## 5.5.3 Potential intervention options

Where dominance is present in the market the UR would have recourse to a number of options to ensure that the supplier(s) cannot abuse its position through pricing policies, frustrating entry or lessening innovation opportunities.

At a high-level the options, in isolation or combination are:

- the options set out in this paper that were not already in place; and
- a return to “conventional” retail price control—this could be a replication of the process that underpins the current process for regulating prices or a lighter touch approach (that could subsequently become more sophisticated should market concentration continue to increase).

Where “full” price control was introduced it would be necessary for the UR and supplier(s) to clearly establish the exact nature of the price control. For example control of operating costs, margin, and wholesale hedging, network charges, and all credit. This process can typically commence up to two years prior to the price control being implemented. This would not be suitable in a market where the newly defined dominant supplier could lose market share and therefore not require price control. It would be more sensibly applied if market conditions meant that the number of suppliers reduced (due to new entrant failure or ordered exit) and the likelihood of further entry was deemed to be low.

The second lighter touch approach would be to apply one or more of the options set out in this paper such that the dominant supplier(s) was subject to closer monitoring and rules regarding how prices were formed and presented to customers. For example dominant suppliers could be subject to a price to beat tariff or a tariff spread cap. This would deliver similar outcomes with less resource from the UR and regulated suppliers as customers of the dominant supplier(s) would in essence have a price cap and a range of price differentials that would be set such that market power could not be exerted. As previously mentioned the UR would need to consider recourse to Competition Act powers in the first instance to remedy the situation.

## 5.5.4 Verification

Full price control would be similar to the requirements on suppliers currently price controlled. Where other options were introduced the verification would follow those recommendations.

## 5.6 Gross margin cap

### 5.6.1 Description

Suppliers would be obliged to provide offers to customers within a maximum gross margin (as defined below). It is expected that tariffs with a lower gross margin would be available and the cap set to ensure that no customers, particularly those that have not or choose not to switch suppliers, are exposed to unreasonably high tariffs.

The obligation would be enshrined in supply licences and audited against financial accounts and REMM data submissions.

### 5.6.2 Application

The UR would establish the allowable maximum gross margin cap that took account of only the costs a supplier could control and not known charges expected to be passed through in customer prices (taxes and regulated network costs).

There are a number of approaches to define allowable margins.

- *Expected returns methodology*—based on REMM submissions the UR would estimate reasonable revenue to be collected from customers taking into account bad debt and market wide (systematic) risk, such as wholesale market shocks, economic downturn etc. From this the UR would determine the retail margin necessary to cover the identified risks;
- *Bottom up methodology*—the UR would look at the assumed supplier investment base and estimated costs. This would be compared with the modelled revenue and earnings from which the supplier can secure a return that equals its estimated cost of capital; and
- *Benchmarking*—making use of REMM submissions the UR would assess indicative margins of all suppliers and create a range of margins to compare against each other and those in other markets, such as water and telecoms. As part of this step, it could also consider a range of issues. These include: different customer churn rates between suppliers, any known special/ one off investments, credit rating, mix of customers (to include suppliers that operate in both electricity and gas and across the domestic and business market), time supplier had been operational.

In the NI context the benchmarking approach would be the most appropriate as information provided to the UR under the REMM will be sufficient for the regulator to monitor trends in margins over time and have a dataset against which ranges can be established and how suppliers and the market as a whole responds (in margin terms) to systematic risk. The regulator also has evidence and experience from current and historic retail price controls to inform its assessment of a gross margin cap.

In setting a cap the UR would also allow for systematic risk, such as changes in economic conditions or wholesale price shocks. The review of the cap would take place annually, unless market condition required the review being brought forward (for example sudden rises in wholesale costs).

The assessment would necessarily focus on more established players in the market as it is generally assumed that the new entrants operate at a loss for the first few years of activity. Moreover there are economies of scale that are achievable in retail where costs to serve per account should be lower for suppliers with larger customer bases.

The cap could be expressed as a gross margin for all suppliers or as a share of an annual bill. While the former would be simpler to verify and administer the latter could deliver greater consumer benefit provided it could be verified and implemented. As noted previously the assumption is that suppliers seek to recover fixed costs through a standing charge (operational costs, non volume related networks charges etc.) and volumes based costs via the unit rate (wholesale, network and some policy costs). We also assume that a typical supplier would seek to find savings on its fixed costs and margin on its volume based charges. Where this assertion holds true the margin per

customer account would be a function of consumption—i.e. a higher consuming customer account would be more profitable for a supplier than a lower consuming account.

Consideration would need to be given to whether it is workable or meaningful to introduce gross margin caps per consumption band. If the gross margin cap is applied across a suppliers' entire customer base it would be possible to segment customers by consumption and move margins between customers by consumption levels and churn rate. Further research would be necessary to understand the probability that this activity would take place and how it could disadvantage customers, particularly vulnerable disengaged consumers.

Gross margin caps for individual suppliers would be possible, but more complex. It would also run the risk that competitors could infer more easily supplier operational costs and approach to trading.

A market wide cap would be set such that more efficient suppliers would more easily price offers that were competitive and retained reasonable margins.

A gross margin cap could be determined as:

### Step 1: Determine retail margins

$$M = R - NC - PC - WC - SC$$

M = total retail margin by supplier (by market: electricity/ gas/ household/ small I&C)

R = revenue from energy sales (by market: electricity/ gas/ household/ small I&C)

NC = network costs (by market: electricity/ gas/ household/ small I&C)

PC = policy costs (by market: electricity/ gas/ household/ small I&C)

WC = wholesale costs (by market: electricity/ gas/ household/ small I&C)

SC = operating costs

- Presented for each customer group and in aggregate for the supply business as a whole. Reconciliation to regulatory accounts at the end of each financial year.
- All values to be expressed by component in £mn, percentage and £/MWh supplied
- Taken from REMM margin methodology

### Step 2: Determine indicative margin between sticky customers engaged customers

1. Determine from REMM submissions the fraction of customers for each supplier over the previous four quarters that are:
  - a. number of sticky customers on “dead” tariffs
  - b. number of customers on fixed contracts and rates
  - c. number of customers on current variable rate
  - d. number of sticky customers
2. Using available tariff rate information ascribe margin from step 1 to each customer segment by taking known consumption information as per bands in table 5.4.1

total margin = margin a. + margin b. + margin c.

3. Assume sticky customers are being supplied through type a. and type c. tariffs, although not all type c. customers will be sticky.
4. Determine for each supplier the indicative margin between sticky and engaged consumers.
5. Determine market wide spread of indicative margins between sticky and engaged consumers.

### **Step 3: Set gross margin cap**

The cap could be set such:

1. total gross margins are capped at the (for example) two thirds point of the largest suppliers in the market; or
2. total gross margins are capped at the (for example) two thirds point of the range of sticky customers across the entire market; or
3. total gross margins are capped by giving additional weighting to the margins of largest suppliers sticky customers; or
4. a combination of the above.

#### *5.6.3 Verification*

The UR would analyse REMM data submissions. Deducting the total of all costs from the revenue in each customer group will produce a gross margin value for each customer group. The margin figures will be reported on a quarterly basis showing their component parts by the customer groups in absolute money terms, percentage of total revenues and per unit revenue.

The margin figures should be reconcilable to figures reported annually by suppliers in their regulatory accounts. A statement of this reconciliation should be provided by suppliers at the end of each financial year, as defined by licence.

## **5.7 Price-to-beat tariff**

### *5.7.1 Description*

The regulator would determine a tariff rate that all suppliers would have to match or better. The price to beat tariff would represent a reasonable price that took account of all supply costs and a reasonable margin. To give effect to the option it would be necessary to underpin the obligation in licence or possibly secondary legislation. Mechanisms would be in place to change the tariff rates in response to changing market conditions.

The tariff would comprise two elements: a standing charge to recover suppliers' fixed costs and unit rate to cover volume based charges. This would ensure an equitable approach for all consumers with different consumption levels.

### *5.7.2 Application*

The UR could take a benchmarking approach to establish a bottom up cost stack to determine the elements of the price to beat tariff. The primary source of information would be REMM submissions, but reference would also be made to forward wholesale prices and a hedging strategy

that modelled how a supplier purchases energy. This could be a blend of ex-ante and ex-post assessments. Network charges, taxes and some policy programme costs would be known ahead of time. A hedging model and reference to wholesale market price reporters would establish commodity costs. Forecasts of seasonal normal demand could be taken from system operator projections to determine future demand volumes.

This approach though would be resource intensive for the UR and be open to significant error if the regulator did not have sufficient expertise to continually appraise the price. Moreover the approach could lead to consumer confusion as it may appear to many that the regulator endorses the price to beat tariff which by design would be the highest price offer in the market.

Alternatively an independent third party could be assigned the role of determining the tariff rate. This would have the benefit of ensuring that the independent party had sufficient expertise to derive the most effective price and reduces the consumer confusion that the UR endorses the tariff. This approach was adopted in the Australian retail markets where an independent body set allowed gross margins.

Requiring a sufficiently expert and resourced independent third party to calculate the price to beat is the preferred approach, although this will come with additional costs.

Under either approach the model used would be published so that all suppliers could replicate the price to beat assessment themselves to give an indication on how prices may move in response to cost changes. An example is set out in the table below.

**Table 5:7: Proposed bottom up approach to create the price to beat tariff**

Step 1		
	Ex-ante	Ex-post
Network charges		As published
Wholesale costs	<p>From hedging model:</p> <ul style="list-style-type: none"> <li>▪ u% seasonal contract 1</li> <li>▪ v% seasonal contract 2</li> <li>▪ w% month ahead contract</li> <li>▪ x% week ahead contract</li> <li>▪ y% day ahead contract</li> <li>▪ z% “shaping” costs</li> <li>▪ imbalance costs</li> <li>▪ mark-to-market/ credit costs</li> </ul> <p>Note: different approaches for gas and fuel and taking account of peak/ off peak in power.</p>	
Operating costs		<ul style="list-style-type: none"> <li>▪ customer services—energy trading and settlement, retail pricing, marketing, customer</li> </ul>

	<ul style="list-style-type: none"> <li>acquisition and retention, billing, customer enquiries and complaints and debt management;</li> <li>business services—finance, HR, regulation, general management, IT, facilities and premises and insurance and rates.</li> </ul>
Retail margins	<ul style="list-style-type: none"> <li>Benchmarking of range of indicative margins from REMM trends, as described in section 6.5</li> </ul>
Policy costs	<ul style="list-style-type: none"> <li>PSO (electricity)</li> <li>RO (electricity—at buy out price)</li> <li>CCL (small I&amp;C only)</li> </ul>
Demand	From system operators for seasonal normal conditions
Allocate standing charges	$(\text{Sum of operating costs and network charges} / 365 \text{ days}) / \text{customer numbers} = p/\text{day}$
Allocate unit rate	$\text{Sum of hedging and policy costs} / \text{demand (kWh)} = p/\text{kWh}$

The independent third party would re-run the model on a quarterly basis to take account of changes in hedging costs and other costs, plus refine demand forecasts. The UR would provide at least one quarter’s notice of the intention to change the price to beat rates and include tolerance bands where modelled costs moved by  $\pm 5\%$  that would negate the need to change rates.

### 5.7.3 Verification

The UR would verify continuously that suppliers were only offering products that matched or bettered the price to beat rates.

**Table 5:8: Summary of options**

	SMP	“Inactive” tariff for incumbents	“Default” tariff	Tariff spread cap	Dominance thresholds	Gross margin cap	Price-to-beat tariff
Open to all consumers	✓ (SMP intervention on larger suppliers)	✗	✓	✓	✗	✓	✓
Household and small I&C	✓ (SMP intervention on larger suppliers)	Different application between markets	Different application between markets	Household only	As determined by dominance metric	Different application between markets	Different application between markets
Specific consumer segment	Different application between markets	Only eligible consumers with incumbents	✗	Household only (?)	Only dominant supplier customers	✗	Different application between markets
New entrant exemption	✓ (SMP intervention on larger suppliers)	N/A	✓	✗	Only dominant suppliers	✗	✗
Ex-post/ ex-ante assessment	Mix (where SMP is found)	?	Ex-post	Ex-ante	Dependent on regulatory intervention	Ex-ante	Mix
Explicit regulated price	✗	✓	✗	✗	Dependent on regulatory intervention	✗ (cap)	✓ (cap)