

Review of the Effectiveness of Competition in the Northern Ireland Energy Retail Market – Phase II Regulatory Implications

Options for Consultation

December 2015



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

Protecting consumers is at the heart of the Utility Regulator's (UR) role and working to deliver sufficient effective competition in the Northern Ireland (NI) energy market to protect customers is an integral part of our focus. Phase I of this review assessed the state of competition in the NI energy markets and highlighted areas which may require intervention. It endorsed the maintenance of price controls on dominant suppliers as an appropriate regulatory response.

This second phase of the review considers the regulatory options for the NI energy supply markets which could replace the status quo should the current form of price regulation cease. Cornwall Energy have developed a set of options for the NI market which could be employed in the event that the current form of regulation is changed which the UR are now consulting on. Bilateral meetings with stakeholders also helped inform the option development laid out in the Cornwall Paper, as well as consideration of the provisional findings of the CMA energy market review in GB.

Audience

Consumers and consumer groups; industry; and statutory bodies.

Consumer impact

The strategic goal of this project is to ensure that consumers are effectively protected in the NI energy markets. The direct consumer impact of this is likely to be on the end user price, when the current regime of price regulation on the incumbents only ends. However, all options are open including having no direct price regulation at all. This decision will be taken on the basis of the circumstances at that point.

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Glossary

CMA	Competition and Markets Authority
GB	Great Britain
I&C	Industrial and Commercial
NI	Northern Ireland
Ofgem	The Office of Gas and Electricity Markets in Great Britain
REMM	Retail Energy Market Monitoring
UR	The Northern Ireland Authority for Utility Regulation or the “Utility Regulator”

1. Strategic Background

1.1 Protecting consumers is at the heart of the Utility Regulator's (UR) role as outlined in its statutory duties. The UR operates to ensure both consumers are adequately protected and that open competitive markets are actively promoted.

Review of Effectiveness of Competition in the NI Energy Market Phase I Findings

1.2 During 2014 the UR commissioned Cornwall Energy to review the condition of energy supply competition in NI. This project assessed the NI energy markets along similar metrics as those followed by the UK Competition and Markets Authority (CMA) and Ofgem in their *State of the market assessment*¹, but recognising significant physical, size and market maturity differences between NI and GB supply markets.

1.3 The Cornwall Phase I report² laid out the findings in relation to the state of retail competition in the NI electricity and gas retail markets. The report made a number of secondary recommendations (e.g. around measures to improve customer switching rates, need for a price comparison website), which will be dealt with separately by the UR. The conclusions of the Phase I report were:

- The NI market has achieved reasonable levels of switching given the context of the market and its maturity.
- The 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

¹ The Competition and Markets Authority, Office of Fair Trading and Ofgem, "*State of the market assessment*", (March 2014), <https://www.ofgem.gov.uk/publications-and-updates/state-market-assessment>

² http://www.uregni.gov.uk/publications/ur_review_of_retail_market_effectiveness_-_cornwall_energy_report/

competitors focused on discounting of the Power NI price; gas incumbent market shares remain similarly high, with similar pricing strategies.

- There are limited supply players in the energy supply market and it is highly concentrated.
- Given the fundamental lack of scale of the NI market, this is unlikely to change and the number of suppliers in the market is unlikely to materially increase.
- Whilst competition has been reasonably effective up to now, given the structural characteristics of the market and the lack of sufficient critical mass to attract a larger number of suppliers, relying on competition is not enough on its own to effectively protect customers. Northern Ireland has only circa 788,000 domestic electricity customers and circa 167,000 domestic gas customers in the greater Belfast Area. (NI has less than 3% of the total number of domestic electricity customers in GB and, for example, is only around 70% the size of the market in greater Manchester).
- Those customers who wish to switch have arguably already done so, and it should not be expected that switching rates will continue as they have up to now. Research indicates high levels of “stickiness” amongst customers similar to those seen in GB.

- 1.4 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 co-exist with the ongoing development of competition. The Cornwall paper stated *“the NI experience strongly suggests that regulation and competition can successfully co-exist”*.

Review of Effectiveness of Competition in the NI Energy Market - Phase II Objectives

- 1.5 The UR began Phase II of this project in April of this year. The project's core objective is to assess the options for a future regulatory framework

(potentially including some form of price regulation) in a market where the current regime of price controlling the former supply incumbents only may no longer be appropriate. Price regulation in this context may or may not include the UR actually setting retail prices in some way. The detail of Phase II and the options which were developed as part of the project are discussed further in the accompanying Cornwall report.

- 1.6 The scope of Phase II covers the NI electricity and gas domestic and small I&C retail markets only. The larger end of the I&C energy markets were not within the scope of Phase II, as these were found on balance to be sufficiently competitive in Phase I.
- 1.7 Also, as stated in the information paper which was published in April 2015³, we intend to monitor the condition of competition in all sectors going forward. It is likely that the REMM⁴ project will be used as the tool to carry out this monitoring. In addition to this, there will be ongoing liaison with customers, suppliers and consumer bodies.

Legal Context

- 1.8 The NI gas and electricity retail market liberalisation commenced during the last decade. This ongoing process continues to take place within the wider context of European legislative requirements to open energy markets across the EU, whilst also maintaining high standards of public service and ensuring the protection of final customers, and the UR principal statutory duties.

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http://www.uregni.gov.uk/news/view/ur_publishes_information_note_on_review_of_effectiveness_of_competition_pha/

⁴ http://www.uregni.gov.uk/news/view/retail_energy_market_monitoring_remm_final_decisions_published/

- 1.9 Promoting effective competition and protecting consumers are both obligations of a national regulator under EU law. There is a duty to achieve each of them. It is for the member state and the NRA to decide on the policies which strike the correct balance in achieving both obligations in the context of each particular jurisdiction.
- 1.10 Price regulation is compatible with existing EU law and can be employed by a regulator as a means of protecting customers, as long as any such intervention is justified and proportionate.

CMA Review and Findings, and relevance to NI

- 1.11 The final report of the current CMA review of GB energy markets⁵ is due for completion in April 2016. The provisional findings were published in June 2015⁶. Previous to this, the CMA stated that its focus and concerns were not on the wholesale energy market in GB, but rather the retail sector where they identified certain concerns on consumer harm.
- 1.12 The findings highlighted that there were a combination of features in the GB market which have an adverse effect on competition. For example, one of the areas examined by the CMA related to ‘weak customer response’. Within this area they highlighted the issue of the ability of suppliers to use their unilateral market power to charge more to their “inactive” or “disengaged” customers. They also pointed to the fact that energy is a homogenous product and as such customers are less interested in it as a product of “choice”, and in their ability to switch providers.

⁵ <https://www.ofgem.gov.uk/gas/retail-market/market-review-and-reform/state-competition-energy-market-assessment>

⁶ <https://www.gov.uk/cma-cases/energy-market-investigation>

1.13 The CMA have made a number of initial proposals and remedies to help address the issues which will be the subject of further consultation.

Amongst other things these include:

- removing from domestic suppliers' licences the "simpler choices" component of the RMR rules—this would including removing the four-tariff cap;
- measures to address the barriers to switching by domestic customers;
- the introduction of a new requirement in the licences of retail suppliers to provide price lists for micro-businesses on their own websites and to make this information available to price comparison websites;
- 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;
- additional measures to provide customers with additional information to reduce perceived barriers to accessing and assessing information;
- measures to prompt customers on default tariffs to engage in the market; and
- a "transitional safeguard regulated tariff" for disengaged domestic and micro-business customers to protect them from the abuse of market power by their suppliers.

1.14 These provisional findings and the proposed remedies have been considered by Cornwall and the UR in the development of potential future regulatory options for NI. As with Phase I of the project, we wish to be cognisant of the findings and final decisions taken by the CMA and evaluate their merit in the NI context. To this end we are liaising directly with the CMA and discussing their market investigation findings and their relevance to NI. However, we are mindful that the NI market is fundamentally different from that of GB. This is true in terms of scale, number of suppliers and potential for new entry. Cornwall and the UR have

however given consideration to the relevance of the provisional findings in development of the options and policy approaches for consultation. As previously stated, the CMA are currently planning on publishing their Final Report in April 2016 (with provisional decision on remedies in January 2016). The UR will likely publish the decision paper of this Phase II after April 2016 and as such we will take into account the CMA decision on remedies.

Current Regulatory Framework

- 1.15 Since the liberalisation of the energy retail markets in electricity and gas in NI, UR has followed a policy of continuing to price control the former incumbent gas and electricity suppliers who remain dominant in certain market sectors, whilst progressively lowering the threshold for price regulation as competition developed in the larger user end of the markets.
- 1.16 Power NI in electricity, and Firmus (Ten Towns areas) and SSE Airtricity (Greater Belfast) in gas, are currently subject to retail price controls in the household and small I&C markets. The UR has stated⁷ in the most recent price control settlements that for gas it “will consider the issue of the customer scope of the controls again at the time of the next Firmus (and SSE Airtricity) price controls”.
- 1.17 The UR took a very similar approach in electricity stating that there are set criteria which will automatically trigger a further consultation on the reduction or removal of the Power NI price control in the 0-50MWh non-domestic market. The criteria to be satisfied were:
 - Power NI/Energia must have a combined market share (by consumed units) of less than 50% for two consecutive quarters; and

⁷ http://www.uregni.gov.uk/publications/firmus_energy_supply_ltd_price_control_final_determination

- there must be a minimum of three independent suppliers, each of which has at least a 10% share of consumed units in the relevant market⁸.
- 1.18 It is important to be clear that the meeting of these criteria merely outlined the basis on which a further consultation would take place, at which point all of the relevant factors would need to be considered in detail.
- 1.19 With regard to domestic electricity customers, the UR also clarified that it currently views the domestic market as one market, irrespective of the way in which customers decide to pay for the electricity that they consume. The UR has not outlined a specific set of criteria for the domestic market, as the position in relation to that market is much more complex and will require detailed consideration of a wide range of factors, including in particular the need to ensure a high measure of protection for the interests of vulnerable consumers alongside the promotion of competition.
- 1.20 This regime to date has been successful, and today domestic and small business customers enjoy both the benefits of competition with a choice of providers, alongside price regulation which ensures that there is a regulated price (which is transparently set) that customers can avail of should the competitive market not provide reasonable offerings. The regulated price allows the dominant suppliers to cover their efficient cost levels, together with a regulated profit allowance.
- 1.21 The other suppliers in the market have tended to price at a discount to the regulated tariffs and as such the regulated tariffs have, to a large extent, acted as a “price to beat” or price cap on the market. This model has helped to ensure that the NI market has not encountered the problem of a lack of price movement transparency which customers and media in the

⁸ What this means in practice is that the market would consist of at least Power NI/ Energia plus two other suppliers which are independent of them and which each have a market share of at least 10%.

GB market have complained of; and has been welcomed by consumer bodies.

- 1.22 The model effectively allows UR to deliver customer protection, including against supplier dominance which was identified in the Cornwall Phase I findings, whilst also promoting effective competition where possible. As highlighted previously in this paper Cornwall stated that there was likely to be a requirement for this 'hybrid model' to continue until the tests previously specified as triggering a consultation on removing the current controls are met.
- 1.23 It is anticipated that any new regulatory framework will only be implemented **after** a cessation of the prevailing electricity and gas price control regimes which apply to dominant former incumbent suppliers only.
- 1.24 At the heart of the UR's objective in this project is to ensure that if intervention is necessary, following the lapse of the current price controls, competition and regulation (in whatever form it may take) coexist to deliver sufficient protection for all household and small I&C consumers.

2. Phase II Regulatory Options

- 2.1 As stated in section 1, the core objective of Phase II of the Review of Effectiveness of Competition is to assess the options for a future regulatory framework in a market where the current regime of price controlling the former supply incumbents only is no longer appropriate.
- 2.2 It is important to note that whilst we are consulting on the options stated below it may be the case that the UR may implement a policy which involves no explicit direct price regulation or one which involves some form of price regulation, or none of the options discussed. The UR could take the decision to end all price regulation and let competition by itself protect customers with regard to price.
- 2.3 The UR engaged Cornwall Energy Limited to help develop potential options for a future regulatory framework in the NI energy market.
- 2.4 Specifically, Cornwall were engaged to assist the UR with producing a full list of options for consultation which could potentially be employed in a new regulatory framework after the cessation of the current regime. This included:
- Research into other jurisdictions' regulatory frameworks in energy supply markets;
 - Defining each of these potential options in enough detail so respondents can give their views on them;
 - Undertaking stakeholder engagement in the development of potential options;
 - Developing methodologies for the implementation of the identified options, which are included in the consultation paper, to allow consultees to make an informed consideration of the options; and
 - Consideration of any outcomes of the ongoing CMA review of the GB energy market, and the potential regulatory impacts/lessons for NI, and if this has an influence on the options which UR may consider

Project to Date

- 2.5 The project formally commenced in April 2015 when the UR published an information paper.
- 2.6 Since the commencement of the project Cornwall Energy have been developing an “Options” paper for the UR which contains the potential options for a regulatory framework once the current form of regulation ends. These are the options which the UR is now consulting on. The Cornwall Energy paper is contained in **Annex I** to this UR paper.
- 2.7 As noted, research into regulatory frameworks operating in other jurisdictions worldwide was used to help inform the development of the options for consultation and to ensure as far as possible that no viable options were overlooked.
- 2.8 During the course of developing the options, Cornwall also conducted a number of stakeholder engagements in NI. This was done through a number of bilateral meetings with suppliers and consumer groups. Stakeholders were given the opportunity to view the proposed options being considered in advance of the meetings. In this context, the meetings were used for detailed discussion on the options and their relevance in the NI context. Stakeholder views were taken into consideration in the further development and refinement of the proposed options for consultation.
- 2.9 As previously highlighted the CMA review and their provisional findings were also taken into consideration.

Options for consultation

- 2.10 As stated above, the Cornwall paper which provides the detail on the various options for consultation is contained in Annex I to this paper.

2.11 The options developed by Cornwall could potentially be used as the basis for a future regulatory framework for the NI energy market after the current form of regulation has been removed.

However, as mentioned at the beginning of this section whilst we are consulting on the options stated below it may be the case that the UR may implement a policy which involves no explicit direct price regulation, or one which involves some form of price regulation, or none of the options discussed. The UR could take the decision to end all price regulation and let competition by itself protect customers.

2.12 Seven options have been developed by Cornwall Energy which, as previously stated, the UR are now consulting on. They are :

1. **Significant Market Power** – undue preference and undue discrimination licence obligations would be switched on for any supplier deemed by the UR under established criteria to have significant market power (SMP).
2. **Inactive Customer Tariff** - for incumbent suppliers' disengaged customers (not all suppliers as with option 3). This option would only apply to the former incumbent energy suppliers.
3. **Default Tariff** - for those consumers unwilling or unable to engage with the market. All suppliers will offer this tariff (not just incumbents as with option 2). Therefore this option would apply to all suppliers.
4. **Tariff Cap Spread** - limitation on the differences between the most expensive and cheapest tariffs of a supplier.
5. **Dominance Thresholds** – setting market thresholds above which if a supplier or suppliers are deemed sufficiently dominant to be able to exert market power a price control or other regulatory solutions would be implemented.
6. **Gross-Margin Cap** - where suppliers would only be permitted to put rates into the market with a maximum level of gross margin.

7. **Price-to-Beat Tariff** - offer determined by the UR that suppliers would have to match or better.

2.13 As stated previously, any change in regulatory framework would only take place when the current form of price controls on the incumbents had been removed.

Scope – domestic and small I&C coverage

2.14 Section 1 highlighted that this project covers both domestic and small I&C customers. Small I&C refers to electricity business consumers with an annual consumption up to 50MWh. For gas, this covers business consumers with annual consumption up to 73.2 MWh. At this stage we are sufficiently concerned about ineffective competition for the small I&C customer group that our view is that we may potentially adopt one of the options contained within Annex 1. We note here that the CMA review in GB also contained several areas of concern over customer detriment in the small I&C sector.

2.15 The findings of the Phase I report were not conclusive about the state of competition in the small I&C market in Northern Ireland. In GB the CMA initial findings point to a number of issues with this category of customer and certain negative outcomes for customers. They highlighted the fact that the level of margin being earned on this group was high. The data received through REMM will allow the UR to further ascertain if the NI I&C market is functioning well. However it is our view that it is reasonable to assume that we will see at least some of the same problems as the CMA have identified in GB – the small I&C customers in NI will have similar characteristics as their GB counterparts.

2.16 We are also of the view that micro businesses display many of the same characteristics of domestic customers and as such should arguably be afforded some, if not similar, protection. However, we are also mindful of

the fact that the small I&C market has some differences to the domestic one: there are more suppliers, the customers are businesses not households and for many, but not all, energy bills make up only a small fraction of their outgoings.

- 2.17 We are not in a position to say that the issues which have been identified in the GB market will not be replicated in the NI energy market and as such we are taking a prudent view to allow them to remain in scope at this stage.
- 2.18 It is difficult to state at this stage, in the absence of the REMM data required to make a considered judgement, whether any option taken in the small I&C market will be the same as any option/s chosen for the domestic market.

Future Implementation Approach

- 2.19 The aim of Phase II of the project is to allow a viable set of options to be developed which stakeholders are consulted on. This will lead to a final set of options with a preferred option/s which can be used when required. The rationale for carrying out this piece of work in advance is that we are of the view that the market needs an indication of how the regulatory model will change and also it ensures we are ready when the change in regulatory framework needs to be made.
- 2.20 In terms of the scheduling of implementation of any new regulatory framework, the timescales at this point are unclear. The current incumbent supplier price control regime will continue for the foreseeable future, where they are deemed to be dominant in the relevant energy markets.
- 2.21 This dominance may gradually erode and potentially lead to a situation where an incumbent's market position relative to other suppliers changes to a point where they can no longer automatically be deemed to be dominant. This could happen in either the small I&C market or the domestic market or indeed both.

2.22 As highlighted previously, in terms of the seven options outlined above, the UR may decide to implement a policy which involves no explicit direct price regulation, or one which involves some form of price regulation, or none of the options discussed. This is because it may be the case that the UR would take the decision to end all price regulation and let competition by itself protect customers in relation to price.

Under this scenario we would need to use the monitoring framework to observe the market outcomes for customers and if these were detrimental it could lead to the reintroduction of price regulation. **This decision however can only be taken by looking at the NI market situation at the time when the current regime ends and when the reality of the market is observable. We need to maintain a level of flexibility at this juncture and cannot fetter our discretion regarding any future decision.**

2.23 Our eventual decision on what, if any, form of regulation will follow the removal of the current price controls will be taken in the context of our legal framework which includes:

- Our statutory objectives under Articles 12 and 14 of the Energy (NI) Order 2003, noting that these are different as between gas and electricity; and
- the relevant obligations set out in the Third Package which are incorporated through Articles 12 and 14 of the Energy Order.

2.24 In the interim it is important to allow the market to develop and it may be that competition will be working sufficiently by the time any new regulatory model is required. The UR will continue to monitor and promote competition in the market and this includes some of the recommendations from the Phase I report.

3. Stakeholder Consultation

- 3.1 One of the primary purposes of the consultation is to provide the UR with stakeholder information and views to help the UR assess the options which have been developed by Cornwall, as well as the option of no price intervention, with regard to: deliverability, applicability and practicality in the NI context.
- 3.2 It will also provide the UR with some of the initial information required to consider whether each of the options meet the tests of proportionality and necessity (although this analysis will only be capable of being fully carried out at the point at which the current price controls are to be removed).
- 3.3 We note that consultation on the options detailed in the Cornwall energy paper prior to the point at which we would consider removing or amending current controls is looking forward a step. However, we are doing so in the context of providing transparency and with a view to developing a clear way forward for the electricity and gas retail sectors.
- 3.4 The UR wishes to ask respondents the specific questions below regarding the options provided in the Cornwall Energy paper (**respondents should be clear in their returns whether they are referring to domestic or I&C market or if their responses apply to both**):

Q1. Whether each option strikes a fair balance between the rights of customers and the rights of any supplier which would be subject to that option?

Q2. Whether each option strikes an appropriate balance between the protection of customers and the promotion of competition?

Q3. Whether each option is likely to protect vulnerable customers (including, in particular, persons who are chronically sick or disabled, of pensionable age, on low incomes or residing in rural areas)?

Q4. What are the burdens that are likely to be placed on suppliers made subject to each option?

Q5. Are those burdens disproportionate to the benefit secured and, if so, is there a less intrusive or onerous measure could be implemented by the UR?

Q6. Do consultees have any other comments on the options put forward?

Q7. Are there any other options not included in Cornwall's list?

3.5 The UR also wishes to seek views on the issues below

Q8. Feed back is sought as to whether or not there should be a period during which the energy retail markets are allowed to operate with no price controls, subject to enhanced monitoring. This consultation seeks views on whether there should be a period of deregulation or an immediate move to any of the options presented.

4. Next Steps and Responses

4.1 The Cornwall paper contained in Annex I to this paper sets out in detail the options which are being consulted on.

4.2 The UR wishes to hear respondents feedback on these options, including the elements within each that they support and those they do not. In each case the UR is keen that respondents clearly articulate the reasons for their views.

How to Respond

4.3 The UR is keen to hear all stakeholder views on the proposed policy approach and the options.

Responses to this consultation should be forwarded to reach the UR on or before 4pm on Friday 18th March 2016 to:

Nicola Sweeney

The Utility Regulator

Queens House

14 Queen Street

Belfast

BT1 6ED

Email: Nicola.Sweeney@uregni.gov.uk

4.4 Your response to this consultation may be made public by the UR. If you do not wish your response or name made public, please state this clearly by marking the response as confidential. Any confidentiality disclaimer that is automatically produced by an organisation's IT system or is included as a general statement in your fax or coversheet will be taken to apply only to information in your response for which confidentiality has been specifically requested.

- 4.5 Information provided in response to this consultation, including personal information may be subject to publication or disclosure in accordance with the access to information regimes; these are primarily the Freedom of Information Act 2000 (FOIA) and the Data Protection Act 1998 (DPA). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things with obligations of confidence.
- 4.6 In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Authority.
- 4.7 This document is available in accessible formats. Please contact: Nicola Sweeney on 028 9031 6622 or nicola.sweeney@uregni.gov.uk

Next Steps

- 4.8 Once all the responses to this consultation paper are received and analysed, the UR intends to issue a final report which will analyse stakeholders' responses to this consultation. We indicated in our information paper that the anticipated timelines for this report to be issued was December 2015. However, in light of the delay in the publication of the CMA final report (which they now indicate may be April 2016) we intend to delay the issue of our final report until we are clear if their findings may impact upon any approach we take. Any final decision as to what will follow the removal of the current price controls will only be made at the point of removal, in light of the prevailing market conditions at that time.