

**Utility Regulator's Draft
Forward Work Programme
1 April 2012 – 31 March 2013**

Consultation

Power NI's Response

20 January 2012



Introduction

Power NI welcomes the opportunity to respond to the Utility Regulator's (UR) Draft Forward Work Programme for the period 01 April 2012 to 31 March 2013.

As stated in our previous responses, Power NI welcomes this process of consultation as a constructive step towards providing visibility of regulatory strategy and an indication of the key short to medium term UR priorities.

As the electricity supplier to circa 700,000 customers within Northern Ireland, Power NI has reviewed the document and would make the following comments with regard to specific matters of interest –

Price Controls

A price control review should be set against a backdrop of striking a balance between protecting customers and ensuring that companies are able to finance their activities in a sustainable way. Principles of best practice regulation should be observed including providing regulatory certainty, giving due consideration to all aspects of the market as well as changes in the operating environment. Of particular importance within recent price controls are the capital requirements to support the business's operations and the implications of risk.

Power NI acknowledges that policy contexts are evolving and the regulatory framework must follow suit. To prevent regulatory uncertainty developing however, this evolution must be managed in a transparent, inclusive and engaging manner.

Given various governmental targets, the encouragement of investment in the Northern Ireland energy sector and economy generally, is of paramount importance. If these targets are to be delivered, balancing the long term benefit and the short term impacts on consumers can only be achieved through reasonable returns on capital and regulatory certainty / consistency.

To ensure that companies are able to finance their activities is critical to the UR's duties. This can only be achieved within the current (and foreseeable) economic climate by the detailed assessment of capital requirements to finance a regulated activity and the cost of that capital. Providing adequate returns on capital ensures ongoing financeability and maintains investment confidence. The UR therefore must ensure that it carries out robust analysis utilising industry best practice to deliver transparent reasonable decisions.

Power NI strongly believes that the UR should recognise the effect of the margin in this context and that this should be set at a reasonable and appropriate level following a detailed building block approach to analysis.

Considering net margin in isolation, while driving opex allowances below an efficient level represents an unreasonable strategy.

In Power NI's view there are four main objectives of a price control in an increasingly competitive market such as the present situation. It should:

- Protect customers from prices that are higher or service quality that is lower than competitive levels;
- Ensure that suppliers are able to finance their activities;
- Promote competition by facilitating additional entry. This is unlikely to happen unless prices are set as they would be in a fully competitive market by reference to potential entrants' prices and margins and not by reference to the costs of the most efficient company and returns on capital consistent with a monopoly network business; and
- Encourage efficiency, both productive efficiency (by providing incentives for companies to reduce costs) and allocative efficiency (by ensuring that prices reflect costs). When prices reflect costs, customers are able to make efficient choices that ensure goods and services are consumed when the benefits obtained from them exceed the costs of providing them.

Power NI believes that these objectives accord with the UR's duty to "protect the interests of electricity consumers with regard to price and quality of service, where appropriate by promoting competition" and acknowledge that there is a balance to be struck between consumer costs and allowing sufficient margin to enable a supplier is able to secure appropriate finance.

Power NI does not consider that these objectives led to the recent methods of deciding a price control adopted by the UR; which has been to forecast operating costs on the basis of a level of costs below that achieved in the previous year and to add a small margin consistent with a low risk, asset rich regulated business.

The UR has also engaged in a series of short term price controls that are increasingly truncated and have lacked the supporting analysis that a regulated business would have the right to expect.

Short price control terms remove the incentive for efficiency. A standard utility price control that allows efficiency savings to be retained by the company for five years would (at a 7% discount rate) give 30% to the company and 70% to the customer. This assumes a rolling incentive that allows gains towards the end of the period to be retained in the next price control period, as is the case for transmission and distribution in Northern Ireland. If costs are rebased at the end of each five year period to the level of costs in the fourth year (which is probably the latest data available) and efficiency gains are distributed evenly the ratio would be something like 20%:80%.

Such continuous review therefore compromises the basic premise of incentive regulation, which is to provide a reasonable return for risks taken in securing savings, with the greater proportion of savings passed to the customer.

Regulated Tariff Reviews

The UR has a number of regulated tariffs to review which feed into the electricity prices paid by consumers. As the only price regulated electricity supplier, Power NI is reliant upon the timely publication of these elements. The timetable ensures that the end tariff is submitted to the UR and critically publicised in the correct timeframe. Over recent years Power NI has experienced slippage in approval of these tariff components (for example the PSO rate was only published on the 12 August 2011 when retail tariffs were due on 10 August 2011) and would urge the UR to develop and ensure compliance of a reasonable tariff timetable.

Monopoly Regulation

While Power NI is aware of work underway through the SIG Group regarding the standards of service provided by monopoly networks businesses, we would urge the UR to consider Northern Ireland Electricity's (Transmission and Distribution acting as common services provider) responsibilities to Suppliers as well as those directly with consumers. Many of Suppliers interactions with customers are dependent upon the actions of NIE T&D, the accuracy of meter readings being the primary example. Timely fieldwork and responses to Supplier driven queries on behalf of a customer should be afforded the same level of protection as if the query came directly from the customer.

Retail Electricity Competition

Power NI has also noted that there was no reference within the UR's Forward Work Programme in relation to the production of a deregulation roadmap or explicit reference to the UR reviewing the electricity retail market and the scope of regulation.

With active competition in all sectors of the electricity supply market within Northern Ireland, it remains the reasonable expectation of Power NI that the UR would outline their glide path to full electricity deregulation in a similar manner to the CER publication in the Republic of Ireland.

Power NI believes that if a market is demonstrably competitive, the prolonged application of a price control will compromise the proper operation of a competitive market and is in effect counterproductive. Regulation can in fact inhibit the development of or distort competition and therefore the UR should

be cognisant of potential unintended consequences of continued price controls.

Unnecessarily extending price controls in competitive sectors is a policy which differs from other markets and creates undue regulatory risk. This could impact the efficient securing of capital as global financial institutions have an expectation of regulatory consistency.

Over recent years extensive competition and switching has taken place within the commercial sector. This has also recently begun to develop in the domestic market. This clearly illustrates the evolving nature of the electricity market in Northern Ireland, an evolution which will continue throughout the life cycle of this price control.

Power NI would encourage the UR to give urgent consideration to an immediate further reduction of the scope of price control in the business sector focused on customers consuming greater than 50MWh and group customers. Power NI believes that there is clear evidence of active price competition in these sectors.

The removal of the retail price control will allow these consumers to engage with a greater number of suppliers who are able to tailor products, participate in the tendering process, provide quotations and compete for their business on a level playing field. This is a requirement which has been clearly communicated by consumer associations and customers alike as it provides increased 'real' competition whilst having the comfort of consumer protection through normal regulatory arrangements.

Power NI believes that this interim step would have a positive effect on the electricity market, is consistent with the UR's statutory objectives¹, removes a real current competition inhibitor, is consistent with GB and European policy decisions, and facilitates headroom to give further consideration to the regulatory approach. To further delay this proposed next step in order to conduct market reviews assumes that all sectors of the market are at the same level of maturity, which is clearly not the case.

The UR must look to minimise the burden of regulation in terms of unnecessary interference in the market, complexity of rules, rate of change and aim to achieve consistency and clarity of approach.

Lower consumer prices will always be a perceived benefit and desired outcome especially in the current economic climate; however service delivery and innovation are also important factors. In restricting the market, new costs of competition are added, the cost of regulation is maintained and diseconomies of scale are forced. Many of these costs would not be incurred

¹ As reaffirmed by the National Audit Office, which states that "the processes used by Ofgem, Ofcom and Postcomm for removing retail price controls were consistent with their statutory duties of protecting consumer interests through the promotion of competition." and "The removal of price controls is an important step in the development of competition"

in a market without competition or a fully competitive market. It is inevitable therefore that the half way house approach taken by the UR in relation to price regulation is in effect adding cost to the consumer.

Single Electricity Market (SEM)

A successful retail market is contingent upon an effective wholesale market. In 2007 the Regulatory Authorities (RAs) in conjunction with government and the electricity industry established the Single Electricity Market (SEM) to give effect to an all island wholesale market for electricity.

In the design of the SEM the RAs (including the UR) were particularly conscious of the portfolio of supply and generation held by market participants active within the market. In the interests of transparency, competition and both wholesale and retail market development the RAs implemented a range of measures to define market power and mitigate against any possible exploitation of a dominant position.

The Bidding Code of Practice (BCoP), Market Monitoring Unit (MMU), Directed Contracts (DCs) and Economic Purchase Obligations (EPO) are all active measures playing an important role within the SEM. As a supplier, Power NI welcomed the implementation of these measures and continues to believe that the BCoP, MMU and DCs are important controls on the cost of wholesale electricity, while the EPO is intrinsically linked to retail competition and deregulation.

Power NI acknowledges the continuously evolving nature of the wholesale electricity market with increasing competition, investment, divestment, wind capacity and interconnection all potentially changing the current landscape. It is in this context that the UR must be mindful of the effect regulatory measures have on the opportunity for 'gaming' both in the spot and contract markets, as well as the availability of reasonable hedging products and volumes especially given the knock on effects into the retail market.

Securing effective hedges is fundamental to ensuring competition and delivering products that end consumers want. While little consideration was given to the contract market during the SEM design and development, the fundamental effect the contracts have on end consumers should prompt the RAs to attach greater importance to this area. The lack of liquidity is of real concern and Power NI would urge the UR to carefully consider any decision in relation to market structure, participant structure or mitigation measures which reduce liquidity. Consequential increased exposure to fluctuating pool price, contract scarcity and a lack of a reasonable contract market will all ultimately manifest in greater costs borne by end consumers and may make certain entities participation in the market untenable.

Power NI believe that the current market already suffers from such a degree of scarcity that contract price premiums have been seen in the NDC market. Reserve prices in many cases are far in excess of DC equivalents leaving

suppliers and ultimately customers exposed to these high prices. The lack of visibility and clarity of auction timetables and volumes to be sold also contributes to a price premium. Power NI would urge the UR to mandate greater transparency of the contract auction plans and assist the market in moving away from a reactive hedging approach.

In assessing the effectiveness of the BCoP and MMU in regulating the generation offer price into the SEM, the Cambridge Economic Policy Associates (CEPA) study² concluded that the measures have been successful, however clarify that their success should not be interpreted as a reason for their removal. Power NI concurs with this view and would suggest that enhancing the transparency, engagement and proactive nature of the MMU would benefit the operation of the wholesale market.

While the BCoP, MMU and DC measures implemented by the RAs through the SEM design are effective in mitigating against the exercise of market power, there have been few regulatory measures to encourage or enhance any degree of liquidity in the contracting market. DCs, by the RAs own admission, are designed primarily as a market power mitigation measure with their contribution to liquidity a secondary feature.

It is widely acknowledged that the DC product does have a number of flaws such as the contract timing window, type of offer, volume etc however as an active participant in the contracting market, Power NI view the DC provision as essential and would welcome the DC volumes increasing and being offered over a longer time period.

Power NI cannot over emphasise the importance of the contract market and having sufficient volumes available. The contracting outcomes go a significant way to setting the retail price. Power NI believes that as well as assessing the current market arrangements it would benefit the retail market if the RAs actively considered supporting the implementation of an “Electricity Forwards Agreement” type contract structure as an innovative way to circumvent the scarcity issue.

Power NI also continues to be extremely concerned with the UR’s inconsistent view of hedging transfers. The approach adopted to date, has prevented Power NI’s participation in sectors of the competitive market and resulted in customers not being able to secure quotations from all active suppliers. This reflects poorly upon the operation of the electricity market, frustrates competition and is contrary to the UR’s obligations. The regulatory exclusion of a supplier from the tendering process in effect reduces the choice for a customer, potentially exposing them to the price premium of a limited field.

Currently within the Single Electricity Market (SEM) all Suppliers are not settled using the same methodology. Global Aggregation will ensure that this is corrected and the fundamental Trading and Settlement Code (T&SC) objective of avoiding undue discrimination achieved. Power NI therefore

² Published as part of the Market Power and Liquidity workstream

strongly advocates the expedient implementation of global aggregation. The current market arrangements do not achieve the T&SC section 1.3 (6) objective of avoiding undue discrimination. The Supplier who is obliged to assume responsibility for an ESU is settled in a different manner to and assume a greater risk than other Suppliers active in the SEM. Global aggregation corrects this imbalance. Given this and mindful of knock on effects of deregulation, changes to TLAFs and other market factors it is important that global aggregation is implemented in a timely manner. Global aggregation cannot be implemented in Northern Ireland prior to the Enduring Solution, however due to the reasons set out Power NI urges the UR to ensure that it is implemented either with the Enduring Solution or immediately thereafter.

The SEM is also currently faced with compliance requirements relating to Capacity Allocation and Congestion Management. This workstream is following on from the Intra Day Trading Project. Power NI acknowledges that the Intra Day Project was faced with difficult timing issues however would urge the UR to be mindful of the effects and costs of engaging vendors prior to participants at a detail level.

Consumer protection

Power NI welcomes the inclusion of a UR action to consult on and implement a new code of practice on marketing and door-step selling. Power NI would urge the UR to give this action a high priority. Experience in the GB market has shown that door-step selling generates a high number of customer complaints and general dissatisfaction with the electricity industry. While Power NI does not engage in this practice, customer feedback and calls have made us aware of similar dissatisfaction in the NI market.

Vulnerable Customers and the EU IME3 Legislation

Power NI will continue to be at the forefront of providing value added services in support of society's most vulnerable customers. As competition develops, particularly in the domestic sector, consumer protection becomes increasingly relevant. Power NI welcomes the goals of the IME3 Directive and will continue to actively engage with the UR to seek its successful implementation.

Transparency underpins the IME3 directive. The implementation of information transparency requires a balance to be struck between inundating the customer with data and the simplicity of presentation. The provision of data has cost implications which will ultimately be paid for by the customer. Careful consideration is therefore required of the potential benefits resulting from the information provided. Throughout the IME3 review the UR should be mindful of the additional costs which will arise from placing onerous new requirements on suppliers without a clear cost benefit assessment.

Within the IME3 consultation paper and during IME3 considerations, the UR appears concerned regarding the percentage of customers who have not switched in GB. While the statistics are useful the UR should be mindful that the goal is an effective market with well informed, protected consumers who are aware of the option to switch. Switching per se will not necessarily achieve greater protection, service or price (particularly post any introductory offer) for a consumer. This is especially the case in a market where the incumbent is an efficient, price competitive supplier providing excellent customer service. To advocate switching suggests that the UR is recommending one supplier over another and therefore seeking to unduly influence the operation of the market.

Smart metering

Power NI is somewhat surprised that Smart metering was not included in the Forward Work Programme. This is an area which has been lacking clear regulatory direction for some time and the publication of a decision paper in 2012 would be a welcome development.

Conclusion

The Forward Work Programme contains a substantial number of regulatory goals and represents a significant challenge. Taking the above comments in a constructive manner, Power NI believes the programme contains reference to the majority of expected areas and looks forward to working closely with the UR and other stakeholders where appropriate.