CER Consultation on the ESB PES's Revenue Regulation Framework

NIE Energy Supply's Response

16 April 2010

The Irish Commission for Energy Regulation (CER) and the Northern Ireland Authority for Utility Regulation (AUR) have said in their joint memorandum of understanding that they will apply a *"consistent and harmonised approach to the regulation of wholesale and retail markets"* and they have jointly commissioned work on retail regulation including the Skyplex report, "A Review of K-Factors and Supply Margins in the Single Electricity Market", on which these present proposals are said to be based.

The proposals are therefore of interest to NIE Energy Supply (NIEES) and we should like briefly to make a number of points concerning them.

The two chief points are that we consider that:

- The proposed restriction of allowable contract costs to 50% of forecast demand potentially harms PES customer interests; and
- The extent to which CER appears to wish to retain power to approve tariffs is incompatible with the proposed asymmetric correction (k) factors, which potentially make PES profits dependent on tariff setting.

The draft decision paper seems to contain four proposals that, while there are some interactions between them, can be considered largely separately. These are to:

- Restrict which generation costs may be allowed by limiting contracts for differences (CfDs) to only 50% of forecast demand;
- Limit the size of under-recovery that may be corrected by setting a cap of 3%;
- Limit or remove entirely the return of over-recovery below that size limit; and
- Change the process whereby ESB PES sets tariffs, particularly in respect of the role played by CER.

Contracting Cover Restriction

It is not clear why CER is proposing to change the definition of maximum allowed revenue (MAR). This presently includes any energy contract market purchases efficiently purchased by a PES under its economic purchasing obligation (EPO). CER proposes to set a maximum of 50% contract cover.

Excluding CfDs (and presumably other hedges such as on fuel prices), and so forcing PES tariffs to reflect pool prices more closely, would be likely to increase tariff instability and may also damage prospects for generation investment by reducing contract demand. It would also be likely to reduce protection for PES customers and to lead to inefficient market outcomes.

We think that the restriction would be bad for customers and would severely complicate the already difficult task of tariff management. It is also incompatible with the economic purchasing obligation (EPO). Where a supplier is not free to pass on its purchase costs it is not reasonable to subject it to an EPO in its present form.

If a price control effectively prevented a PES from hedging more than 50%, which is less than what is presently considered to be economic, the EPO would need to be altered so that the PES should purchase economically but only amongst the purchase options that are recoverable under its price control.

We would also note that vertically integrated companies under common ownership benefit from implicit hedges, even if no CfDs are explicitly written. Restricting hedging by one part of a vertically integrated company may have implications elsewhere.

Asymmetric Correction Factors

It is reasonable to seek that correction factors should be minimised, although the proposed CfD restriction will make that more difficult. However, NIEES does not consider that asymmetric correction factors outside a tolerance band have great advantages, particularly if other incentives – such as a licence obligation or partial asymmetry (reducing the proportion of under-recovery assigned to the k-factor) – are available to keep errors down. There is also the considerable incentive that it may not be possible to recoup a large under-recovery in a competitive market.

Nevertheless, we are not opposed to the proposed change provided that a PES is free to adjust its tariffs and the additional risk this creates is recognised by an increase in the allowed margin.

Asymmetric correction within the tolerance band – whereby PES would retain any over-recovery but still be entitled to reclaim an under-recovery - has the advantage of restricting the number of instances when the price control might force the PES to price below competitive levels and so removes a problem for competitive entrants.

Approval Powers

More consideration needs to be given to precisely how the mechanism would work. CER seems to wish to use its approval powers to resolve any problems but, for the reasons given below, we think this would be bad regulatory practice.

NIEES agrees with the sentiment underlying CER's question 5, that PESs should be free to set tariffs subject to their conforming to the PES's various obligations. Tariffs must be consistent with the price control and, where the PES is dominant, be neither predatory nor discriminatory. However, it is not quite clear what system is being proposed by CER. The question remains as to what happens if the regulator is of the view that the PES has not demonstrated that it is setting a particular tariff, for a particular customer category, in line with the revenue formula. It is not directly stated but it would appear that CER's proposal would reserve to itself the right to substitute its own forecasts for those of the PES and refuse the change.

CER says, *"PES will be required to demonstrate to the Commission, prior to changing any tariffs, that they are reasonable and cost reflective*, which, if this means "demonstrate to the Commission's satisfaction", puts the burden of proof on the wrong party. Regulators should not have the power to intervene unless a breach has been demonstrated.

It would be particularly serious if, as would be likely under asymmetric correction factors, such an over-ruling affected the PES's profitability. This would not be a transparent rule-based system but arbitrary regulation and, if this is what CER intends, it may expose them to potential legal challenges.

Some passages suggest that CER has a similar attitude to the EPO. Section 5.2 of the paper speaks of CER needing *"to approve the set of CfDs that PES selects to meet the target 50% contract cover"*.

In our view this is not how an EPO should, or does, operate. The obligation is on the supplier and, if there is a breach, it is the regulator's duty to demonstrate that that is the case and enforce a remedy. It should not be the regulator's duty to substitute its own judgement for that of the PES and determine which contracts may be included in a portfolio for price control purposes.

Margin

Finally, we would also comment that a 2% profit margin is inadequate for an efficient energy retailer in a competitive market.

CER quotes the higher margins found by NERA but ends up choosing a much lower figure (ie 2%) and then adjusts that down further to 1.3%. This is presumably on the grounds that there would be an expected over-recovery of 0.7% (or perhaps rather more to cover the increased risk inherent in the asymmetry) but no detailed justification is given for the figure.