Draft Decision on the ESB PES'S Revenue Regulation Framework (CER/10/042)

Airtricity Response to

Commission for Energy Regulation

April 2010

Introduction

Airtricity welcomes the opportunity to comment on the Commission for Energy Regulation's (CER) consultation paper on the "Draft Decision on the ESB PES's Revenue Regulation Framework"

It has always been our belief that effective competition is the best mechanism for bringing benefits to energy consumers. This competition will hopefully bring with it improved product innovation, improved choice, improved quality and effective competitive consumer pricing.

While this competitive market is developing we believe that the aim of regulation is to correct for instances of market failure. Once competition is deemed to be well established in a market we envisage that the role of a regulator should move from that of revenue and tariff setting to one of conduct regulation and compliance monitoring within the market.

We see this proposed revenue control as the bridge between the current regulated market and the fully competitive market that is fast developing. As such we believe this control should, as much as possible, ensure that the ESB PES is operating on a level playing field with other market participants. The control should ensure that the ESB PES is operating in a commercial manner, and carries the associated rewards and risks.

This will ensure that once it is decided that the deregulation of PES tariffs should take place the impact on the competitive market will be minimised, and the transition should run smoothly.

It is essential that both suppliers and customers have a clear understanding of how this transition will be managed, and we welcome this consultation as a step in this process. However, it is imperative that regulatory controls are not removed prematurely, as to do so could severely damage if not destroy the competition that has already started to develop.

In planning for this competitive market we believe that, the CER's statutory obligations other than protecting the interests of customers should be considered, in particular;

- **not to discriminate unfairly between licence holders,**

- **to promote competition**

It is with this in mind that we have reviewed the consultation paper and request that the CER take the following comments/response into account before making a final decision on the future regulatory controls that will apply to the ESB PES.

General Comments

It is imperative that the transition from a market with regulated prices to one without is handled with extreme care. If the process is rushed it will most likely undermine the early stage competition that has begun to develop.

In previous responses we have highlighted our belief that the CER should lay out a clear vision of what the competitive market, which is starting to develop, will look like and what regulatory structures need to be put in place to support it.

We have also previously identified numerous issues that need to be addressed for a fully functioning competitive market, e.g. global aggregation, transparency of energy costs, the disaggregation of network costs, and costs allocation and cost reflectivity issues and also how k –factors will be treated in a competitive environment.

If the majority of these issues are addressed they will go a long way to resolving the issues we highlighted as being prerequisites to deregulation. As we believe that the necessary criteria for deregulation are unlikely to be met in 2010 it is essential that the CER continue to progress these issues at this time.

Unfortunately we do not believe that this current consultation addresses these issues. Our response is broken into two distinct sections, the first deals with the consultation proposals and the second section deals with these further issues that need to be addressed.

Consultation Proposals: Maximum Allowed Revenue with Asymmetrical K-Factors

The consultation proposals would seem to equate to a situation whereby tariffs would be set on the basis of Pool price pass-through and a combination of CFD's purchased by the PES.

We do not believe that this is answer.

This would result in the price risk being passed to the customer; we believe that this risk should remain with suppliers who are best placed to mitigate price volatility.

Margin

It is our belief that the PES should operate on a level playing field with independent suppliers within the market. As such we believe that the PES should given the freedom to contract as they see fit, which is the case with independent suppliers. In line with this ability to hedge as they see fit the PES should also be allowed a margin commensurate with the risks/rewards that this freedom entails.

The current margin does not reflect the reality of a supplier competing in a competitive market; it is artificially low due to the protection provided to the PES under the current regulatory rules. For example in the UK were competition is firmly established margins are much larger than the 1.3% allowed in the PES revenues (however this includes services such as meter reading).

Ex-Post Tariff Adjustments

This proposal also talks about a tariff adjustment that would be applied ex–post; we cannot see how this is any different to the current application of a k–factor.

We believe that K–Factors should be abolished and are therefore strongly opposed to this proposal.

While it may go some way in incentivising the PES to reduce any over or under recoveries, it would further exacerbate the situation whereby the PES tariffs are not reflective of the costs of supply in a given year.

As stated above in a fully competitive market, K–Factors could not exist. We believe that, rather than dissipate the barriers to competition that are currently attributable to K-factors this proposal would actually further enhance these barriers, and we are strongly opposed to it

Developing Competition

We also believe the level of freedom afforded to the PES in the tariff setting process is inappropriate given the developing nature of competition in the market. While competition is still in its infancy we do not believe that the PES should be afforded the same freedom as it would in a fully competitive deregulated market.

We are of the opinion that the premature removal of appropriate pricing controls would damage this developing competition and ultimately constrict consumer choice. In the long term it is effective competition that will deliver best value to consumers.

The proposals also seem to allow the PES the freedom to price in a predatory manner, to undermine the competition that is currently starting to develop in the market. The asymmetrical nature of the proposals means that the PES could easily set their tariffs at a level 3% lower than fully cost-reflective levels. In a market where margins are so small, this could easily undermine the ability of competitors to offer viable alternative tariffs to customers, and undermine the competition that is starting to develop.

Customer Switching

We also oppose the suggestion that PES be allowed to set/reset tariffs as they see fit; this is deregulation by another name. Such an approach could only act to enhance market inertia, by causing confusion to customers who are considering a change of supplier. It is well established that customers are reluctant to change supplier when they believe that their incumbent supplier will change tariff prices in the near future; they are unsure as to whether they will miss out imminent reductions.

Therefore we believe that PES should only be allowed to set prices only twice in any year; the October tariff setting as currently applies, followed by a midyear price review similar to the gas market.

Regulatory Analysis

The Commission's proposals seem very complex. Given the level of analysis that will be required to ensure that the PES are obeying the regulatory rules and not gaming the system, we are concerned about the CER's ability to carry out this analysis in a timely manner.

For example, in the May 2009 price reduction, PES did not directly pass through the simple change in DUoS charges as required by the regulatory Direction. Published and implemented prices included an element of rebalancing between different tariff components that was apparently overlooked by the Commission and it was not clear from the subsequent tariff change in October, that the earlier mispricing had been remedied and appropriate value correction implemented.

Price cap regulation was used successfully in GB to overcome the problems caused by the use of k-factors. We believe that this form of regulation also address valid concerns about how to address falling market demand as well as customer churn due to increased competition.

Timelines

The timelines associated with the Commission's proposals seem unduly hasty at best. In the recent consultation on a roadmap for deregulation, the CER indicated that some sectors of the market may be deregulated as early as October 2010. We are fast approaching May 2010 and for market participants to be unsure at this stage, both of what sectors of the market will still be price regulated and how this regulation will work, is unacceptable.

This overly-complex proposal has introduced material regulatory uncertainty into the electricity market and the Commission appears to be rushing the decision making process on these issues to meet deadlines rather than seeking to nourish competition in the interests of customers.

Neither this decision nor the one on the "road map" can be made in isolation, it is essential that market participants have a clear understanding of the regulatory controls that will be in place during the transition to a fully competitive market.

Also, given the ex-post nature of the proposals, we are concerned that if issues of predatory pricing were discovered, it would not only be long after the tariff in question had expired but would also, most likely, only be found out after that market segment had already been deregulated.

Given the very complex nature of the issues raised within this and the "road map" consultation, we felt it would have been very beneficial for the CER to have hosted an industry forum, with all the relevant stakeholders in attendance, to discuss the issues.

We are disappointed that the Commission did not agree with us in this regard, and we would again request that the CER host such a forum. We believe it would be invaluable in ensuring that all market participants are fully bought into the current regulatory process and resulting decisions.

Further Issues

We believe that the following additional issues need to be addressed to ensure an effective and fully-functioning competitive market.

K-Factors

In a competitive retail market K- factors cannot exist. Therefore we are disappointed with the Commission's proposal to allow a +/- 3% band around the PES allowable revenues. We do not see how this is different to the current K-Factor practice. Furthermore it is difficult to see, from the current proposals, exactly how the changing revenue requirements of a PES with rapidly-moving market share are being addressed. It has already been acknowledged by the Commission that the existing under-recoveries are irrecoverable in a competitive market.

We have always argued that there are a number of ways in which the use of K- Factors in the current regulatory regime has created a barrier to entry for suppliers wishing to enter the retail market, namely:

- The use of K- Factors distorts incumbent supply tariffs in a given year so that they will not accurately reflect the underlying costs of supply in that year. The fact that prices being charged by the incumbent are not reflective of the costs that an independent supplier would face undermines the ability of a competing supplier to make an economically viable offer to customers.
- The lack of detailed information in the market as to level of hedging employed by the incumbents, means that it is impossible for independent suppliers to predict if there will be a negative, positive or even neutral k – factor being applied in the following year.
- The political pressure, which is understandable especially in the current economic environment, to keep tariffs down means that there is no certainty to the future application of a k – factor. This arbitrary application places a substantial risk on competing suppliers who must price at a discount to incumbent tariffs in the early stages of a competitive market.
- K – Factors provide the incumbents with a hedge against their energy purchasing costs. If in a given year the PES gets their purchasing strategy wrong, they are still guaranteed recovery of their costs. This hedge is not available to independent suppliers.

- The guaranteed recovery of costs, means that the PES is able to operate with an artificially low margin, thus suppressing to opportunity for suppliers who do not have this ‘free’ hedge to compete in the market (although this certainty may be being eroded by loss of market share).
- As suppliers will have differing customer portfolios the impact of k-factors will vary between licensed suppliers, unless they can match the PES portfolio from year to year (without changing their market share).
- As recent decisions have shown, K-factors become unsustainable as competition develops. The current revenue cap regulation does not work when customer numbers deviate significantly from forecast i.e. when there are large numbers of customers switching supplier. It is also extremely hard, if not impossible, to ensure that the customers responsible for any over/under recovery are the ones to see the resulting benefit/penalty.

In our opinion the only way to remove these barriers to entry and to competition is to discontinue the use of k – factors in the tariff setting process. This has been seen to work in other jurisdictions where competition has been established for longer, for example in GB where price cap regulation was used successfully as competition developed.

K-factors should be abolished and a more commercially realistic margin for the incumbent allowed. This would not, as is often argued, prevent customers obtaining lower prices. They can switch supplier. Increased competitive pressures will ensure that suppliers are incentivised to offer tariffs at compelling levels to customers.

Events over the past year, and in particular the CER’s recent decision to disallow k – factors for the 2009/10 tariff year support the above argument. By default, the CER has accepted that K – factors are unsustainable and inappropriate for a competitive market. It is therefore unclear why the Commission should believe the more complex revenue management arrangement, proposed in this consultation, has any hope of delivering the hoped-for outcome.

Wholesale Market Liquidity

Limited opportunities for hedging in the Single Electricity Market mean that energy costs are largely inappropriately fixed at one point in the year, at the fuel prices prevailing almost half a year ahead of the commencement date. This arrangement would never exist in a properly-functioning, competitive market.

Suppliers aim to stabilise the cost of wholesale energy through hedging, but available contracts last only up to 12 months and must be bought over a short period four to five months prior to the start of the tariff year. Contracts on offer are insufficient to enable all suppliers to be fully hedged and this drives up the cost of hedging, while still leaving significant exposure to Pool price. To avoid cliff-edge tariff price changes and unexpected mid-year changes, as has happened over the past year, the CER must address the quantity and duration of hedging contracts.

Currently there is no functioning secondary market to enable Participants to refine their hedge position. Lack of such a market increases risk and therefore cost to suppliers, which must inevitably feed through to customer prices.

More liquidity, variety of duration, and also volume available in the hedging market, would provide suppliers with more opportunities to accumulate and trade directed contracts during a year, thus ensuring that suppliers are able to buy hedging contracts at timely intervals and market-reflective prices throughout the entire year.

Transparency

We have always stated that the level of information provided on the PES revenues and tariffs is inadequate. From the information currently given it is impossible to ascertain if they are fully cost reflective. There needs to be greater transparency in the allocation of costs both within and between customer categories. PES should also be properly separated from the Networks business; using the same MPCC retail market message communication hub as independent suppliers and with Networks and PES both having their own billing systems. PES must not be allowed structural cost advantages compared with market entrants.

In a developing competitive market, it is vitally important that tariffs are transparently simple and cost-reflective.

There must be clear transparency and rationale with regard to how tariff charges are constructed and costs allocated to particular customer groups, and indeed how these costs are then allocated within each specific tariff group. This is particularly important where PES supplies a mixture of competitive and regulated products and there is a risk of overhead misallocation away from the competitive sector.

We are disappointed that proposals in the current consultation do nothing to improve transparency. In fact, given their ex-post nature, we believe they will actually decrease the level of transparency with regard to PES regulated tariffs and revenues.

Given the dominant position of the ESB PES it is wholly appropriate that the level of information published should enable analysis as to whether these allowed/approved costs are accurately reflected in the tariffs proposed by the PES.

Assuming that pass through costs such as network and market operator charges are properly included within in each customer segment, there is insufficient information in the proposals to demonstrate that PES Supply costs and margins will be correctly applied across all customer and tariff categories. We therefore ask the **Commission to ensure that any regulatory control provides a clear and detailed breakdown of how all costs are individually allocated across the different customer/tariff categories**.

Pre – requisites to Deregulation

In our response to the CER consultation on a "Roadmap for Deregulation" (CER/09/189) we highlighted issues that we believe are a pre-requisite to deregulation namely:

- **Re-branding of ESB supply businesses** – The issues of branding in relation to the ESB supply business must not be underestimated.

  The 3rd Package is clear that brand separation is a requirement for vertically integrated distribution system operators and the supply branch of such undertakings. This has particular resonance in the Irish market where the vertically integrated undertaking is also state owned and as such there is a perception among consumers that the undertaking is actually state sanctioned in its offerings. Corporate advertising (e.g. Féis Ceoil) inappropriately links assurance of supply by ESB with delivery by ESB Networks. Customers should not be fed any message that links Networks to any supplier, as this is undermines willingness to switch by any customer having concerns as to the reliability of competing suppliers.

- **Global aggregation** - In the retail market, the issue of cross-subsidy can only be solved if all suppliers have to compete on the basis of the same market structures; ensuring all suppliers compete on an equal footing. This means that the ESB PES business should be included in the Settlement process in the same way as other Suppliers.

- **Wholesale Market Liquidity –** Limited opportunities for hedging in the Single Electricity Market mean that energy costs are largely inappropriately fixed at one point in the year, at the fuel prices prevailing at that time.

  Our concerns in this area are well documented in this and previous responses.

- **Role of the Regulator** – We believe it is imperative the there is a clear understanding of the role the regulator will take once the market has been deregulated.

- **Retail Market Failures -** A number of structural failures of the retail market require remedy. For example current market structures inhibit all suppliers from offering tariffs to micro-generators, or offering recipients of the Free Electricity Allowance the same facilities as are available from the ESB PES.

We are disappointed that the CER has not obviously taken the opportunity provided by this revenue control consultation to ensure that the above barriers to competition are removed while the market is transitioning to a fully competitive/deregulated state. At this time of developing competition, we would have expected the ESB to be particularly open to regulatory suggestions for changes that would accelerate development of full competition and deregulation.

We believe that this consultation would have provided a perfect opportunity for a more creative approach.

Conclusion

In summary Airtricity believes that the use of k –factors should be discontinued. As we have previously stated in a fully competitive market they would not exist. In a fully competitive market the PESs would face the same risks as independent suppliers, and would not be guaranteed full recovery of their costs. They would have to decide whether to absorb/pass back any under/over recovery to customers. With sufficient competition in the market suppliers will be incentivised to pass back the benefit of over recoveries and absorb the loss of under recoveries in order to win/keep customers from other suppliers.

There must be clear rationale and transparency with regard to the individual cost components of the published ESB PES tariffs, both on an overall and individual tariff basis.

The current level of information proposed does not enable respondents accurately ascertain if the proposed tariffs are individually costs reflective, and as stated above Airtricity believes that **cost-reflective pricing must prevail in the retail electricity market**, to avoid damaging the competition in supply that is now starting to develop.

As stated previously the premature removal of appropriate pricing controls in relevant sectors of the market could potentially damage developing competition and ultimately constrict consumer choice.

As competition increases in the retail electricity market, it will become increasingly difficult to predict the impact of customer switching on ESB PES revenue. Furthermore, although ESB Customer Supply, ESB Networks and ESB Power Gen may operate as effectively ring-fenced businesses, it will require increasing regulatory insight to judge the correct allocation of ESB Corporate and PES business overheads to each customer grouping.

We believe that a form of Price cap regulation, which was used successfully to overcome these problems in the UK market, is appropriate for the current state of the Irish electricity market, and are happy to discuss this idea further with the CER.