

CER Consultation Paper CER/13/302

Market Monitoring in the Electricity & Gas Retail Markets

Vayu welcomes the opportunity to comment on the Commission for Energy Regulation's ("CER") consultation paper which considers market monitoring in the electricity and gas retail markets – CER/13/302. The proposed marketing monitoring structure has been revised from the 2011 consultation in a number of areas, but essentially it is designed to compel suppliers to incur costs without due consideration how these costs could be offset by suppliers. The CER has access to the regulatory accounts of all suppliers and will therefore be well aware of the tight margins being earned by non-vertically integrated retail energy suppliers.

Summary

Reviewing retail markets is a necessary step to ensure a well-functioning market. The CER does not appear to have looked at the experience in other developed markets to assess if its approach is reasonable. In GB, ofgem has recently issued a paper on how it proposes to report on the state of the energy market by introducing an assessment framework¹ that consists of three stages:

- A description of a well-functioning market, and how competition should work to deliver desired outcomes;
- An explanation of the broad categories of reasons why the competitive process may not be working as it should (potential 'sources of harm'); and
- An explanation of how it will use data and information ('indicators') to identify features of the market and analyse, investigate and conclude on how these features affect the process of competition and outcomes for consumers, including vulnerable consumers.

In our view this framework appears to be a reasonable approach to assessing how markets are operating as it will look at both short-term and long-term indicators.

We acknowledge the reduction in the level of detail now being requested in the revised consultation paper. However, we believe that the level of detail requested in the proposed indicators is still very intrusive and there is no clear signal from the CER what actions it could take on foot of this market monitoring. Other than to publish the findings, the CER has not announced what measures it proposes to use to assess whether or not the market is functioning to meet its objectives of a) promoting effective competition and b) ensuring Customer protection.

The CER have requested stakeholders to give feedback on the expected costs of implementing these proposals. However, the CER provided no information on the costs it will annually incur to put this framework in place. We have no doubt that the CER will look to increase the levy on suppliers to cover these costs, but suppliers are not in a position to easily pass on their own costs to Customers. This is contrary to an overall drive towards improving efficiencies in the

¹ <https://www.ofgem.gov.uk/publications-and-updates/state-market-report-assessment-framework>

market. This will require suppliers to develop and adapt their IT systems and to hire additional resources to manage this exercise throughout the year.

We support the change in the proposal to separate out domestic and non-domestic retail margins between gas and electricity. However, we do not support the proposal to split supply costs or depreciation and amortisation costs below the gross margin line. This is a significant issue as suppliers will have differing views on how these costs should be allocated between their different lines of business.

The CER should take a more pragmatic approach and simply report an aggregated figure for these costs across the entire supply business. This should also apply to the depreciation and amortisation costs. The CER should appreciate that this exercise, if applied, will require suppliers to analyse individual expenses within line items of expenditure.

Although the CER have stated that they would not be doing a cost benefit analysis (“CBA”), we believe that good regulatory principles should apply and that a CBA should be carried out before proceeding. It is inevitable that the added costs of carrying out this analysis for very little benefit will result in higher costs to end-users.

Ofgem has identified a number of potential sources of harm to a retail energy market and features that may cause this harm. These are:

- Unilateral market power;
- Weak competition between suppliers;
- Barriers to entry and expansion;
- Vertical relationships; and
- Weak customer response.

Given the size of the Irish market and market concentration in certain aspects, we see merit in looking closely at vertical relationships, particularly if there are any signals that transfer pricing is an issue that is restricting trade or disadvantaging non-vertically integrated retail businesses in any way. The top 4 suppliers, who each have substantial generation portfolios, hold almost 95% share of the non-domestic electricity supply business as at Q3-2013.²

EU Directive 2009/73/EC details the specific market monitoring activities the CER must carry out to observe distortions and restrictions to competition (Article 41 (1)(j)) and restrictive contracts (Article 41(1)(k). In situations where this activity has been confirmed it must bring “any relevant cases to the relevant competition authorities”. We believe that it is now time to review the cooperation agreement between the CER and the Competition Authority, which pre-dates much of the new EU legislation to reflect these requirements.

Timing

We will address this in more detail later, but we would like to highlight an issue of particular concern relating to the reporting timetables.

Section 3.5.2 – Retail Margins, states that the CER proposes to oblige suppliers to report retail margins on an “*annual basis aligned to the tariff year*”. As this is October to September this is

² CER/14/043 - Electricity & Gas Retail Markets Report Q3 2013

unworkable proposal for many suppliers who have a financial year from January to December. If suppliers are to provide figures on an accurate basis we suggest the reporting period is aligned with a supplier's financial year. In GB, Ofgem recognised this and currently allows entities with financial year ends other than December to report in line with their own financial year ends; albeit they have to report within a tighter timeframe.

Use of Data

Section 2.6 of the paper seeks to address suppliers concerns with regard to how it proposes to use the data collected. Other than suggesting that the CER will use the data to provide a “robust commentary” on its quantitative analysis it does not provide much substance to this commentary. The remaining qualitative analysis will be provided by the production of the Annual Consumer survey.

There are a number of questions that should be addressed by the CER on this: For example, will the market monitoring framework provide information to support an investigation by the CER and if so what would prompt such a step? Are there specific measurements to trigger this? If so, these should be published to ensure transparency for all stakeholders.

We are open to discussing our views in more detail and our comments on specific questions follow:

Question 1

Respondents are invited to comment on the proposals presented for the electricity and gas market segmentation? Respondents are also invited to suggest alternative market categories.

In our view the CER's proposal to retain Option 1 for both gas and electricity is a viable structure for the market and PAYG Customers forming a sub-set of the domestic category is logical. If the CER opted for either Options 2 or 3 it would involve significant changes to IT systems and writing of reports to collate the data in line with each category.

However, we believe there is a more appropriate segmentation of electricity Customers. All of these end-users are classified as either Quarter Hourly (“QH”) or Non-Quarter Hourly (“NQH”). However, a number of DG5 end-users are classified under both QH and NQH. We believe that electricity end-users should initially be classified as either QH or NQH and then sub-divided into the DUoS categories. This would also aid in keeping costs lower to upgrade IT systems.

Question 2

Respondents are invited to comment on the proposal on Networks submitting data based on Eurostat bands once a year? Respondents are also invited to make alternative suggestions.

We do not believe that obliging Network companies to provide Customer numbers and consumption based on Eurostat bands will improve the CER understanding of the market. If anything, it will simply add another layer of costs onto the Network companies that they will look to recover from suppliers. This data will not be in line with Option 1 statistics and should therefore not proceed. No perceived benefits will be derived from this additional reporting.

Question 3

Is the proposed naming convention for the gas market segments accurate? The CER would request that respondents ensure that the proposed naming convention accurately reflects the type of customer within each category.

Correspondence with the CER suggests that the categorisation of gas Customers should be amended from that proposed, to one that is in line with the current segmentation of Customers in the gas eligibility list. This segmentation of small Industrial and Commercial (“I&C”) Customers into Small Business Unit (“SBU”) and Medium Business Unit (“MBU”) was developed by the CER to align tariffs between the domestic sector and SBU’s. Now that the non-domestic market is fully deregulated, we would suggest that there are few additional benefits from this further segmentation and we do not believe it should be further split to align with the gas eligibility list.

Additionally, if the gas sector was segregated further, it would add a further layer of costs onto suppliers to carry out additional analysis to meet the segmentation requirements.

Question 4

Respondents are invited to comment on the whether the indicators outlined for measuring switching are sufficient and if not, what other methodology could be used?

We note from the paper that the CER has requested BGN to investigate how to upgrade its systems to collate data on the “switches completed” indicator. We would respectfully request the CER to fully explain the reasons for this request. We understood that substantial monies were recently spent on upgrading systems, which should have been capable of analysing this data. This comes as a surprise to us as the FVT sector is within the NDM group of Customers and the market messaging platform (GSCC) was designed for the NDM market.

The CER should define what is meant by a “dual fuel” Customer. We do not agree that all suppliers should be required to supply data on switches by this category of Customer. We believe that it should apply to domestic Customers only as I&C Customers procure their energy requirements in a different way to households. Although the CER considers it important to collect this data, it has provided no information as regards what it hopes to achieve by collecting data on switches completed for dual fuel end-users.

Question 5

Respondents are invited to comment on the proposals outlined for measuring renegotiations. Is there any other methodology that could be used?

The paper is not clear on what is defined as a renegotiation. Industry will need a clearer position to confirm if renegotiation should only include a successful renegotiation; not all renegotiations lead to a successful renewal of a contract. The CER should be conscious that a number of Customers (e.g. supermarket chains) contract for sites on an aggregated basis as they have sites that may be classified in both the small business and medium/LEU’s (or FVT/RTF for gas) categories and may have bespoke agreements in place. Therefore, defaulting to a standard

tariff at contract end date is not an option. We believe these sites should be from this reporting requirement and the supplier should be able to justify their exclusion.

Question 13

Respondents are invited to comment on the whether the proposals for monitoring the diversity of tariffs are sufficient. Respondents are also invited to make alternative suggestions.

Tariffs by their nature indicate that multiple customers have been offered the same price plan. The CER should be clear on what is meant by “multiple customers” and this should take account of a suppliers Customer base in each sector. For example if a supplier has less than 1% of its Customers in that sector on a tariff we do not believe that this group should be included in the reporting requirements.

Customers, who are classified as small business, may not necessarily be on a fixed tariff. They may have negotiated a bespoke supply agreement with their chosen energy supplier. We do not believe that these sites should be included in the periodic reporting of tariff diversity. We support the CER’s position that large and medium business users should be excluded from this analysis.

Question 14

Respondents are invited to comment on the whether the proposals for monitoring end user prices are sufficient. Respondents are also invited to make alternative suggestions.

We do not see the need to include Customer numbers for each category in this table. Network companies will be providing Customer number information in any event under Proposal 2.

Question 15

Respondents are invited to comment on the whether the proposals for monitoring price spread are sufficient. Respondents are also invited to make alternative suggestions.

We fail to see why this should be split by supplier as the information will be published in aggregate and the highest and lowest tariff information should be possible to derive from the “Diversity of Contracts” information. The CER will have sufficient information to derive the required detail.

Question 16

Respondents are invited to comment on the proposals for retail margins. Respondents are also invited to make alternative suggestions.

It will be no surprise that the proposals for retail margins will generate the most debate about the information to be supplied to the CER in its assessment of the level of competition in the retail market. However, we welcome the fact that the CER accepted our proposal from the previous consultation that the analysis of retail margins should be split between domestic and non-domestic.

There is a significant degree of granularity being sought by the CER to assess the depth of competition in the market. Without spending significant sums of money on IT systems and resources it is doubtful that suppliers would be in a position to provide the CER with the detailed

information it requires. It appears that the main focus of the CER's goal in this process is to be seen to be putting a squeeze on retailers, without a real understanding how supply businesses are under real pressure from a number of different external factors to maintain margins. For example, the CER will be well aware of the Government's Better Energy programme which obligates suppliers to generate energy efficiency credits or pay significant penalties if targets are not met.

The momentum in this paper appears to be that the CER are trying to justify their position in the media by being seen to do all they can to drive down prices. For the I&C sector, price is a primary driver when making procurement decisions, but it is not the only driver. More and more Customers are looking at what other value-add services suppliers can provide as well as their overall customer service levels.

The proposed structure is intrusive, too bureaucratic and overly expensive for small suppliers, especially when compared to what is being required of suppliers in other jurisdictions. We are adamant that a cost benefit analysis ("CBA") must be completed. To impose these obligations on suppliers without the CBA ignores good regulatory practice. We do not agree with the comment in the paper that the CER does not have information on supply costs or retail margins; the CER receives regulatory accounts from all suppliers on an annual basis.

The proposed arrangements will place a large administrative burden on Vayu. We will have to employ additional resources and spend money adapting and developing a number of IT systems (including billing, CRM and financial accounting) to meet our obligations. These costs will include specification, writing code to extract relevant data, testing, commissioning, report writing etc.

It will be very difficult to justify passing these costs onto Customers. Vayu's business is not revenue regulated; we do not enjoy the benefits of correction factors. We cannot absorb all additional costs being imposed; yet Customers will not be willing to pay for these costs.

An important aspect of this analysis is how costs, that are incurred on a portfolio basis, should be allocated for segmentation purposes. Each supplier will employ different risk mitigation techniques, unique to their own requirements. We note that the paper is silent on how the CER believes these should be handled. Without clear guidance, the allocation of these costs could be open to manipulation and could call into question the accuracy and integrity of the reported data.

We are conscious of the CER's concerns with regards to the interpretation of generation data and that by including additional information including, amongst other areas, transfer costs it hopes to alleviate participants concerns. Given the level of vertical integration in the Irish market we believe this to be a reasonable approach.

A number of suppliers in the Irish market will have dealings with the trading units within their respective organisations. We are unclear if the activities of these business units are captured within this framework. If not, we believe they should be. This will include gas commodity trading and CfD's in electricity via DC's, NDC's or PSO levy.

Retail suppliers may provide ancillary services to their Customer base. This may include energy audits and related services. The income and expenses from these activities should be excluded from the scope of the market monitoring framework.

We note the paper's comment that the CER "wishes to highlight that it is not suggesting that margins should be at a particular level". This raises the question as to what the CER intends to do with all the information it receives. The paper is overloaded with quantitative analysis, but is very light on the qualitative measures it will use to interpret the data. For example, will it use it to justify an investigation or launch a supplier probe into prices being charged to Customers? The Gas Regulation Act 2013, gives the CER significant new powers to direct suppliers to change tariffs if it (the CER) believes that prices are set too high.³

Suppliers cannot deliver energy to their Customers without incurring supply costs. However, these costs are incurred for the entire business, not on a specific sector of the business. The major elements of a retailer supplier's costs comprise headcount, IT costs, communication and facilities expenses. Splitting these costs below the gross margin line is a significant issue because suppliers will have different views of how these supply costs should be allocated to business segments. The CER should appreciate that this exercise, if applied, will require suppliers to analyse individual expenses within line items of expenditure. This would be a hugely time intensive task and if automated would potentially require a major overhaul of a suppliers accounting system to create separate cost centres for each category of Customer.

The same principle will apply to depreciation and amortisation expenses. If a supplier launched a CRM system for its entire portfolio it would be extremely difficult to allocate these costs to individual categories of Customer.

VAT should be excluded from the table of information. This is an expense that has no bearing on a supplier's financial performance or margin.

Although the Customer Survey points to price being the main driver for choosing one supplier over another, the CER appreciates that it is not the only determining factor. The CER should publish the questionnaire to Customers at the same time the results of the Customer Survey are published.

Our final point on retail margins is that we fundamentally disagree with the proposal to align the reporting timetable with the tariff year. The majority of suppliers in the Irish market have December year ends and one or two others have a March year end. If September is used the CER will receive numbers based on management accounts that a) have not been audited and b) may have misleading figures compared to the financial year end e.g. estimates may be used throughout a given year, but would be adjusted at year end in line with audited figures. The CER should have more confidence in the reported numbers if they were supported by audited figures. In GB, when ofgem proposed a December reporting date, a number of suppliers made representations that this did not align with their financial year end and this was accepted; albeit they have a tighter timetable within which to report.

³ Sec. 43 of Gas Regulation Act, amending Sec. 2 of Act of 1987.

Question 17

Respondents are invited to comment on the proposals outlined for measuring arrears. Respondents are also invited to make alternative suggestions.

Not financial reporting packages will be set up to segregate out customers into the various categories at Customer set up time. Typically there is no flag mechanism to identify each by category. An IT system will have to be developed to categorise Customers. This will be time consuming to construct and will need constant monitoring to ensure it reflects the current Customer base at any point in time.

We believe the arrears should be a split between domestic and non-domestic Customers only.

Question 18

Respondents are invited to comment on the proposals outlined for measuring contract breakage penalties. Respondents are also invited to make alternative suggestions.

We do not believe that Customers should be allowed change supplier when a legitimate supply contract has been agreed. The Debt Flag process is not a suitable alternative and furthermore does not even apply to larger Customers. The measure will only be effective when the CER realises that penalties are not an effective measure for breaking contracts and should introduce a change of supplier objection process for non-domestic end-users.

Question 22

Respondents are invited to comment on whether the de minimis threshold is reasonable. Respondents are also invited to make alternative suggestions.

We believe the de-minimis threshold of 1% is set too low, as no individual entity with this level of market share could ever be in a position to influence the market or prices. We disagree with the comment that a supplier with 1% market share is “significant”. In our view, a more reasonable figure would be 5%.

We also would like clarification on why the CER selected 4 as the minimum number of Customers in electricity to ensure Customer confidentiality. If a number should be picked, it should align to the EU figure of a minimum of three (3) Customers.

We would also like clarification why the CER has chosen to use a 1% consumption threshold in electricity, but a 1% share of Customer number in gas. The measures should be consistent. The CER provided no justification to support this position.