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

1. Introduction

1.1. The Consumer Council welcomes the opportunity to respond to the Utility Regulator's (UR) consultation on the review of the effectiveness of competition in the Northern Ireland Energy Retail Market – Phase 2 Regulatory Implications.

1.2. The current system of pricing for domestic and small business electricity and natural gas consumers in Northern Ireland (NI) is a combination of price regulation and unregulated competitive pricing. The Consumer Council believes this 'hybrid' model is currently delivering benefits for consumers. As such we would not advocate a transition from the system at present.

1.3. While the current system is broadly delivering benefits to consumers in terms of overall cost, UR must be sure all consumers are benefitting. The Consumer Council has worked with UR in preparing its Consumer Protection Strategy (CPS). This document has an action plan to ensure all consumers, in particular vulnerable consumers, receive the full benefits that the current 'hybrid' system offers. We will continue to work with UR, the energy industry and other stakeholders to help deliver proposals within the CPS.

1.4. While price is the most important issue for energy consumers, other factors such as innovation, new technology and customer service are also important. UR is continuously monitoring the market, identifying

the benefits and detriments to all consumers of the current system and considering options to deal with problems that arise.

1.5. The current review is welcome because it sees UR looking forward and recognising the existing system may not always be appropriate for NI. UR is quite rightly preparing for a market that may change and considering the options if it does. Before it comes to making significant and possibly irreversible changes to the domestic energy market, UR must ensure its decisions are based on firm evidence.

2. The current benefits of price regulation in NI

2.1. Currently price regulation is providing NI domestic and small business consumers with the following benefits:

- Lower prices than GB or RoI;
- Transparency that provides confidence the price is a fair one;
- Significant savings when switching electricity supplier; and
- Price protection for disengaged (non-switching) consumers.

3. Comparison with the GB market

3.1. It is a clear policy aim of the European Union to liberalise the energy markets of member states and at supply level remove price regulation. When considering the merits of the current 'hybrid' system in NI, it is useful to compare the situation in other markets. Most EU countries still have some form of price regulation for domestic consumers. Meanwhile,

the GB electricity and gas markets are the most liberalised in Europe, having had no price regulation since the 1990s.

4. Prices

4.1. NI has recently seen a round of price cuts averaging around 10% from both electricity and gas suppliers. In GB a number of the largest suppliers have reduced their prices by around 5%. With all these changes in place by 1 April 2016, NI domestic natural gas and electricity prices will be significantly lower than GB.

Region	Electricity comparison	Natural gas comparison
Great Britain	NI is 16% cheaper	NI is 23% cheaper
Republic of Ireland	NI is 25% cheaper	NI is 22% cheaper

4.2. This has not always been the case, for example, during 2009, NI domestic electricity prices were on average 13% higher than GB. However, regulatory scrutiny in NI has ensured consumers can be confident the price they pay reflects accurately the overall cost of supplying the energy. Hence the recent decreases in regulated tariffs in NI reflect the substantial and sustained falls in the wholesale gas and electricity markets over the last 18 months.

4.3. For example, in the case of gas, between February 2015 and February 2016, 'within day' wholesale gas prices reduced by around 40%. Following the most recent tariff decrease, consumers will have

experienced an overall reduction of 25% in their gas bills over the same period. As wholesale gas prices represent 39% of the whole tariff, and as the other costs are fixed, the final price reduction is broadly in line with the reduction in the wholesale price.

5. Transparency

5.1. The transparent nature of the NI price regulation model provides confidence and trust to consumers. The Cornwall Energy Phase 1 Report found 74% of NI electricity customers and 69% of NI gas customers trust their supplier. Contrast this with GB, where the energy market has no price regulation. Ofgem has found that in GB only 30% of customers trust their energy supplier.

5.2. Furthermore, in GB, concern is being expressed that prices are not reflecting the cost to supply and current wholesale price drops are not being reflected in customers' bills. In January 2016, Dermot Nolan, Chief Executive of Ofgem said of the GB market, "Energy companies are 'overcharging in many cases' with prices failing to fall in line with dropping wholesale costs"[1].

6. Competition

6.1. In the NI electricity market, price regulation of Power NI effectively creates a 'price to beat' for other suppliers. In recent years this has

[1] http://www.bbc.co.uk/news/business-35321723.

benefited domestic consumers with significant savings to be made by switching supplier and/or changing billing and payment method.

6.2. Competition in the NI domestic electricity market is developing gradually. Two new electricity suppliers[2] recently entered the market and new products, tariffs and offers extended choice for consumers with savings of over £100 per year available at one point to some domestic electricity consumers[3]. Currently, a Power NI customer with average consumption who receives paper bills and pays by a method other than direct debit can save over £142 a year by switching[4].

6.3. During 2015, the Consumer Council continued its 'Switch & Save' campaign to raise consumers' awareness of the benefits of shopping around for all domestic fuels. We have so far carried out 41 public events within communities across NI.

6.4. As a result of all of these developments, domestic electricity switching rates showed an increase in 2015, after three years of decline. In 2014 the rate of switching in the NI electricity market was 5.7%, and in 2015 this had increased to 11.3%. By comparison, in 2015 GB had a switching rate in electricity of 12.2%.

[2] Click Energy and Open Electric.
[3] Consumer Council, Electricity Comparison Table, 11 January 2016.
[4] A Power NI standard rate customer consuming 3,800 kWh per year at a unit rate of 16.38p pays an annual bill of £622. By switching to SSE Airtricity's Home Electricity 24 tariff, receiving e-bills and paying by direct debit the customer will save £112 per year. The customer will also receive a £30 welcome bonus.

6.5. Currently in NI there are five electricity suppliers undercutting by up to 23% the price regulated and cost reflective incumbent tariff. The question that arises is whether this is a sustainable.

7. Consumer protection

7.1. While switching is increasing in NI, we recognise many electricity and even more gas consumers, have not yet engaged with the market. The experience of GB suggests there is a significant group of 'sticky customers' and these consumers are more likely to be vulnerable or on a low income. Price regulation protects these customers by ensuring the price they pay reflects the cost of supply, and they do not subsidise cheaper tariffs which are designed to attract more engaged consumers.

7.2. In this way price regulation in NI provides protection to consumers which is not enjoyed by their counterparts in GB. The value of this approach is demonstrated by the Competition and Markets Authority's (CMA) recent recommendation concerning the introduction of a temporary safeguard price control to protect customers on prepayment meters[5].

7.3. Below we consider each of the seven options presented in the paper.

8. Option 1 – Identification of Significant Market Power and consequent licence conditions

[5] CMA, *Energy Market Investigation: Summary of provision decision on Remedies* March 2016.

8.1. This option will provide limited protection to the customers of supply companies that are deemed to have Significant Market Power (SMP). The application of this option would present challenges to UR in a price deregulated market. These would be:

- Monitoring the market to identify SMP and consumer detriment;
- Switching on and off regulation for a company deemed to have SMP; and
- There is no protection for sticky customers of non-SMP suppliers.

8.2. It is an absolute prerequisite to the removal of the current price control system that no supplier has SMP. If in a deregulated market the existence of SMP emerges, it will be a clear sign competition is not working. However, we would agree if SMP is identified, prompt and robust intervention would be required.

9. Option 2 – "Inactive customer" price controls for Power NI, Firmus Energy and SSE Airtricity gas supply

9.1. The Consumer Council recognises this option would provide protection to some customers while also promoting competition. By requiring incumbent suppliers to set a tariff for inactive customers, subject to approval by UR, many disengaged customers and customers who have never switched would be protected from being charged high prices.

9.2. However, the ability of the option to protect the interests of consumers is limited by the view outlined in the options paper that any consumer

who has ever switched supplier is an active consumer. The option will not protect customers that have switched at some stage in the past but are now, for one reason or another, disengaged from the market.

9.3. While a customer who has switched in the past may be aware they can switch supplier, they may lack the information or confidence in the market needed to motivate them to switch. For example, they may be unaware of the amount of money they could save by switching. Secondly, as the consultation acknowledges, the option will not protect customers that move to a property supplied by an incumbent supplier. For example, an individual could move from a property supplied by a non-tariff regulated supplier to a property supplied by Power NI / SSE Airtricity / Firmus Energy and not be protected by the inactive customer price control.

9.4. Despite the option's shortcomings it would likely have a positive impact in terms of protecting many vulnerable customers. This is because vulnerable customers are more likely than others to be inactive in the energy market and the incumbent suppliers have the largest number of inactive customers[6].

10. Option 3 – "Default" tariff

10.1. The Consumer Council believes the option of a default tariff provides a good balance between protecting the interests of consumers and

[6] CMA survey evidence shows there is a somewhat higher proportion of those with some of the characteristics of vulnerable customers among the most disengaged and inactive domestic customers. CMA - *Energy market investigation Notice of possible remedies* July 2015.

promoting competition. The default tariff would act as a safety net for disengaged customers. It would also protect customers who reach the end of a fixed term tariff offer and do not switch to a cheaper tariff or supplier. It is appropriate that the terms of the tariff would ensure disengaged customers do not subsidise lower tariffs that are used to attract new customers.

10.2. The Options Paper explains it would be the responsibility of each supplier to set the price of its default tariff and UR would monitor the tariff rates. There is, however, a need for further information to explain what action UR would take if costs are considered unjustifiable.

10.3. The Options Paper explains consideration would need to be given regarding how the default tariffs are constructed. For example, the tariff could have a low standing charge with a high unit rate, or a high standing charge and a low unit rate. If this option is chosen for introduction following removal of the existing price controls, the protection of all vulnerable consumers should be prioritised when designing the tariff.

10.4. The Consumer Council believes it would be reasonable for UR to take an ex-post approach to assessing default tariffs. However, it would be essential for mechanisms to be established by which suppliers will discount customers' future bills if tariffs are found to have been set too high. This would be similar to the K factor aspect of the tariffs currently subject to price control.

10.5. The Consumer Council believes the default tariff option would provide a degree of protection to consumers disengaged from the energy market.

It also recognises setting the default tariff at the same price for all suppliers would provide benefits in terms of consistency for consumers. However, there is a danger uniform default tariff pricing could have the unintended effect of reinforcing consumer disengagement.

10.6. Permitting suppliers to price their own default tariff, subject to approval by UR, could protect disengaged consumers while encouraging consumer engagement, as prices would vary. If the default tariff option is to be considered further it would be helpful for UR to conduct a cost benefit analysis comparing the impacts of uniform and variable default pricing.

10.7. The Options Paper notes new entrant suppliers could possibly be exempted from being required to have a default tariff until they reached a predefined number of customers or percentage of the market. However, there is a risk an individual may switch from an established supplier to a new supplier and later be transferred onto a higher tariff. At the same time the new supplier may introduce a lower priced tariff to attract new customers. To avoid such a scenario occurring it would be preferable to require all new entrants to provide a default tariff from the outset.

11. Option 4 – Tariff cap spread

11.1. The Consumer Council understands the aim of the tariff cap spread model is to require all suppliers to price tariffs within a defined spread. This would ensure disengaged customers are not subject to non cost-

reflective charges and stop suppliers subsidising cheaper tariffs for engaged consumers.

11.2. The Consumer Council considers this a useful option for encouraging suppliers to seek innovative means of reducing costs, enabling them to offer cheap tariffs and attract new customers, while protecting disengaged customers from unfair high prices. It is important, however, that any cap on the spread between cheapest and most expensive tariffs protects vulnerable customers and households in fuel poverty.

11.3. The example presented in Table 5.4 of the Options Paper indicates a 29.6% tariff spread at a consumption level of 1,000kWh/yr, 2.5% at 2,500kWh/yr and 9.7% at 5,000kWh/yr. Permitting the largest spread at the lowest level of consumption will mean consumers on expensive tariffs who are unaware they can switch, but are trying to minimise their energy use, will lose out. This is because the higher price they are paying at their low level of consumption may be subsidising a lower tariff for an individual consuming a larger amount.

11.4. The Consumer Council acknowledges UR stipulating a percentage spread that is the same for all suppliers would provide clarity for consumers. However, permitting suppliers to determine their own range of spread, subject to approval by UR may be more conducive to development of the market. For example, enabling new entrants with a high proportion of engaged customers a larger spread than incumbents with a high proportion of sticky customers would facilitate the growth of competition in the market. This would be to the benefit of consumers.

12. Option 5 – Dominance thresholds

12.1. The Options Paper explains if dominance was found to be present in the energy market UR would have recourse to a number of options. These could be used to ensure the dominant supplier cannot abuse its position through pricing policies, frustrating entry, or lessening innovation opportunities. It is stated that the options include those outlined in the Options Paper, or a return to a conventional retail price control.

12.2. The paper explains if a dominant supplier has reached a position through fair means in an effective market, this suggests its prices and services are most attractive to consumers. It asserts that preventing the supplier from offering the same to a greater number of customers could result in detriment. However, this fails to recognise that in the absence of a price control a supplier could become dominant by offering low rates to new customers, subsidising these tariffs at the cost of disengaged and vulnerable customers.

12.3. The Consumer Council does not accept having switched supplier at one stage is an indicator of ongoing engagement in the energy market. An individual who has at one time switched may subsequently become disengaged. The absence of any regulatory measures could result in the growth of a supplier's market dominance at the expense of its disengaged and vulnerable customers.

12.4. Introducing a conventional price control, or an alternative measure once a supplier has become dominant, may prevent the exertion of market

power, and protect its disengaged and vulnerable consumers from that stage on. However, it will not rectify any harm the consumers have incurred up to that point. It would be preferable to retain some form of regulatory instrument to ensure if any company grows to a position where UR needs to consider recourse to Competition Act powers, the growth has occurred without harming disengaged consumers.

13. Option 6 – Gross margin cap

13.1. It is the Consumer Council's perception that while the gross margin cap option would provide protection for consumers, it appears in comparison to other options that it would result in significant additional work for UR. Furthermore, while consumers would benefit, it is unlikely they would understand the process due to its complexity. This may result in the potential adverse effect of sustaining disengagement from the energy market for sticky and vulnerable consumers.

14. Option 7 – Price-to-beat tariff

14.1. The Consumer Council notes the suggested price-to-beat tariff would comprise two elements: a standing charge to recover suppliers' fixed costs and a unit rate to cover volume based charges. To ensure protection of vulnerable consumers the charge to cover fixed costs should be levied in relation to the amount of energy used, rather than as a flat rate for all customers. Charging a flat rate would inhibit the ability of customers to keep bills low by minimising their energy use.

14.2. The Options Paper notes the price-to-beat tariff would be resource intensive for UR, and could be open to significant error if UR did not have sufficient expertise to continually appraise the price. It also suggests consumers may consider UR endorses the highest priced tariff in the market. The Consumer Council disagrees this view would be held by consumers. The current Power NI price control effectively sets a price for competing suppliers to beat. The Consumer Council's energy market monitoring indicates Power NI has consistently had the highest prices for domestic consumers in NI. The Consumer Council has not encountered evidence suggesting consumers regard UR as endorsing the highest priced tariff in the market.

14.3. It is suggested an independent third party could be assigned the role of setting the tariff rate to overcome the perceived difficulties mentioned above. The Consumer Council believes this is unnecessary, particularly because it will result in additional costs. Given UR has extensive experience in setting price controls, further information would be required to justify transferring responsibility for setting the price to beat tariff rate to a third party.

15. Additional issues

15.1. Question 7 asks *"are there any options not included in Cornwall's list?"* The Consumer Council notes UR is sufficiently concerned about ineffective competition for small I&C customers that it may adopt one of the options contained in the Options Paper. The Consumer Council

supports the CMA's initial proposal[7] for the GB energy market that suppliers should publish price lists for micro-businesses on their websites, and make the information available to price comparison websites. This would promote transparency and benefit competition. The Consumer Council believes the publication of micro-business tariffs should be required in NI regardless of UR's chosen way forward.

15.2. Question 8 seeks feedback 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. As discussed in response to Option 5, the Consumer Council believes there is significant risk to disengaged and vulnerable consumers inherent in the operation of the energy retail markets with no price controls. The Consumer Council therefore would not at this stage support a period of deregulation.

15.3. The current price controls provide protection to disengaged and vulnerable customers of the incumbent gas and electricity suppliers. However, under the current arrangements if the Retail Energy Market Monitoring project finds evidence of significant numbers of sticky customers associated with any of the non-incumbent suppliers, there may be a need to introduce additional protection. The Consumer Council would suggest some form of default tariff or tariff cap spread for non-incumbent suppliers may be required to protect their customers.

15.4. The seven options are quite complex, potentially resource intensive for both UR and the industry, and the impact on the market is difficult to

[7] CMA - *Energy market investigation Notice of possible remedies* July 2015.

predict. An example of this is the four tariff rule in GB. This aimed to simplify the market for consumers. However, the CMA is currently proposing removing the rule on the grounds that it limits competition and innovation.

16. Conclusion

16.1. It is the Consumer Council's view that the 'hybrid' model of price regulation is currently acting in consumers' interests, and now is not the time to move away from it. However, it is important to anticipate and be prepared for changes in the market. The Cornwall paper is a welcome exercise in assessing the possible options available to UR if changes in the market require a change in regulation. In considering potential changes to the regulation of the NI energy markets UR must ensure consumers do not lose any of the protection provided by the current system of price regulation.

16.2. The seven options set out by UR offer an interesting insight as to actions it may consider if a deregulated market fails to benefit all consumers. This is the scenario the current CMA inquiry is tackling.

16.3. When it comes to making significant and possibly irreversible changes to the domestic energy market, UR must ensure its decisions are based on firm evidence and consumer feedback about other models, while addressing the unique features of the NI market.

16.4. If you require further information or you wish to discuss any aspect of this response please contact Richard Williams on 02890 251649 or richard.williams@consumercouncil.org.uk.

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