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Assembly

Committee for Enterprise, Trade and
Investment

OFFICIAL REPORT (Hansard)

Electricity Prices: Energia Briefing

13 June 2013

NORTHERN IRELAND ASSEMBLY

Committee for Enterprise, Trade and Investment

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Members present for all or part of the proceedings:

Mr Patsy McGlone (Chairperson)
Mr Phil Flanagan (Deputy Chairperson)
Mr Steven Agnew
Mr Gordon Dunne
Mr Paul Frew
Mr Alban Maginness
Mr Stephen Moutray
Mrs Sandra Overend
Ms Sue Ramsey

Witnesses:

Mr Tom Gillen	Energia
Mr John Mawhinney	Energia
Mr John Newman	Energia

The Chairperson: Hansard will be present during this briefing. I remind Committee members and members of the public that mobile devices should be turned off, as they interfere with Hansard's recording.

With us today are representatives from Energia. They are Mr Tom Gillen, its managing director; Mr John Mawhinney, its operations manager; and Mr John Newman, its trading and regulation director. You are very welcome to the meeting.

The format of these meetings is that we allow you 10 or 15 minutes maximum to give us a bit of an overview of your company. We will then have a question-and-answer session and engagement with members. Will you be fronting on this, Mr Gillen?

Mr Tom Gillen (Energia): Yes, but I will be relying on my two colleagues. I will speak about the company first and then talk quickly about the paper. We will then take you through our presentation.

A lot of people have not heard about the Energia group. We were founded in 1999 and operate in electricity markets in the Republic of Ireland (ROI) and Northern Ireland. We are vertically integrated, which means that we own generation and that we supply businesses. We work only in competitive markets; we do not work in regulated markets at all and have nothing to do, for example, with Power NI or any of the regulated markets in the South of Ireland. We work completely in the commercial and competitive markets.

Energia is the largest supplier to business on the island of Ireland. We have built two gas generators, and one in four wind farms on the island is connected to Energia in some form.

Our headquarters is in Belfast on Newforge Lane, and we have other offices in Omagh, Cork, Dublin and Galway. We have a turnover of around £1 billion and employ 224 members of staff, the majority of whom work in Northern Ireland.

Given the nature of the business that we are involved in, we compete against other entities, so price drives what we do. Over our years of operation, we have saved customers significant amounts of money through different contracts, which we will go into detail about later.

Before I discuss the slides, I will go into a wee bit of background on the issue that we are talking about. The Utility Regulator's paper was published in March, and it covered three next steps. To paraphrase those next steps: it wants to investigate supply competition, which has a direct implication for us in the markets in which we work; it wants to keep pressure on electricity network prices, and our view is that that is a statutory duty of the regulator and something that it would do anyway; and it wants to look at the EU target model of integration, which is again something that we see as being one of its statutory duties.

When we saw the paper and its conclusions, two things came to us: first, we felt that the analysis was incomplete and that the conclusions and the next steps drawn were wrong; and, secondly, a number of customers contacted us. We have relationships with large-user customers that stretch back well over a decade. Two things came out of the conversations with customers. First, a direct accusation was made to us that the competition is not working and that, effectively, we had been making money in a non-competitive fashion over the years. That is damaging for us personally and for our reputation. Secondly, customers could not make head nor tail of the paper. If you think about a business that has a site in Northern Ireland and other international sites, the management of that business will see the press about the issue, and the site here will be asked to explain that to headquarters. However, the analysis is not in the paper to explain the differences. We started to do our own work, and the result is the presentation that you have in front of you.

We met the Department of Enterprise, Trade and Investment (DETI) in April, Manufacturing Northern Ireland in the first week of May, and some of the largest customers in Northern Ireland directly. We held a large-user conference in May and met 38 of our large customers that we have direct representation with. We met the Confederation of British Industry (CBI) at a very senior level and throughout its organisation a number of times during May. We met the Northern Ireland Authority for Utility Regulation (NIAUR) and took the author of the paper and the regulator through the slides that we are going to take the Committee through today. It is fair to say that no one has come back with any faults from our analysis or given us any pushback on it. When we go through the presentation, we will explain why that is. Last week, the regulator presented to the Committee, and we are pleased that he has taken on board a lot of what we pointed out to NIAUR; namely, the differences, particularly between the ROI and Northern Ireland. The paper raises very important policy issues around the treatment of costs to businesses.

Our job, and why we are here today, is to try, through the paper, to get you to a level of understanding so that you make the correct decisions. From the outset, it should be made very clear that we hold no policy direction on this or view on what should happen with the costs between business users. We have no view on them at all. Our view is that it is specifically for the Department and politicians to make those decisions.

It will be worthwhile to take you through the slides, which are exactly the same slides that we went through with a number of those parties. When you go through them — they are not that difficult to understand — and get to the end, they will certainly explain why there are differences between Northern Ireland and the Republic of Ireland and what the scale of those differences is. It will probably take us 15 minutes to run through the slides. Feel free to ask any questions as we take you through them. Is that OK?

The Chairperson: We will allow you to make your presentation, and the questions will come from members after that.

Mr Gillen: OK. John will take us through the slides.

Mr John Mawhinney (Energia): Chair and members, I propose to go through the slides quickly. No doubt you will have heard a lot of the stuff from the regulator last week.

We have broken down the slides into a number of different elements that sit within any electricity price. We look at wholesale electricity, competition in the market, regulated charges, and levies. We will then show you some analysis that we have done.

We start off with the electricity wholesale market, which is the single electricity market (SEM). The first thing to say is that suppliers do not discriminate between the Northern and Southern markets. It is a single electricity market, so it does not really matter. It is the same price, North and South. In the Irish context, it has to be recognised that we are at the end of a supply line and do not have the economies of scale that you see in GB or elsewhere. There is a common recognition that GB prices are too low; indeed, the GB market is looking at what it can do to try to attract new generation. The Single Energy Market Committee has a number of times endorsed the pool price and the mechanisms through which the price is calculated. It is a fairly heavily controlled market. Indeed, as you can see in the slides, the SEM Committee and the regulator have given the market an assurance that they are happy that the market is working, and working in a proper and fair manner.

As Tom said, we do not really operate in a regulated retail market. However, to all intents and purposes, everything that we do is controlled by the regulator. If you look, for example, at the SEM, the system marginal price and the capacity payment mechanism are set with the governance of both regulators. The network and pass-through charges are also set annually by the regulators, North and South, normally running from 1 October to 30 September. Levies, and so forth, are really in the hands of government, as are the taxes. The final element of somebody's electricity cost is our element — the supplier cost — and that is quite small.

One of the things that can be drawn from the paper is the very clear inference that the differential between ROI and NI was largely down to the lack of competitiveness, particularly in the industrial and commercial (I&C) market. As we go through the paper, you will see that competition is not the problem here, and we will spell out why for you. I will take competition as an item. As Tom said, we are, and have been for quite some time, a major supplier in the market. We have many highly competitive and innovative products. Speaking for our own business, in what we call an April contract round, I can say that over half of the businesses went out to competitive tender. That entails the businesses themselves going out to competitive tender on their own or using some of the major consultancies. In Northern Ireland — indeed, in Ireland — a large number of Great British, American and European consultancy bodies now do tenders. The feedback that we get from them when we are in the tendering process is that they cannot get, even in GB, some of the products that they see in the market in Ireland. They say that some of our products are way ahead of the GB market in providing opportunities for customers to take forward hedges and do risk mitigation. Therefore, competition is rife in this sector.

The Chairperson: Will you clarify one thing? I am a wee bit unclear about what you mean when you talk about competition for consultancy. I am a wee bit unclear about the difference between a highly competitive market competing for consultancy or competing for supply.

Mr Mawhinney: What I am saying is that customers can go out to get competitive prices in a number of ways. They can do that themselves — just go out and make contact — or employ consultancies to tender for business of their behalf.

The Chairperson: Yes, and in that market you have been highly competitive or been able to consolidate the market yourselves. Realistically, how many would you compete with?

Mr Mawhinney: Suppliers?

The Chairperson: Yes.

Mr Mawhinney: There are five active suppliers in the market.

The Chairperson: For the type of market that you have consolidated?

Mr Mawhinney: For the market that we are in, yes.

The Chairperson: Thank you for that. Please continue.

Mr Mawhinney: We have a highly competitive market, with consultants looking at all the suppliers and all the products. Margins are not high. Therefore, the price divergence indicated in the paper — typically in the order of £20 per megawatt hour (MWh) or 2p per kilowatt hour (kWh), which is a very high differential — cannot be down to a lack of competition. Even were suppliers to provide power free to the market, you would not narrow that gap by very much. Therefore, it cannot be competition.

The analysis shows us first that it was not disaggregated. Therefore, it is difficult to draw any conclusions, because you have nothing meaningful from which to draw them. We think that it is very important that this should be done on a like-for-like basis, particularly if you look at the quite dramatic scale of some of the other countries outside Ireland to which we were compared. In doing our analysis, we chose a representative sample of 45 large energy users (LEUs). We did their modelling and transferred them into a ROI model and modelled them one more time, as if they were relocated into the ROI market. The analysis that we will go through with you covers what we believe is extremely representative. It is an absolute like-for-like comparison.

Another point to make about the paper is that, as Tom said, some of the stuff was not very clear in it. The paper chose the 2011 tariff year for the comparison, and there were things in it such as the Irish Government's clear intention in setting the use-of-system (UoS) tariffs to move £50 million from industrial and commercial customers into the domestic market. That was clearly indicated to be a main driver, yet there is no recognition of it in the paper.

Secondly, in the same year, LEUs in the South also had a significant rebate applied to their bills, to which, again, there is no reference in the paper. Although there was a differential in prices, the swing, the use-of-system charges and the levies almost accounted for that differential. It would have been such an easy thing to have had that included in the paper, but it was not there. In questions in the Oireachtas, the Irish Government made it very clear that that is what they were doing. It is not as if it was something that nobody knew.

The regulator's report used 2011 end-user prices. We have annualised the ROI domestic market to make it simpler to look at. You can see that the ROI domestic market is typically £13 to £14 per MWh above the Northern Ireland price. When you cross over to the industrial commercial market, you can see that the differential is something in the order of £17 per MWh. You can almost see the swing from one tariff group to the other. The LEU rebates played a significant part in all of that. It was quite a significant rebate, and it finished at the end of September last year. We thought that that was going to make a difference. We then ran it using the current tariff year, so we are now using 2012-13. It has not really improved dramatically. It becomes very obvious that the subsidy of large industrial customers versus domestics in the ROI market has continued. As the LEU rebate has diminished — you can see that it is only negative £4 per MWh — the transmission use of system (TUoS) and distribution use of system (DUoS) tariffs in the South have been changed to reflect the fact that that was coming out. The differential has largely been maintained.

The next steps highlighted in the report were a bit premature, because a full and proper analysis had not been done, especially on the like-for-likes. The report shows Northern Ireland LEUs versus ROI LEUs. The top 26 customers in the South of Ireland are directly connected to the transmission system only, so they do not pay any distribution charges at all. Those top 26 customers' volume is bigger than the industrial and commercial market in Northern Ireland. That puts it on a scale for comparisons, and that is why we felt that we needed to take a representative group of customers —

The Chairperson: Can you explain to me — I am not a technical person — what you mean by them not being directly connected?

Mr Mawhinney: Imagine the journey of power out of a power station. It will come out and will come on to the transmission system. That will be at a certain voltage level. As you get nearer to customers, you will drop down voltage levels into what is called the distribution system. In the 2012 slide, you will see a TUoS charge and a DUoS charge. Twenty-six of the largest customers in the Southern Ireland market directly connect to the transmission system and therefore do not incur any costs on the distribution network.

The Chairperson: Does that mean that they have their own cabling?

Mr Mawhinney: They connect directly to the transmission system and then maintain the cables in their own site.

The Chairperson: That is grand. Thanks for that.

Mr Mawhinney: I was trying to highlight the scale. When you compare customers, unless you are comparing like with like, the economies of scale for the North and the South are dramatically different. The largest customer in Northern Ireland is less than 10 MW. None of the top 30 customers in the South is below 30 MW. You are not comparing like with like in any shape or form. The analysis that we have presented takes a very representative sample.

The report reached some conclusions without having done the full analysis. Therefore, network charges, and the allocation of those charges, is more to do with government policy, as Tom quite rightly said. Critically, when you look at the representation, we need to look at competitiveness. Resources are scarce in all our Departments. If you are to address things, you need to look at stuff so that you can get the best result for that allocation of resources. It is certainly around network charges and the allocation of costs in them at which you need to look. To summarise, supplier margins do not contribute to the issue that we are talking about. If we were to do it for free, that would not narrow the gap.

Mr Gillen: Thank you, John. That is the introductory presentation finished.

The Chairperson: Thanks very much for that. Some of the big users on the rest of the island are reducing the network charge, the connection charge, the cabling charge and all of that by having their own stuff. Is there not a possibility that that can be done here to reduce charges?

Mr Mawhinney: Northern Ireland has a slightly different network structure. The highest voltage that customers can connect to the network in Northern Ireland is 33,000 V, which is still on the distribution system. It is quite far up the distribution system, but it is still part of the distribution network. Customers such as Michelin, which spoke to you last week, will be connected to the 33,000 V network, but it cannot go any higher owing to the Northern Ireland infrastructure.

The Chairperson: Is there a legal obstacle, or is it just a technical or electrical reason why it cannot be done?

Mr Mawhinney: I suggest that it is more for technical and electrical reasons. I do not believe that it is for a legal reason.

The Chairperson: In other words, if a firm were to invest in an upgrade itself, it could be done subject to the figures working out.

Mr Mawhinney: Yes. The only cautionary word that I would sound is that there is a scale to all of this.

The Chairperson: I appreciate that.

Mr Mawhinney: If a smaller customer takes on its own network, and so on, it becomes costly. You need to be up the scale, so we are back to the scale thing again. As I said, the largest customer in Northern Ireland is less than 10 MW. The vast majority of customers in the South are above that.

The Chairperson: Yes, that is the point. Your business case would have to work out before you would attempt it. The customers in the South are able to do it because they are big enough to do it.

Mr Mawhinney: Correct. It comes back to scale again.

The Chairperson: You refer in your submission to a point that has come up before. Under the heading "Conclusion & Next Steps", you state:

"reducing our dependence on fossil fuels."

We are increasing the capacity for the use of non-fossil renewables. The point has been made to us, which you are probably more aware of than the rest of us, is that the reason that Power NI upped its

prices was down to the fluctuations in the price of gas and the markets that it is heavily reliant on. You make the point here that we have to reduce dependency on fossil fuels. How do you see increased reliance on renewable sources of energy having a levelling effect on the ultimate cost of the electricity coming out? Will it have a levelling effect?

Mr Gillen: John will have a go at answering that, but I will try to explain the theory behind it first.

Renewable energy has zero cost. Each unit of production does not cost anything to produce. Therefore, although there are laws around this, when it enters the market, it basically comes first in the market. Therefore, if there is 1,000 MW of wind, that gets stacked up in the market, and the 1,000 MW of wind is run, what that does in the SEM is that it knocks out the top 1,000 MW of the expensive plant. Therefore, you are displacing the expensive plant with the zero marginal cost plant. That is how it works. The theory is that reduced prices will be knocked out. We own two power plants in the South of Ireland. We know that we get knocked off when wind is high. Our plant, which costs €50,000 or €60,000 per MWh, will be knocked off by a plant that does not cost that much, and that reduces prices. Therefore, it does have an impact on prices. Now, quantifying it —

The Chairperson: That is exactly it.

Mr Gillen: There are a lot of papers on what the numbers mean. It is not our job to go around and quantify what those numbers are, but it will certainly have the effect of reducing prices.

There is another impact if you are not importing fossil fuels. The island of Ireland has nothing. Wind is the only resource that it has. Governments in both jurisdictions and, indeed, Europe have bet on wind. They are effectively saying that wind will displace fossil fuels because they do not like the uncertainty of fossil fuel prices going up and down. When fossil fuel prices are very high, as they have been recently, Governments prefer to have wind. When fossil fuel prices are very low, wind is not the best bet. However, on the whole, the view among everyone is that fossil fuel prices will —

The Chairperson: We heard last week that one of the companies that broadcasts itself as being heavily reliant on the renewables sector for its energy bumped its price up by the same scale as Power NI. Many of us found that a wee bit hard to understand, given that that company says that a good part of its energy comes from wind. It seems that the company was piggybacking on an opportunity to bump up its costs and keep its margin a wee bit lower than that of Power NI, which it says is heavily reliant on gas and is subject to fluctuations in the price of gas. The big question is how you prevent that piggybacking exercise? Is further regulation required to prevent it? Companies all have to make profits: that is why you are there, and we understand that. However, those profits should not be exorbitant or excessive, to the point at which the consumer is shafted once again.

Mr Gillen: It is Airtricity that you are talking about, so you will have to ask its representatives that question when they appear front of you. We speak only for our company. We have not increased prices for consumers, because we handle our pricing in a very different way from the regulator and Power NI. As John says, we have customers who want complete flexibility. All that a lot of the large users want is to be at the market price. That means that if the cost of gas goes up or down, they are willing to pay the price, because that is what their competitors are paying. We ask our smaller businesses whether they want to fix the price. If they want to fix the price, that is locked into their contract for a year, two years, three years. For us, prices did not move at all. They did not go up by 78% and they did not fall. You have to direct the question of why Airtricity put its price up to representatives of the company.

The Chairperson: I appreciate that.

Mr Gillen: It is a market. Power NI's prices are managed by the regulator, who, I am sure, pushes them down as low as he can, when he can. It could be that Airtricity has been losing money on its customers for some time so the prices had to go up eventually.

The Chairperson: You said that, when you looked at the regulator's research paper, it was "incomplete". Is what you have submitted to us today your completion of that?

Mr Mawhinney: This is a piece of analysis that should have been done before the paper was issued. When you read the regulator's paper, it is sort of inconclusive, yet it had conclusions about what the next steps should be. Our query, and that of our customers, was why we are spending time looking at

this when network charges are the main issue. If you look at the slide for 2012 as an example, you will see that we have looked through all the elements that make up a customer's cost. I will take you through those, if you feel that it will help you.

The Chairperson: We have the statistics in front of us, and members can absorb them. That is the bit that you say was incomplete.

Mr Mawhinney: Yes, it was incomplete. We have done this work for a specific group of customers, who are very representative. Somebody might turn around and say, "Why did you use them instead of another group of people?" We believe in our knowledge of the market, and this was a very representative group. The findings are easily transportable from North to South because there are very similar tariff structures in place.

The Chairperson: All the customers in your research are higher-end business users?

Mr Mawhinney: Correct.

Mr Flanagan: Gentlemen, it is good to hear from you. It is great to hear from you, because I had never heard of Energia before.

Mr Gillen: Few people have.

Mr Flanagan: One of the big differences between you and Power NI is that you do not spend a huge amount of money on advertising, because, at the end of the day, it is the consumers who are the ones who pay for advertising. In your paper, you describe yourselves as, "a vertically integrated energy business". What does that mean?

Mr Gillen: We have generation and supply.

Mr Flanagan: Is that all under the one company?

Mr Gillen: It is all under the Energia group, yes.

Mr Flanagan: Therefore, you do not do the same as SSE, which has a generation company and a supply outfit.

Mr Gillen: No. You also said that one in four wind farms has a long-term contract. Do you own those or do you have some sort of arrangement —

Mr Gillen: We have a very small share — around 15% — in seven or eight wind farms, but we do not have anything to do with the vast majority. Effectively, those are wind farm producers who are not part of the Electricity Supply Board (ESB), Bord Gáis Éireann or SSE. They are independent. They bring their projects to us, and we help them through the banking and project finance process. We also act as their interaction with the market. They do not have to set up their own systems. That is what the power purchase agreement does.

Mr Flanagan: What do you get for that? Do you get a financial return out of the profit or a guarantee of electricity supply?

Mr Gillen: In the SEM, there is no guarantee of an electricity supply because it all goes into a pool, so it does not work like that. It depends what the contracts are, but we do get paid for it; yes.

Mr Flanagan: Is it really of any benefit to you as a supply company or is it just another revenue stream for you?

Mr Gillen: It is a revenue stream. I will give you an example, although I cannot name the customer because they will not let us, but we have integrated the product of five wind farms that we have agreements with, and we have sold that on to a very large customer that has been based in Northern Ireland for five years because he wanted access to renewable power at a price that did not fluctuate when he was doing his forward planning. We treat it as a source of power for ourselves as well, but it is a matter of what you do with that once you have it. For example, a lot of large customers in

Northern Ireland want to be badged as using renewable energy. That allows them to pass that renewable energy on because part of the deal that we have with customers is the greenness element of that: we can transfer that to our customers if we want to.

Mr Flanagan: One of the things that we touched on last week with the Utility Regulator was the fact that all generators are paid the price of the highest generator in the market, which I find quite strange, particularly for wind farm operators. Would it not make more financial sense for wind farm generators to be paid a fixed price over a 20- or 25-year period? They will know what return they are going to get if the wind blows, instead of giving them either nothing, or £50 or £60 per megawatt hour.

Mr Gillen: OK. I will have a go at that first, and then John can jump in. The problem with that is that you are transferring the risk on to the consumer. You do not know when you set that price whether it is going to be good for the consumer or not. The way that it is done at the moment is that the renewables obligation certificate pays a proportion of it, and the rest is left at the risk of the generator. The problem with setting a price and guaranteeing return over 15 or 20 years is that we are asking the consumer to take that risk, but when you set that price, you have no idea what is going to happen in the future, therefore, you cannot quantify that risk. That is why policymakers step out of that and put the risk on the generator.

Mr John Newman (Energia): I heard your questions last week regarding system marginal price and the fact that all generators get the same price.

Mr Flanagan: Patsy talked about bidding £2 or £3 for a bag of spuds.

Mr Newman: If he can sell them at £3, he will sell them at £3. If you can grow them for £2, you will still try to sell them at £3. That is the way that the market works. You will try to maximise your profit. In the electricity market —

The Chairperson: Therein lies the issue for the consumer.

Mr Gillen: Yes, but that is what competition is about. It is to make sure that those costs are kept as low as possible for any commodity.

The Chairperson: That is if you use the free market as a method of control.

Mr Newman: It is.

Mr Flanagan: We do not. We use the most expensive people to set the price.

Mr Gillen: In electricity generation? Do you want to run through marginal cost?

Mr Newman: It is a commonly accepted economic model that that is how markets work, whether they are explicitly regulated to result in the marginal price, or whether they do it through competition. Electricity industries across the globe often use system marginal pricing in a similar way that we do in Ireland. A lot of markets in the United States do it. There is a successful Nord pool in Norway and Sweden, and they use a single, clear pricing mechanism. It is also done in Spain and Australia.

The reason why electricity markets have an explicit mechanism to achieve the desired outcome that a competitive market would is to promote transparency so that people can see where the prices are coming from. That is what has happened in Ireland. In fact, Ireland has gone a step further than a lot of the markets, in that, as well as having a defined system marginal cost or system marginal price mechanism, there is an additional layer of regulation on top that says that generators must offer to generate at a cost related to their underlying fuel costs. So, as a gas-fired generator, our cost of generation is driven by the price of gas and the price of carbon emission permits. When we are offering to generate, you can see what we are offering and link that back to the cost of gas and CO₂.

Mr Flanagan: For somebody who owns a wind farm or engages in another form renewable energy generation, the price that they are paid is not reflective of the cost at all. It is the price that they bid at; that is not what they are paid.

Mr Newman: It is reflective of the value. Let us say that you are a farmer who puts a wind turbine up on his land, which many farmers do. When you sell that electricity, although it might cost you nothing to generate, you are not selling it for nothing: you are getting a figure related to the system marginal price.

Mr Gillen: It is the value of the product. There is a reason why the system marginal price works. I talked at the start about putting 1,000 MW on the market, displacing the top 1,000 MW. If you let everyone bid what they want, effectively that wind farm could bid as high a price as it wanted: it could bid above the marginal cost and bid to the plant that is knocking out the top end, so you would be paying much more for energy. The marginal cost is there to ensure that everyone bids at cost. If you have an efficiency, which wind does over gas generation, it bids in at zero and gets that efficiency payment. Why does it need that payment? If the generator does not get paid the marginal cost, it could not afford to build a wind farm. The scheme in the UK means that you need some market income for the investment to work. In Ireland, that is derived through what is known as infra-marginal rent, which is the difference in the money the generator makes between the marginal unit and their wind farm.

Mr Flanagan: You say that if the wind farm operators were not paid the value of the commodity or did not get the price that gas and oil generators get, they could not afford to develop wind farms. However, we have wind farm generators posting profit margins of 79%.

Mr Gillen: That was in the Utility Regulator's report. That was operating profit. The figure below that is their margin, and we cannot work out what that means, although it is lower than 20%. I could not just go out, build a wind farm and access returns like that. There is a 10-year development from starting to talk to someone to getting the thing constructed and joining the market. While you are building that one wind farm, you have may three or four other projects on the go that never make it.

There are very high capital costs: wind farms are expensive to build. The wind farms that we have built have taken between eight and 10 years to pay back. You would not see that type of investment in manufacturing. Those returns might seem high, but there is a big lump of money invested.

I will say a few things about the regulator's report. First, it takes a snapshot of one year: 2011. Who knows what the future returns will be? They may be nothing like that. I would be surprised if, this year, they are anything like those in 2011, given where prices are. Secondly, the money is covering not just the cost of the wind farm but the cost of all of the development opportunities that they are involved in. Thirdly, things may go wrong for the wind farm developer. That is quite important because in Northern Ireland over the years we have been laboured with contract costs for the likes of Kilroot, Ballylumford and, to some extent, the Moyle interconnector, where consumers have had to pick up the tab if things go wrong. If the wind farm goes wrong, it is the owner's problem and the bank's problem — it has nothing to do with consumers. A very important part of electricity generation and how you design these markets is who takes the risks, because utilities are long-term investments over 15 to 20 years. We have built two power plants in Dublin, which have cost us £500 million. We are making losses this year on those plants. That is the way it is.

Mr Flanagan: Are you making an actual loss, or a loss based on the investment you made at the start?

Mr Gillen: An actual loss.

Mr Flanagan: You have provided us with the views of the SEM committee and the Utility Regulator. The SEM committee states:

"The SEM model of setting prices in a transparent and cost reflective manner is not only assisting to promote competition and attract new investment, it has also resulted in improvements in the availability of generation plants".

The Utility Regulator's report states:

"After over four years, the SEM continues to delivers benefits to consumers. The SEM ensures that the price of electricity charged to consumers is reflective of the costs incurred by the generators to actually produce the electricity".

I am not asking you to speak for them; I am asking for your expertise. How was the price of electricity charged to consumers by, we will pick on Airtricity, reflective of the costs incurred by the generator, say SSE, to actually produce the electricity? I do not understand how that sentence makes sense.

Mr Gillen: You would have to ask SSE. All marginal cost does is recover the short-run marginal cost: the price to generate the next unit. There are significant costs on top of that in building the thing, financing it, etc. Those costs have to be recovered. I do not know what the regulator had in his mind, but I assume that that is what he is talking about. This market fairly compensates generators for their investment and the fuel that they burn. It is not our argument; it is Airtricity's argument. The suggestion is that, because the thing generates at zero, whatever prices or gas prices do, it should still charge zero. However, if that were the case, nothing would be built.

Mr Flanagan: I am not saying that it should charge zero, but there needs to be some sort of fixed payment for a period of 20 or 25 years, regardless of where prices for fossil fuels continue to go. Renewable energy generators should have a much greater downward impact on prices. If the price that they were paid per unit was fixed and agreed before they started to develop something, it would have a better impact on consumers, instead of delivering an excessive profit margin for generators.

Mr Gillen: I am sure you are aware that, in 2017, they are changing the Northern Ireland schemes for how renewable generators are paid. There is going to be a refit programme.

Mr Flanagan: That is incentivisation —

Mr Gillen: You have to be careful, especially given the history that this country has had of long-term fixed-price contracts. Over the long term, they tend not to work, because you only ever sign those contracts when you really need something. It is kind of an act of desperation. Therefore, the people who build those things extract as much out of it as possible. You then find in a few years that economic situations or political circumstances change, and you find those contracts very much out of the money. The experience we have had of that in this country has been pretty disastrous.

The Chairperson: I appreciate you taking the time to move into areas that are not directly your responsibility. It is good to hear your take on them.

Mr Dunne: Thanks, gentlemen, for coming today. I have found it interesting. Looking at the analysis of the end-user prices for 2012, is it fair to say that domestic customers in the Republic are heavily subsidising the business users?

Mr Gillen: They are indeed.

Mr Mawhinney: As I said in the paper, there was a very clear indication that they were going to move circa €50 million out of the use of system tariffs for large industrial customers into the domestic sector. To be honest, that is why we did the analysis looking at 2012, to see whether, as time has moved on, that has changed. Really, when you compare 2011 and 2012, you can see that it is not really changing, specifically when you take into account that the large user rebates, which are a separate issue, are being done away with. Therefore, they have a lesser influence in 2012 than they would have had in 2011. So, as they have gradually been coming out, the DUoS and TUoS tariffs appear to have been structured to maintain the differential.

Mr Dunne: The DUoS variable is very high in the Republic in relation to domestic customers.

Mr Mawhinney: Correct.

Mr Dunne: Effectively, they are subsidising it.

Mr Mawhinney: Correct. As I said, you can see that Manufacturing NI also used the same quote. It was a clear question in the Oireachtas. In summary, they said that they had two choices: we can have people working and have a manufacturing base that allows people to work and earn, even if that means high prices at home; or we can have no jobs. That seems to be the approach that they have taken.

Mr Dunne: The domestic consumer is paying. What about the interconnector, which has been debated and talked about? What are the long-term benefits of that for yourselves?

Mr Gillen: Is that the North/South interconnector?

Mr Dunne: The proposed one.

Mr Gillen: It is treated as part of the transmission network. To take a step into the theoretical, the way the market works is on an all-island basis, or what is called an unconstrained market. Unconstrained just means that there are no wire constraints around it. Where the North/South interconnector comes into play is when you talk about constraints. Effectively, on the island of Ireland, we have a surplus of generation. That is all in the South of Ireland at the moment. The North of Ireland has a deficit of generation. The only new generation to be built in Northern Ireland is wind. The Systems Operator for Northern Ireland (SONI) has told us that there are no plans in the next 10 years to build any thermal generation in Northern Ireland. Therefore, the North/South interconnector becomes critical for security of supply and to reduce costs. That is why it is important.

Mr Dunne: Will you benefit, or hope to benefit, from it?

Mr Gillen: In money terms, we would not benefit. It would make no difference financially to us.

Mr Dunne: Would it give you any opportunities —

Mr Gillen: No, because it is part of the transmission network. It is going to be owned by asset owners; by SONI and EirGrid. It is not going to be a competitive interconnector. It differs from the interconnector between Scotland and Northern Ireland or the one between Dublin and Wales. This interconnector is needed for security of supply and to reduce imperfections charges. The reason those get built up is that, if you have a surplus in the South, the market will say that more plants in the South should be generating. However, because it cannot get the power to Northern Ireland, it effectively means that Northern Ireland plants have to generate, and that costs consumers.

Mr Dunne: Is there a shortage of energy on the mainland?

Mr Gillen: In England?

Mr Dunne: Yes.

Mr Gillen: The expectation is that there will be a deficit in generation. That is being planned for.

Mr Dunne: What about the cost of connection for renewables? For people who are setting up plants and wind farms, the cost of connection to the grid is a big issue. Is that still a deterrent for people?

Mr Gillen: There is a new structure for connection costs for wind farms in Northern Ireland that groups sites together, which seems to make a lot of sense. The regulator and NIE have come up with that. The one that we are dealing with at the moment, for example, is at Magherakeel. That substation has been built for wind farms. The wind farms will directly finance that and build it. The issue about connections and wind farms is to do with the risk of actually getting the connection. So, when I was talking earlier about having three or four wind farms on the go, you might get one or two that actually get built. You may find that they cannot get connections to the grid. If they are offered a connection, it might be expensive. On the whole, grid connections are what grid connections costs. That is kind of the business that we are in. For some wind farms, the grid connection costs might be too high and it just does not get built.

Mr A Maginness: Thank you, gentlemen, for a very interesting presentation. I am not certain that you and the Utility Regulator's paper are really in conflict. You have said that the Utility Regulator implies that the differential between Northern Ireland and the Republic, in terms of industrial commercial prices, results largely from lack of competition. I am not so certain that he was saying that last week.

Mr Gillen: He was not saying that last week.

Mr Mawhinney: It is an interesting one.

Mr A Maginness: But you are saying that the paper said or implied that. Do you think that he has changed his tune?

Mr Gillen: To be fair to the regulator, he has put the paper out there, he has taken evidence in and he has changed his mind. I have no problem with that at all.

Mr A Maginness: So, really, you are at one in relation to —

Mr Gillen: I think we are now.

Mr A Maginness: You are now. Right. I was just wondering where the conflict was. That has been resolved. What do you think competition is like on the island of Ireland?

Mr Gillen: In our sector?

Mr A Maginness: Yes.

Mr Gillen: It is very competitive. For example, Northern Ireland is a very small market, by any stretch of the imagination. There are five companies like ourselves competing in it at commercial sector level. Under public sector quotes, we supply all the schools in Northern Ireland. When that quote process went through, there was a huge amount of competition and two tenders. They got a very keen price out of it.

Mr A Maginness: What about the South?

Mr Gillen: There is greater competition in the South. It is a slightly bigger scale. It depends what market you are looking at, but there are similar companies, with some smaller companies that compete in the South as well.

Mr Mawhinney: You would certainly see a lot of the multinationals doing all-island deals, for example. That is very common now. Five or six years ago, that was less so.

Mr A Maginness: Are they doing that in the North, the South or both?

Mr Mawhinney: Both.

Mr A Maginness: That should mean that commercial prices should be lower.

Mr Mawhinney: From our side, that is where the competition is. Those guys are doing huge tenders. Everybody is in those tenders, which could take two or three rounds to conclude. Competition has got the market to where it is at. Indeed, I watched last week's meeting. You asked some of the guys from Manufacturing NI whether they had been out, and they had. We know that because we deal with some of them. The market is very competitive and the margins are down at very competitive levels.

Mr A Maginness: As far as I can see, there are two differences between the South and the North. One is the scale of business or manufacturing in the South. It tends to be larger and they can do their own thing, as it were. Therefore, that acts to ensure that prices are a bit lower.

Mr Mawhinney: Because they are bigger?

Mr Gillen: Well, no. That is not correct.

Mr A Maginness: Tell me where I am wrong.

Mr Gillen: We are talking about supply competition and a very small percentage on top of that. Most of the bill is made up of generating costs. The reason why the SEM was put in place is because it was decided that Northern Ireland and Southern Ireland were too small to make any difference and that way to get lower prices was to combine the two markets so that there is competition in the sector. That is derived through what we have just talked about: short-run marginal cost. There is no doubt

that prices are much lower than they would be otherwise because that market is put in place. That drives competition on the wholesale sector. At the supply end, that is done through us competing with each other.

Mr A Maginness: But scale must have an effect.

Mr Mawhinney: Scale has an effect, simply because the bigger you are, most likely what you will find is that your usage is more level. Therefore, the more level your consumption pattern is, the better price you will have. You will generally find that, for example, large pharmaceutical companies and people like that take a large and fairly steady load, half-hour by half-hour in the day. That will always get you a better price.

It is a bit like driving your car. If you drive it erratically, up-and-down all the time, you will get poor fuel consumption; if you drive it steadily, you will get better fuel consumption. You can almost take that analogy to electricity. If you use electricity fairly evenly, which the largest guys tend to do because it is a big load, they get a better price.

Mr Gillen: Probably another aspect that scale affects — John, correct me if I am wrong — if you are Hewlett-Packard or the big pharmaceutical plants, you will have a number of people who concentrate solely on energy cost. That is not just the bit that we work on; we also deal with energy efficiency and renewables. They spent a lot of time on that. When it comes to competition, they are happy enough with the price. They are looking at what they can do themselves get that cost down. That involves hedging and taking bits out. However, when you get down to smaller users, they just do not have that expertise and they cannot do that.

Mr A Maginness: The other difference arising from your presentation is government policy. We have the statement by Minister Ryan who said that the Irish Government wanted:

"to mitigate the cost of energy for industry."

That was a deliberate policy decision. Mr Dunne has pointed out that there is a consequence to that, which is that there will be an increase or a higher level of pricing for the domestic consumer. However, that is a policy choice for government, is it not?

Mr Mawhinney: Very much so. As Tom said at the outset, it is not something that we have any control over.

Mr A Maginness: I am just wondering how that policy choice could be considered by the Northern Ireland Executive, and what the reaction in the Assembly and among the public might be.

Mr Newman: I think that, probably, from our perspective, the important thing is to give the policymakers the right information to make those decisions. That is what we have tried to do in response to the original paper by the Utility Regulator. We have tried to set out how the differences have come about, which are not in the competitive part of the market but in the uncompetitive part, namely government policy and the cost of actually using the wires.

Mr Gillen: I have some experience of how that decision came about. The operation in the South is slightly different. They are more prone to get everyone together into a room and try to work out what can be done. They give priority to jobs, and huge priority to multinationals.

Mr A Maginness: Do you mean as social partners?

Mr Gillen: At that time, the social partnership was starting to fall away. This happened after the recession started. There was a real fear in the South of Ireland that large users were going to flee the country. There was acceptance at the highest levels of the Government that something had to be done very quickly. That is how that came about. To be honest, it surprised us when it happened, but it was quite public and there was no anger. We all worked in the South of Ireland and there was no backlash of any sort at all about it. Everyone seemed to accept that that was what needed to be done. That has continued, it will continue and it will not change now.

Mr Agnew: Thank you, gentlemen, for the information so far. The energy market is complex, whether the regulated or the competitive market, so all the information you can give us on all the various

aspects are appreciated. You will have seen that from our meetings last week. We will be hearing from Power NI after you. We are trying to hear as many voices as possible and get perspectives from across the industry to help us understand it better. Ultimately, our priority is the needs of the consumer. Often, that is perceived just as the lowest price, but sustainability and security of supply are other aspects of that. We have to look at the long-term picture, not just the short term or the next price that is set. This is a complex area. Let me check that I have picked up correctly: did you say that, if you reduce your margins, it will have little impact on price?

Mr Gillen: With respect to Energia's margins, we would go nowhere near curing the issues here. What suppliers do for large customers is all the hedging requirements, energy efficiency advice, billing, etc. If you took all that stuff away, it would not make a dent in this thing.

Mr Agnew: OK. I suppose that that is the case across your competitors as well; not just Energia.

Mr Gillen: It will be the same across all of them.

Mr Mawhinney: If you take the gap that was highlighted in the regulator's report, as I said at the beginning, it is around £20 per megawatt hour. To you and me, that is 2p per kilowatt hour. The supplier margins in this market are decimal points of a penny, so it is not going to cure a 2p per kilowatt hour differential. That is why I said that, even if we were to sell for nothing, it will only make a decimal point of a penny differential. It will not sort out the problem. The problem lies, fairly and squarely, in both the regulated charges and in government taxation policy. That is what is going to have the big impact. If we were to transition the wholesale market into something else because we thought it was a good idea to change it, that same wholesale market would be common to both North and South. So, if you happened to be able to drop the price — for talk's sake — by £10 per megawatt hour, it will drop by £10 per megawatt hour in both markets, but the gap will still be there.

Mr Agnew: It will not have an impact on the gap, but it will have an impact on overall price.

Mr Mawhinney: Yes, but the gap differential —

Mr Agnew: OK. That is where I was a bit confused. I could not work out why it would not affect prices. I appreciate how it would not affect the gap. I accept that.

I hosted a meeting on Tuesday evening. It was an energy debate, largely about renewables. It was suggested across the board that there should be competition. I understand that, for a lot of markets, monopolies are bad thing, but, in the energy market, there is certainly a section of the opinion that holds that competition has not worked, because of the high capital costs for a lot of things — whether it be generation or grid infrastructure. Having a monopoly system allows planning for the future in a better way than we can do in the more disaggregated system that we have now.

You have read some of the discussions that we had last week. In your view, how is competition working for the end consumer? I go back to the point that everyone will charge in and around the highest cost of energy production and generation. In that type of market, as the Utility Regulator put it, we need all the energy. It is not a case of whether I buy spuds from one person or another — we need all the spuds, to use Phil's analogy. How is competition working for the consumer?

Mr Gillen: We are talking about the business consumers. Prices are cheaper with competition than they would be without it. Security of supply is stronger with competition than it would be without it. After I have answered your question, I will give you an example about a wind farm and about what competition means in practice and what it forces us to do.

I have said this a few times, although perhaps it is not hitting home: the risk attached if you do not have a market is huge. If you push that, if you or the Department, as the policy-makers, decide to plan this over the next 10 or 15 years, you put the risk on the consumer. An example of that would be the Moyle interconnector. There is a large bill to fix it because that has been taken on by a mutualised company, which means it is shared. That is out of the consumer's pocket. If you were to do that for the whole electricity sector, you would very quickly run up huge mountains of cost. Northern Ireland is just coming out of the Kilroot/Ballylumford prices, and that was done through the idea that we want to give a very long-term fixed contract because the things that we said were priorities did not turn out like that. There is an inherent danger in doing that.

To explain how competition works, we are trying to build a wind farm at the moment. As we have to get it as cheaply as we can in order for it to be built, every part of our supply process is competitive. For example, I have two accountants who are talking to a bank called NORD/LB in London today to try to get the finance costs down. We are talking to other banks; we are running a competitive process to get the finance for it. We are talking to three or four wind turbine manufacturers, again to try to get the costs down. As to civil contractors, that gets tendered out to three or four people to try to get the lowest cost. The competitiveness that happens at the top end to get prices down filters all the way down the chain, because we know we that unless we build something that is as cheap as we can make it, it will not get into the market and it will not make money. The competition filters down throughout.

Mr Mawhinney: We even take that to the customer end, which was part of your question. We had a meeting yesterday where we looked across our contracts. I mentioned the use of consultancies; we are into the third round of a tender. There are three final rounds, and every time it is the final round, it goes back out again so you can sharpen your pencil a bit more. All the suppliers are there, but we only have control over a small part. Certainly, at the consumer end, yes, competition has driven down prices.

Mr Gillen: What competition cannot cure, and I think this is what you are thinking, is the fact that Ireland is on the edge of Europe and imports everything. We cannot do anything about that. We cannot cure the fact that we are small electricity-wise. To give you an example, you could not build a power plant in Ireland bigger than 450 megawatts, whereas in the UK, they would be building plants at 1,450 megawatts. That is because if a big plant failed, you would be in real trouble. There are a lot of things that make this. Everything around the market structure is to drive what we have in the cheapest way that we can, and it works. Not only do we say it works, the regulators say it works and the EU says it works. Everyone who looks at this market says it works.

Mr Agnew: I didn't shake my head exactly, but I think there is a query about stability of prices. I said that low prices will always seem attractive, but stability of price is also important for forward planning. As was outlined before, every time the gas price changes, the price to the consumer changes. At least fairly frequently, you see significant annual changes and between-year changes. I know the prices fluctuate even more in the commercial market, and I just wonder whether the consumer is prepared to pay a bit extra to have stability. I do not know the answer to that; I put it as a question.

Mr Newman: Our customers, have the option of fixing their prices.

Mr Agnew: That is interesting.

Mr Newman: That is what we bring to the table. Customers can have what they want; they can have exposure to volatile prices because they may think that prices are going up or down, probably because they are going down of course, or they can fix the price through us and get that stability.

Mr Agnew: Would you have a rough idea of what proportion of your customers go for the variable tariff?

Mr Gillen: At the larger end, most of them go for variable, and at the smaller end, most go for fixed. Every public light in the Republic of Ireland is supplied by our company. Taking into account that we have 100,000 business customers, we would be bigger than Power NI in terms of kilowatt-hours sold in the North and South. I have not heard of one complaint, certainly in the past couple of months, about prices being increased, because we have not done it. That is because we work to a competitive model. You talk about customers paying more; our customers do not expect to pay any more for the right to fix prices. They see it as a given because everyone else offers it in the market, therefore we offer it as part of our overall service. Price volatility — the prices going up or down, and the scale of the rise or fall — is a function of regulation. That would not happen in a deregulated market. You would not see things like that happening to that scale.

Mr Agnew: If I may ask one more question —

The Chairperson: Quickly, please, Stephen.

Mr Agnew: It is around renewables. You mentioned that more wind power will knock off future gas generation. As regards the end price, in the overall scheme of things, do you see the extra investment in renewables that is required — grid investment, etc — being good for consumers?

Mr Gillen: We have not done the sums. Certainly, having renewables there is cheaper than not having them, in the market sense. If you add in all the network charges, I have not done all the calculations to work out the answer. However, you must remember that renewable energy is not just around price but is about not being held to ransom over imported fossil fuels. Governments got a big fright, for example, when Russia cut off the gas supply. There is a security angle to that.

There is also the issue of decarbonisation. We have to decarbonise. Renewable energy is, in Ireland, the only way to do that. It is not solely priced based, but it has a competitive element, and that is very important.

Mr Agnew: Thank you. I appreciate that answer.

The Chairperson: Thanks very much for that. I have one or two brief questions. Can you tell me, if you can quantify it, what percentage of the energy your company uses comes from renewable sources?

Mr Newman: It would be roughly 20% or 25%.

The Chairperson: Something like 25%. Right. I notice that you have a turnover of £1 billion. What sort of profit margin do you have?

Mr Gillen: It depends what level you take it at, but I think that group profitability, after tax and taking into account everything else, is pretty marginal. It is just about breaking even, if not slightly below.

The Chairperson: Thanks. If you were sitting in our place —

Mr Gillen: Thankfully, I do not. *[Laughter.]*

Mr A Maginness: You are a wise man.

The Chairperson: And you had three bullet points on the way to reduce energy costs, what would they be? We touched on some of them; for example, regulation and caps on costs. What would you do?

Mr Gillen: There are three things that people need to focus on. First, energy efficiency is an easy way for customers to reduce costs. Things need to be available to allow the customer to do that. We often do a lot of energy efficiency work. We are spending £0.5 million in Northern Ireland this year to get energy efficiency. That reduces costs and creates jobs, but those schemes are liable to be cut because it costs government money to put those things in place. A lot of businesses could make good energy efficiency savings but would not have the £10,000 to invest, and it would not have a payback for a couple of months, but it is a very easy way to achieve savings.

The second way to reduce costs in Northern Ireland is to build the North/South interconnector. Not only is that needed to reduce costs, but, if we do not have it, we will have a serious problem with lights going out. The third is future interconnection —

The Chairperson: Is that about reduction of costs or security of supply?

Mr Gillen: Both.

The Chairperson: OK.

Mr Gillen: It does not matter to us whether it is built overland or underground. That is not our issue. However, it needs to be built. I cannot stress that more. You will be sitting here in three or four years' time having a very different conversation about why lights are going out. What customers will pay for that is hugely different from what they will pay when they have got it.

The third thing is the SEM. It works well and in exactly the way it was planned. We are coming up to EU integration in 2016. To be honest, we have to make sure that that market works well for us as well.

Mr Flanagan: You say it works well; who does it work well for?

Mr Gillen: It works well for consumers. It works well for everyone involved in it. The difficulty with talking about this is that it has been around since 2007, and you have nothing to compare it against. You see Power NI prices going up, but, as a competitive entry in the market, we do not come across customers complaining about it that much at all, to be honest with you.

The Chairperson: OK.

Mr A Maginness: I have one last point in relation to the North/South interconnector. How significant would the reduction in cost be?

Mr Gillen: It is tens of millions at the moment in terms of imperfections. It will increase. The ultimate cost will be if it is not built and the lights go out.

Mr A Maginness: So you get rid of the —

Mr Gillen: We get rid of a good portion of them.

Mr A Maginness: And in that way you reduce the cost.

The Chairperson: Gentlemen, thanks very much for your time. This has been very useful. As you can appreciate more than we can, it is complex.

Mr Gillen: If you want to talk to any of us again please feel free to contact us.