A Review of the Regulated Tariff Formula (RTF) Regime in the Gas Supply Market

CER/08/068

6 May 2008
1. Introduction

This consultation paper sets out a Commission review of the Regulated Tariff Formula (RTF) regime, which has applied to Bord Gáis Energy Supply (BGES) since 2003, and invites submissions from interested parties.

The RTF regime regulates BGES’ dealings with the 200 or so largest, regulated industrial and commercial (I&C) gas customers – as measured by gas consumption - in the State. It is described in detail below, but basically is comprised of:

- a methodology for setting BGES tariffs,
- a code of practice for customer contact with RTF-eligible customers, and
- periodic oversight of BGES’ compliance to the regime’s financial and non-financial terms.

This review is being carried out partly at the request of BGES itself who has submitted to the Commission that the RTF has achieved its stated purpose, is no longer required and should therefore be terminated. A copy of the BGES submission appears in the Appendix with minor deletions requested by BGES on grounds of commercial confidentiality.

The paper sets out:

- the legislative framework pertaining to the RTF (Section 2),
- the rationale behind, and the development of, the regime to date (Section 3),
- how the RTF works (Section 4),
- relevant market analysis (Section 5),
- a summary of BGES’s arguments (Section 6),
- some initial Commission views pertaining to these arguments (Section 7), and
- key questions on which submissions are sought (Section 8).

Written comments should be submitted by post, fax or email to

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2. Legislative framework

Section 23 of the Gas (Interim) (Regulation) Act, 2002 provides that the Commission for Energy Regulation may review and give directions to BGES in relation to the nature or amount of charges by BGES for natural gas supplied to its customers. In conducting any such review the Commission has consistently sought to balance its various statutory obligations which include promoting competition in the supply of gas while protecting the interests of gas end users.

3. Development of the RTF regime

To provide a context for the present review, it is worth recapping the development of the RTF regime to date:

3.1 Initial Commission decision

The Commission’s first direction to BGES on gas pricing in the eligible and non-eligible markets (CER/03/078) was published on 28 March 2003. It established a common pricing regime, known as the Regulated Tariff Formula, which would be mandatory for all customers of BGES consuming between 5.3GWh and 264GWh per annum. The Commission also signalled its intention to review the level of competition for the largest RTF sites (i.e. those consuming more than 146GWh) at a later stage. Under the direction, all BGES industrial and commercial customers which had become eligible to choose supplier during 2002 and 2003 were migrated to the Regulated Tariff Formula on 1 April 2003.

Details of the operation of the RTF formula were set out in an explanatory memorandum which also stated:

- the regulation was intended to give confidence to market participants that price structures had been established in a robust manner; and
- that regulation would remain in place until a competitive market had developed.

3.2 Market assessment criteria

In a supporting document published in conjunction with CER/03/078, the Commission addressed a number of respondents’ queries regarding the

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1 Sites consuming gas for the purpose of electricity generation were offered the option of being regarded as unregulated customers of BGES.
2 CER/03/079: Bord Gáis Energy Supply Proposals for Gas Pricing in the Competitive Market Segment, 28 March 2003
proposed decision, including a request that CER publish *ex ante* criteria for assessing whether and when an adequately competitive market had developed. The paper indicated that such criteria would be determined at a later date.

RTF Direction 04/306 (issued 18 months into the new tariff regime) included the following clarification:

*The Commission will use the following criteria to assess whether the RTF upper threshold should be reduced, or indeed, whether the RTF should be altered or removed altogether:

- The levels of customers switching suppliers in both the RTF and non-price regulated market sectors;
- The sustainability of competition\(^4\) within the RTF market sector; and
- The elimination (through market structures) of any benefit that BGES may enjoy by virtue of its market position.

The RTF market will be assessed against these criteria in 2005 when the Commission reviews the application of the RTF.‘

The same Direction clarified that BGES must discontinue the practice of offering a flat volume-weighted annual price to its RTF customers that were opting for fixed price contracts. It also allowed RTF eligible customers who use gas for the purpose of electricity generation to have the choice of either an RTF or an unregulated supply contract with BGES. This is now commonly referred to as the “CHP opt out” facility for RTF eligible customers.

### 3.3 Threshold reduction request

During the course of the 2005 review, the Commission was asked to consider reducing the upper RTF threshold for eligibility from 264GWh to 57.5GWh, corresponding to the Transporter’s Large Daily Metered (LDM) threshold. The basis for this request was that more than 50% of the Regulated Tariff Formula LDM sites had migrated to independent suppliers. Lowering the RTF threshold in this manner would have had the effect of migrating all the LDM sites into the unregulated segment.

CER rejected this request on the basis that there was no meaningful distinction between LDM and DM customers within the RTF. The Commission also stated that it regarded the level of switching to date in the non-RTF segment

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\(^3\) CER/03/080: Response to Comments Received on Draft Decision on Gas Pricing in the Competitive and Non Competitive Markets, 28 March 2003

\(^4\) This phrase refers to the likelihood of new entrants being induced to exit from the gas market if the regulatory restrictions in the RTF were to be relaxed or removed.
(specifically the unregulated segment) as being insufficient to meet the first of the three criteria listed above.5

3.4 Combined heat and power (CHP) site inclusion

In CER Direction 05/188a, the Commission further clarified that any discussion of market share in the RTF segment ought to take due account of the numerous CHP sites which had opted out of the RTF. The Direction also indicated that CER intended to wait for the outcome of its impending Review of Competition in Gas Supply ("Review of Competition") before identifying a level of customer switching in the RTF segment which might justify removing the regulation. The Direction also amended the capacity charges in the pricing formula, in an attempt to make them more cost reflective.

3.5 Recent Commission decisions

In its most recent RTF Direction (CER/06/168), the Commission reiterated that, pending the outcome of the then-ongoing Review of Competition, the eligibility rules should not be relaxed. In fact, BGES was to apply the CHP opt-out to new and existing customers in a somewhat more restrictive manner. This was deemed necessary after it had emerged that a high proportion of the opted-out sites had failed to provide any documentary evidence of their CHP status as required by the Commission.

Analysis undertaken during the Review of Competition concluded that the degree of RTF customer switching up until mid-2006 remained relatively modest6. Nevertheless, the issue of amending the RTF rules as part of the Review of Competition was briefly addressed in a CER document7 published shortly afterwards. The document made reference to the planned development by BGES of more cost-reflective tariffs for its Non Daily Metered (NDM) industrial and commercial customers, stating that “CER may consider changes to the flexibility of the RTF once the structure of these remaining customer tariffs had been determined.”

CER/07/023 also noted the need for some mechanism whereby an appropriate portion of the portfolio efficiency benefits achieved by BGES would continue to be shared with all of its NDM customers. Moreover, it suggested that (in the longer term) it may also be appropriate to do likewise in the RTF segment. This suggestion was based on the following commercial logic.

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5 CER/05/127: Proposed Direction to Bord Gáis Energy Supply Regarding the Regulated Tariff Formula, 17th August 2005
6 'Introducing Competition Into the Irish Gas Market', Deloitte & Touche LLP, confidential final report to CER, December 2006
7 CER/07/023: Competition in Gas Supply – A Detailed review of Preferred Measures, 19th February 2007
The pricing formula in the RTF includes no discount for efficient management of Transmission Capacity by BGES, although BGES is understood to offer such discounts to its opted-out CHP customers.

Moreover, the pricing formula in all of the proposed NDM tariffs would routinely include such discounts.

Therefore, it would seem reasonable to allow BGES’ RTF customers to avail of similar discounts, provided that evidence of emerging competition and customer choice is observed for the unregulated industrial customers, the opted-out CHP customers and for the largest NDM customers following the introduction of market-based tariffs.

The Commission’s final decision paper⁸ on its Review of Competition confirmed that new market-based NDM tariffs were being implemented with effect from 1 October 2007.

### 3.6 Timing of current consultation

As can be seen from the above, the RTF regime has remained largely unchanged since its 2003 introduction.

Since its inception, the Commission has regarded the RTF as a stepping stone to building effective competition in the wider I&C supply segment. For this reason, CER periodically assesses the degree of competition amongst suppliers to larger industrial and commercial sites.⁹ The Commission has previously considered amending various aspects of the RTF arrangements which some stakeholders evidently regard as unnecessarily restrictive, but which others consider necessary and appropriate.

During these previous assessments, the Commission indicated that it would review the RTF following the completion of its Review of Competition and the implementation of revised BGES Non Daily Metered tariffs. Both of these occurred in late 2007. 2007 also saw a greater degree of RTF customer switching to independent gas suppliers and the full opening to competition of the retail gas supply market.

All of these developments, together with the recent BGES submission, suggest that now is a timely opportunity to re-examine the RTF and its appropriateness and effectiveness.

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⁸ CER 07/126: Competition in Gas Supply – Decision paper, 5th October 2007
⁹ CER also has the legislative remit to do so as highlighted in Section 2.
4. How the RTF regime works

A brief description of the financial and non-financial provisions of the RTF regime follows:

**Tariff Methodology**

RTF-eligible customers of BGES may opt *either* for

(i) an open-ended contract (in which the monthly gas commodity prices are related to a published monthly UK index price) *or*

(ii) a fixed term contract in which the monthly prices are determined at the outset.\(^{10}\)

Under either option the RTF pricing is as follows:

\[
P = \[(\text{ICE Price} + \text{Tgb} + \text{Psw}) \times \text{EUR/GBP} \] + \text{Tti} + \text{Tdi} + \text{Si} + \text{Fixed Charges}
\]

Where:

- \(P\) = The monthly invoice cost of gas for the customer
- \(\text{ICE Price} = \text{ICE Price} = \text{The relevant monthly Intercontinental Exchange (formerly IPE) settlement price or Index price as published in European Spot Gas Markets}\)
- \(\text{Tgb} = \text{GB transportation charges (pass-through at cost)}\)
- \(\text{Psw} = \text{Swing Premium (site specific, but typically between 0.3p and 1.0p per Therm)}\)
- \(\text{EUR/GBP} = \text{The Euro Sterling exchange rate}\)
- \(\text{Tti} = \text{Transportation charges for the Irish Interconnectors and on-shore Ireland Transmission System (pass-through at cost, but with discounts for summer-peaking customers)}\)
- \(\text{Tdi} = \text{Transportation charges for the Irish Distribution System (pass-through at cost)}\)
- \(\text{Si} = \text{Shrinkage charges on the Bord Gáis Transmission System (pass through at cost)}\)
- \(\text{Fixed Charges} = \text{A fixed charge (per kWh consumed) to cover BGES operating costs and 1.3% margin on total costs}\)

\(^{10}\) Customers can choose a three, six, nine or twelve month duration for RTF fixed term contracts.
Note the Swing Premium, which represents the cost to BGES of providing flexibility in daily consumption, has remained unchanged since 2003. The Fixed Charges are structured to reflect seasonal demand and the overall levels are also subject to annual review.

**Customer Contact Rules**

The Standard RTF Contract specifies the customer contact details as well as the start date and (for fixed-term options) the end date. It also includes terms and conditions which specify the rights and obligations of each contracting party. As such, the Standard RTF Contract does not differ materially from the content and format which might be expected for unregulated contracts. It is also similar to the standard Terms and Conditions applicable to Fuel Variation Tariff (FVT) customers. The RTF customer’s choice of pricing option is set out in a Schedule to the Standard RTF Contract.

The Code of Practice obliges BGES to behave in a fair and non-discriminatory manner in its direct dealing with RTF customers. This includes dealing promptly with complaints, and maintaining proper (auditable) records of any contacts. However, the Code of Practice’s stated purpose is to set out an ‘acceptable’ level of contact for BGES staff interacting with RTF-eligible gas users. This includes a detailed list of rules governing when and why BGES may initiate such contacts, and how it may respond to enquiries. This list includes the following specific restrictions:

- BGES may not make any comment to RTF-eligible users about competing suppliers or offers from such suppliers;
- BGES may only provide an RTF-eligible site a quotation in accordance with the prevailing RTF Direction and may only do so during defined time-windows (within two months of the expiry of any current contract);
- If an RTF customer switches away from BGES, BGES may not initiate further contact until at least three months have elapsed;
- Senior management within BGES must ensure that sales staff are familiar with the Code, and must conduct regular reviews of correspondence to ensure compliance;
- BGES must log any requests by RTF customers for information, and must make such records available to the CER; and
- BGES must consult CER in the event of any lack of clarity on applying the price formula for specific contracts.

A list of valid reasons for BGES to initiate customer contact is also provided.

The intention behind these specific provisions is to confer a degree of commercial protection to new entrant suppliers in the RTF segment against potential leverage by BGES of its strength and scale as the Irish gas supply market incumbent. The extent to which they are effective and warranted, or whether they are unnecessarily prescriptive measures, is open to debate. It should be noted however, that the Code of Practice applies only to the dealings
of BGES with RTF-eligible customers, and not to any other I&C market segments.

The Commission has annual audits on compliance by BGES with the RTF rules carried out on its behalf. To date these audits have not shown any evidence of material non-compliance.

5. Market analysis

5.1 Exclusion of self-shipping power generators

In 2007, self-shipping power generators accounted for some 62% of the total annual gas consumption in Ireland. The gas volumes demanded by these sites are sourced directly from the UK wholesale market. Competition for the supply of volumes to these sites occurs at the UK National Balancing Point (NBP), not amongst Irish retail gas suppliers. Moreover, we believe that once a power generation station begins to self-ship its own gas volumes, there is currently no valid commercial reason for it to permanently introduce, or re-introduce, an Irish agent to supply gas volumes on its behalf.

On this basis the Commission considers that, while in theory competition for supply to self-shipping power generators may be open to Irish retailers, in reality there is little or no prospect of such competition emerging because of legitimate commercial considerations and the natural differences between the two markets. Therefore, for the purpose of the present review, we should exclude self shipping gas customers and confine our analysis to the Irish retail gas supply market.

5.2 Commercial participants in the retail gas supply market

Excluding these self-shippers, the first firm other than BGES to supply the Irish gas market was the UK trading arm of RWE, which in 2002 had concluded a contract to purchase the output of the Seven Heads gas field. Because the expected volumes were very large, RWE initially marketed the gas only to unregulated sites. It had some success selling to power generation sites, but none in selling to the unregulated I&C segment, despite being able to offer potential customers substantial discounts compared to the marginal delivered cost of UK gas.

From April 2003 onwards, however, RWE actively sought and won numerous smaller I&C customers in the newly-defined RTF-eligible segment, mostly through its associate retail arm, npower. In 2004, RWE also became involved in supplying gas from the UK to a new CCGT power station in Tynagh, Co Galway. Shortly afterwards, however, RWE and npower effectively withdrew from the market.
Dublin-based energy supplier **Vayu** was established in 2003 and immediately entered the I&C gas segment. The firm’s initial business model was presented as a gas demand aggregator (effectively a purchasing agent) for a co-operative of dairy processors. However, it has since developed a diversified customer base within the RTF segment, acting as a trader rather than an agent. After the withdrawal of npower, Vayu emerged as a main competitor to BGES in the RTF segment. The firm’s marketing and promotional material emphasises its flexible service offering, and in particular the ability to use tools and similar options to reduce average gas purchase costs and to manage market price volatility.

**Energia** (the retail gas arm of Viridian) entered the Irish retail gas supply market in 2002. Its growth in the I&C segment has been gradual, but by 2007 the firm held a substantial number of RTF-eligible customers. Energia’s promotional material emphasises its ability to procure competitively priced gas supplies for retail customers. It also stresses a flexible and user-friendly service offering which enables customers to manage their gas price risk more effectively than was the case prior to market opening.

In 2004, **Flogas Natural Gas** was awarded a CER franchise to serve residential customers in five towns in the Midlands. Flogas has continued to serve these customers following full market opening in 2007 (and the subsequent expiration of its franchise agreement), although it has not so far given any definite indication of expanding into other geographical areas or into serving other types of gas customers.

Three other firms were recently awarded gas shipping/supply licences by the Commission: Gazprom Marketing & Trading, Scottish & Southern Energy and Power & Gas Ventures, Ltd., but are not yet operating in the Irish gas supply market.

### 5.3 Forms of regulation in the retail gas supply market

Prior to April 2003, any I&C customers of BGES consuming less than 264GWh per annum could choose from a range of published BGES tariffs. All of these tariffs featured flat commodity prices, none of which had changed for several years. CER Decision Paper 03/078 changed this by stipulating that RTF-eligible customers would no longer be offered such tariffs, but would instead be offered the RTF, a price regulation formula reflective of monthly wholesale prices. Temporary (price-capping) measures were put in place whereby BGES sought to mitigate the extent of the resulting price shock for certain RTF customers. However, such measures do not seem to have hindered the entry of new suppliers.

Non Daily Metered I&C gas users (below the RTF threshold) continued to avail of the published BGES tariffs. These sites were subject to revenue regulation rather than price control. In other words, BGES supply to NDM customers below the RTF threshold was subject to *ex ante annual fixed tariff approval* as opposed to *ex ante tariff methodology* approval by the CER. This allowed BGES
to enter into long term gas volume purchase agreements for supply to its NDM customers.

As wholesale gas prices continued to increase during the 2003-06 period, these long term contracts became more and more 'in the money'. However, BGES was required – through annual K correction factors - to pass the benefits to customers, including the I&C users. Therefore, although BGES increased its NDM I&C tariffs in April 2003, and again as a result of three subsequent annual revenue reviews, the delivered unit cost of gas for such customers remained consistently lower than that for RTF customers. Consequently, there was no incentive for independent suppliers to enter the NDM I&C segment.

This issue has since been addressed for around 1600 of the largest BGES Non Daily Metered I&C customers who, since October 2007, have been subject to a new price control formula, known as the Fuel Variation Tariff\(^{11}\), which has many structural similarities to the RTF.

BGES’ other Non Daily Metered I&C customers include:
- circa 5,000 medium I&C customers,
- circa 12,000 smaller I&C customers, and
- circa 600,000 residential customers.

These customers continue to avail of flat annual tariffs, for which BGES is subject to revenue regulation rather than price control.

However, these revenue regulated tariffs were restructured in October 2007 in an attempt to improve cost reflectivity, thereby eliminating any cross-subsidies which might distort competition. CER is also considering how, in the longer term, the revenue regulation regime might be augmented to facilitate greater competition and to provide better efficiency incentives.\(^{12}\)

**Figure 1** illustrates the various BGES tariff boundaries in terms of Supply Point Capacity (SPC\(^{13}\)) and annual consumption quantity (AQ\(^{14}\)).

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\(^{11}\) See CER/07/133 - Final Decision on Bord Gáis Energy Supply Fuel Variation Tariff Charges for Commercial and Industrial Customers


\(^{13}\) SPC corresponds to the Transporter’s best estimate of how much gas a NDM site would consume during a particularly cold winter day.

\(^{14}\) An AQ of 5.5GWh corresponds to the Transporter’s threshold for Daily Metered status at a site.
The red line denotes the domestic and small business segment. Businesses with a Supply Point Capacity between 539 kWh and 3750 kWh are revenue regulated (i.e. ex ante annual fixed tariffs). Price regulated Fuel Variation Tariff customers having an SPC in excess of 3750 kWh, but are still Non Daily Metered. The Transporter’s threshold for Daily Metered (DM) status coincides with the smallest of the Regulated Tariff Formula sites, though the FVT and RTF price controls largely replicate each other for the NDM and Daily Metered sites respectively.

**5.4 Competitive position of BGES in the larger I&C gas segment**

Table 1 depicts four year trends in customer gas sales volumes and the corresponding market shares held by BGES in five sub-segments of the larger I&C retail gas supply segment. These sub-segments are:

- Retail power generation customers (i.e. “Powergen” sites which have their gas supplied by third parties);
- Large Industrial Energy Users (LIEUs) which are unregulated by virtue of consuming more than 264GWh per annum;
- Combined Heat and Power (CHP) sites which are eligible to opt out of the RTF (regardless of whether they have actually done so);
- RTF sites which are not eligible to opt out; and
- NDM customers which are now FVT-eligible.

The figures are as of the end of each calendar year. Smaller NDM I&C customers which continue to avail of BGES revenue-regulated annual tariffs were not included in this analysis.
Table 1. BGES historic volumetric market share for the larger I&C segment

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail gas consumption (GWh)</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Powergen retail customers*</td>
<td>0</td>
<td>43</td>
<td>8,194</td>
<td>8,428</td>
</tr>
<tr>
<td>Large Industrial Energy Users (LIEUs)</td>
<td>2,714</td>
<td>2,184</td>
<td>1,794</td>
<td>1,820</td>
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<tr>
<td>CHP sites eligible to opt out of RTF</td>
<td>1,185</td>
<td>1,172</td>
<td>1,117</td>
<td>1,213</td>
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<tr>
<td>Other RTF sites</td>
<td>3,238</td>
<td>3,538</td>
<td>3,566</td>
<td>3,618</td>
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<tr>
<td>NDM I&amp;C sites (SPC &gt; 3750kWh)**</td>
<td>1,662</td>
<td>1,789</td>
<td>1,960</td>
<td>2,133</td>
</tr>
<tr>
<td>Total contestable larger I&amp;C volumes</td>
<td>8,799</td>
<td>8,728</td>
<td>16,630</td>
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<td>BGES sales volume (GWh) by sub-segment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Powergen retail customers</td>
<td>0</td>
<td>43</td>
<td>8,194</td>
<td>8,428</td>
</tr>
<tr>
<td>LIEUs</td>
<td>2,714</td>
<td>1,939</td>
<td>1,513</td>
<td>1,550</td>
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<tr>
<td>CHP sites eligible to opt out of RTF</td>
<td>1,185</td>
<td>1,172</td>
<td>1,103</td>
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<td>Other RTF sites</td>
<td>1,760</td>
<td>1,895</td>
<td>1,625</td>
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<tr>
<td>NDM sites (SPC&gt;3750kWh)</td>
<td>1,662</td>
<td>1,789</td>
<td>1,960</td>
<td>2,133</td>
</tr>
<tr>
<td>Total sales to selected sub-segments</td>
<td>7,320</td>
<td>6,839</td>
<td>14,393</td>
<td>14,300</td>
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<td>BGES market share by sub-segment</td>
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<td></td>
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<tr>
<td>Powergen retail customers</td>
<td>n/a</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>LIEUs</td>
<td>100%</td>
<td>89%</td>
<td>84%</td>
<td>85%</td>
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<tr>
<td>CHP sites eligible to opt out of RTF</td>
<td>100%</td>
<td>100%</td>
<td>99%</td>
<td>93%</td>
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<tr>
<td>Other RTF sites</td>
<td>54%</td>
<td>54%</td>
<td>46%</td>
<td>29%</td>
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<tr>
<td>NDM (SPC&gt;3750kWh)</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>BGES share of sub-segments</td>
<td>83%</td>
<td>78%</td>
<td>87%</td>
<td>83%</td>
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<tr>
<td>BGES market share (sub-segments grouped by date of liberalisation)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Powergen retail + LIEUs</td>
<td>100%</td>
<td>89%</td>
<td>97%</td>
<td>97%</td>
</tr>
<tr>
<td>CHP + RTF</td>
<td>67%</td>
<td>65%</td>
<td>58%</td>
<td>45%</td>
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<tr>
<td>NDM (SPC&gt;3750kWh)</td>
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<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>BGES share of combined sub-segments</td>
<td>83%</td>
<td>78%</td>
<td>87%</td>
<td>83%</td>
</tr>
<tr>
<td>BGES market share (sub-sectors grouped by nature of regulation)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Powergen retail + LIEUs + CHP</td>
<td>100%</td>
<td>93%</td>
<td>97%</td>
<td>97%</td>
</tr>
<tr>
<td>RTF + NDM (SPC&gt;3750kWh)</td>
<td>70%</td>
<td>69%</td>
<td>65%</td>
<td>55%</td>
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<tr>
<td>BGES share of combined sub-segments</td>
<td>83%</td>
<td>78%</td>
<td>87%</td>
<td>83%</td>
</tr>
</tbody>
</table>

* Two CCGT power stations which came on line during 2005 and which to date have not chosen to be self-shippers. Further information is provided in Section 5.1.

** These sites are currently eligible for the Fuel Variation Tariff

BGES holds a very substantial share (83%) of the five sub-segments combined. However, its share of the individual sub-segments varies considerably. The average size of BGES’ customers relative to those of independent suppliers differs significantly too. For example:

- BGES still serves 85% of the LIEU sub-segment, both by volume and customer numbers, despite it having been open to competition for more than 10 years;
- BGES currently holds 93% of the CHP site volumes, despite having lost nearly one-fifth of the customers in this category;
- Conversely, it holds just 29% of the remaining RTF-eligible volumes, despite serving nearly half of the customer sites; and
As of 31 December 2007, BGES serves 100% of the FVT-eligible market, although this is expected to reduce somewhat over the coming months.

The pattern of competition in sub-segments not subjected to regulated tariffs suggests that BGES has successfully defended its considerable share of larger customers. For the Powergen customers, credit issues associated with the delivery of very large monthly gas volumes may be the key determining factor. However, given that the vast majority of RTF-eligible LDM sites have switched to independent suppliers, such credit issues cannot fully explain the consistently low level of switching by LIEU and CHP sites.

The Commission considers that the low level of switching by LIEUs and CHPs is also likely to be a function of the flexibility of service, and/or the level of price discounts which BGES is able to offer when not constrained by RTF rules. The latter may reflect an absolute cost advantage through the efficient use of secondary NDM transmission capacity. (This comprises virtually all of the onshore capacity which BGES uses to supply its RTF and CHP sites.)

One implication of this analysis is that LDM customers may be the ones most likely to return to BGES if the Regulated Tariff Formula was simply discontinued.

5.5 Defining the most appropriate assessment criteria

Breaking down the larger I&C supply segment into five sub-segments highlights the question of which market or markets are the most meaningful when assessing the RTF. The logic being that once BGES’ share of a defined segment is diminished to a certain percentage it would indicate that the incumbent is indeed facing effective competition.

Caution is necessary when utilising this approach. A level of market share is one of many indicators which could signal that BGES is facing effective competition, not the sole indicator. Apart from anything else, the market share data should cover a reasonable period of time if important conclusions are to be drawn from them. Moreover, the second of CER/04/306’s three criteria concerns the sustainability of competition. In other words, the Commission will consider not only BGES’ current market share, but also the likely resulting market share given any changes in the RTF. Some element of judgement is probably inevitable in this regard though of course it should be as informed as possible by data and market analysis.

As further indicated in CER/04/306, the Commission will also take into account customer switching levels in both the RTF and non-regulated I&C segments (i.e. Powergens, LIEUs and CHPs in Table 1) as well as the benefits BGES enjoys due to its market position.

CER/05/188a specified that CHP sites which had opted out of the RTF would be included in any consideration of BGES’ (larger I&C) market share. As of the
end of 2007, the combined CHP and RTF market share held by BGES was 45%. However, if the newly designated Fuel Variation Tariff sites are added to this proportion, BGES’ market share by gas volumes rises to 62%. Neither of these percentages includes the Powergen or LIEU sites.

Notwithstanding the above, the Commission will consider the precedents outlined above as well as the comments of interested parties to determine:

- whether any criteria in addition to those previously set out should be considered in assessing the aspects and effectiveness of the RTF regime, and
- which specific sub-segments of the overall larger I&C supply segment should be included when considering BGES’ market share.

6. Core BGES arguments

The points BGES raise in support of the removal of the RTF can be summarised as follows:

- The RTF has long since fulfilled its purpose and is now no longer required in the retail natural gas market. It could even be suggested that the RTF is now having the reverse effect of what it was intended to achieve; namely to deliver competitive prices and products to natural gas customers.

- In the UK market, Ofgem recently concluded that competition was effective and vigorous in all segments of the domestic energy market while the incumbent supplier held a 52% market share. In Europe, according to settled case law, a 40% market share, only in the presence of significant barriers to entry, can constitute a position of dominance. There are effectively no barriers of entry to the retail gas market in Ireland.

- The success of the RTF regime can be numerically, and principally, demonstrated in the current market environment i.e. the consistent and reduced market share of this market held by BGES (now less than 35%); and the fact that CER has since introduced a similar product for approximately 1,650 Non Daily Metered customers on 1 October 2007.

- Appropriate trading conditions and operating rules have been in place for some time which has allowed the development of an effective competitive market.

- The current RTF market has:
  - Established presence of (two) alternative suppliers
  - Equitable access to equitably operated wholesale markets and transmission systems
  - A reduction in the BGES RTF market share to less than 50% of the total market
• BGES recently commissioned a customer survey of the RTF product. The main findings of the survey results were:
  - In general, respondents do not believe the RTF product is flexible or competitive,
  - There is frustration with the RTF product and in particular the restrictions and inflexibility it imposes in relation to pricing, contract terms and contract length options, and
  - Almost 70% of respondents believed that BGES’ key weakness in the Energy Market was the lack of a flexible product offering; 62% felt it was price.

• It is reasonable to assert that RTF customers would receive greater benefits from a truly competitive market within which a number of suppliers could offer greater product flexibility and pass on efficiency savings to customers. This requires removal of the restrictions surrounding RFT product offers.

• The natural gas supply market does not operate in an integrated environment as the electricity market does. BGES is not vertically integrated organisation with an upstream business unit. BGES operates in an environment with competing fuels.

7. Initial CER thinking

Before going into detail on the various arguments, the Commission would make four general points.

7.1 General Considerations

Firstly, the Commission’s overriding objective in this review exercise is to protect the long term interests of industrial and commercial gas customers. This applies to those customers who are currently subject to the RTF regime, or any wider customer grouping should that emerge as the final outcome of the review. Promotion of competition is one key policy instrument towards achieving that end. That said, it should not be seen as an end in itself or a goal to be achieved at all costs. In other words, for competition to benefit customers it must be sustainable and reflect the natural contestability of the chosen market category and not be based on contrived market definitions or implied “entitlements” by individual suppliers to given market shares. There would be little point in subjecting customers to, say, higher tariffs or inflexible product offerings over a prolonged period if the evidence indicated that the resulting benefits were accruing exclusively to suppliers.
Secondly, any market analysis should be dynamic and forward looking rather than static. The analysis should not confine itself to considering the number or market shares of existing suppliers, but should also consider the possibility
of new suppliers entering the market at reasonably short notice. Barriers to entry are a key measure of the natural contestability of a given market.

Thirdly, most commentators would agree that any regulatory regime based on one supplier being subject to a rigid “X percent market share cap” rule is riddled with practical difficulties, however intuitively appealing it may at first appear. Such a regime runs the risk of evolving into a form of market sharing to the detriment of customers. This is particularly when the number of customers is relatively small, as it is in the RTF case, and one supplier’s “market share” can change significantly at short notice by virtue of the securing or non-renewal of an individual customer contract.

Lastly, liberalisation and competition in the Irish retail gas market – even for industrial and commercial customers - is still at an early stage, by any reasonable historical or international standards. Interim remedies such as the RTF regime designed to tackle structural market shortcomings that may be appropriate for 2008 may not be appropriate for, say, 2010 or 2011.

### 7.2 Initial response to BGES submission

Mindful of this approach, the Commission now wishes to provide some initial comments regarding our previously stated criteria related to assessing the RTF, the market analysis undertaken in conjunction with this consultation, and the BGES submission.

Regarding BGES’ claim that the original decision establishing the RTF lacked any criteria regarding when a competitive market had indeed developed and hence when the RTF would be altered or removed: this is admittedly the case.

Nevertheless, successive CER decisions (in particular, CER/04/306 and CER/05/188a) did establish a clear framework regarding whether and when the RTF would be altered or removed. The analysis undertaken for this consultation suggests that the level of customer switching in the non-price regulated segments (e.g. LIEUs and CHPs) is minimal. Nowhere is this more evident than with sites able to opt out of the RTF by virtue of their CHP status: Bord Gáis Energy Supply ships 93% of the gas volumes to these sites as of the end of 2007.

With such little competitive inroads to the biggest I&C sites, the Commission has concerns related to the sustainability of competition if the RTF were altered or removed. We suspect that LDM sites would be the first to return to BGES if the RTF were simply removed altogether, particularly if an absolute cost advantage exists for BGES due to their efficient use of secondary NDM transmission capacity.

An argument could be made that if this benefit were shared (i.e. via altering or removing the RTF), then BGES’ customers would benefit. CER notes this, but
believes that if competing suppliers exited the market as a result of BGES directly passing these benefits onto their RTF customers, the customer benefit would likely be limited to the short term.

The presence of two independent suppliers does not in and of itself signal that competition is sufficient or indeed sustainable. The presence of these suppliers in conjunction with meeting the criteria established in CER/04/306 would provide a much stronger case that competition was established and effective. It is far from clear whether these criteria are being or can be met in the immediate term, however.

BGES also state that the RTF has fulfilled its purpose. The RTF has perhaps fulfilled the purpose of enabling competition for those customers which would be obliged to avail of the RTF if they were a BGES customer. But, as stated in CER/05/188a, it is, “inappropriate to regard LDM RTF sites in isolation from CHP sites of comparable size which have been allowed to opt out of the RTF.” When these sites are considered together, BGES has a market share of 45% as of the end of 2007.

Moreover, since the 2005 decision grouping the CHP and RTF sites together for market share purposes, the Fuel Variation Tariff has been introduced. As with the RTF, the FVT, “provide[s] a transparent cost-reflective mechanism for pricing to customers, thereby creating a clear target for competing suppliers.”15 In effect, the FVT mirrors the RTF, providing a mechanism to promote competition and long term benefit to the 1600 largest Non Daily Metered I&C sites.

Thus, a strong argument exists for the inclusion of the FVT sites when considering BGES’ market share of larger I&C sites. To do so would mean that as of the end of 2007, BGES supplied 62% of the gas volumes to CHP, RTF and FVT sites.

Regardless of the market definition, the Commission is wary of defining effective competition simply by a market share figure. In fact, as we have previously stated, market share is one of several criteria the Commission will consider when assessing whether competition to larger I&C sites is indeed effective and hence whether price regulation to these sites should be altered or removed. Which specific market share is perhaps open to debate, but the narrowest interpretation of the relevant market share is the BGES gas volumes supplied to both CHP and RTF sites. As of the end of 2007, this share stood at 45%.

Whether the appropriate BGES market share is 45%, 62%, or some other figure, the criteria for assessing the RTF set out in CER/04/306 would appear, on balance, to support retention of the regime. Significant switching by BGES’ RTF customers has indeed occurred, but switching amongst the LIEUs and CHPs has been negligible. The sustainability of competition at this still relatively early stage of market opening in the event of a substantive scaling back or removal of.

the Regulated Tariff Formula is far from certain. Moreover, BGES likely continues to enjoy benefits relative to its competitors due to its legacy market position.

That said, and in consideration of our desire to protect the long term interests of customers, the Commission acknowledges that some of the RTF regime’s customer contact provisions do appear too onerous and interventionist. There are numerous provisions in the RTF Contract, the Code of Practice, and the prevailing RTF-related directions. Some of these are non-financial, such as dealing with complaints, record keeping and the initiation of contacts with customers. Others are financial, such as contract duration, product pricing, and credit terms.

The Commission at this stage would welcome comments pertaining to the appropriateness of these specific aspects of the RTF Contract, the Code of Practice, and the prevailing RTF-related directions. Although the market analysis undertaken in conjunction with this consultation suggests that the outright removal of the RTF’s financial provisions is likely premature, CER invites comments on the comprehensiveness of both the RTF’s financial and non-financial aspects.

### 7.3 Next steps

Interested parties should respond in writing before the close of business on Friday, 30 May 2008. The Commission will consider any such responses before publishing them in June. A related Decision Paper will be published approximately two weeks after the publication of the respondents’ comments.

### 8. Key questions for interested parties

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<tr>
<th>Questions related to Section 3:</th>
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<tr>
<td>1) With respect to changes in the Regulated Tariff Formula, should criteria other than those previously established by the Commission be considered? If so, then please justify why these further criterion are relevant.</td>
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<tr>
<td>2) Is there evidence of emerging competition and customer choice for unregulated industrial customers, the RTF opted-out CHP customers and the largest NDM customers following the introduction of market-based tariffs? If so, is it appropriate for BGES to share with its RTF customers the portfolio efficiency benefits (i.e. efficient Transmission Capacity management) it enjoys?</td>
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Questions related to Section 4:

3) Should any aspects of the following be amended, removed altogether or preserved indefinitely?
   • CER's prevailing RTF Direction(s);
   • The Standard RTF Natural Gas Supply Contract; and
   • The Bord Gáis Energy Supply Code of Practice for Customer Contact.

   If so, which aspects, and why?

Questions related to Section 5:

4) Does Table 1 provide an accurate assessment of BGES’ market share over the last four calendar years?

5) What is the most appropriate combination of larger I&C sub-segments when considering BGES’ market share?

6) To what extent do the higher BGES market shares in the LIEU and CHP segments reflect price discounts, product flexibility, service quality and/or credit issues?

7) Is competition in the supply of gas to larger I&C end users currently effective and/or sustainable? If not, under what circumstances and conditions would it be?

Questions related to Section 7:

8) What would be the likely competitive impact of changes to the RTF regime?

9) What permutations (if any) would improve the effectiveness of competition?

10) Over what timescale ought any changes be phased, and why?

11) Would an amendment(s) to the RTF regime promote greater innovation and better customer service by BGES? By other suppliers? Why?

Invitation for additional comments:

Respondents are invited to provide any additional comments related to competition in the larger I&C supply segment and/or the terms and conditions of the Regulated Tariff Formula.
Appendix

Request to cease price regulation of customers of the Regulated Tariff Formula

A Submission made by Bord Gáis Energy Supply to the Commission for Energy Regulation December 2007
Introduction

This paper addresses the Regulated Tariff Formula (“RTF”). We are requesting that the Commission for Energy Regulation (CER) consider removing the present restrictions on Bord Gáis Energy Supply (BGES) by removing the RTF regulation that has been imposed for the past four years (since 2003). While the initial introduction of the RTF may be considered understandable, it is clear that it has long since fulfilled its purpose and is now no longer required in the retail natural gas market. It could even be suggested that the RTF is now having the reverse effect of what it was intended to achieve; namely to deliver competitive prices and products to natural gas customers.

The RTF was introduced by the Commission for Energy Regulation (“CER”) in 2003 to provide a transparent and predictable market-related formula for participants in the Irish gas market. There are approximately 200 customers in total eligible for the tariff. Originally, eligibility was determined based on a typical annual consumption of between 5.3 and 264 GWH of natural gas. More recently, customers who are deemed to be ‘daily metered’ by Bord Gáis Networks and who consume less than 264 GWh per annum are automatically eligible for the tariff.

Origin

In a consultation paper entitled ‘Proposed Regulated Tariff Formula for Eligible Customers’ the CER stated that the proposed RTF set out “a transparent mechanism that will allow eligible gas customers to determine gas costs on a forward-looking basis for periods from one month up to twelve months ahead. It will also provide a clear target for new market entrant suppliers to match in providing supplies to customers. Absence of a market-based price could deter new market entry. The proposals will give confidence to market participants that price structures have been established in a robust manner and will be regulated until a competitive market has developed.”

The CER did not at that time outline the criteria or parameters that would apply to determine when such a competitive market would be deemed as having been developed and therefore when price structures were no longer required to be regulated. Given the current retail market environment, this situation requires urgent attention. In the UK market, Ofgem recently concluded that competition was effective and vigorous in all segments of the domestic energy market while

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16 CER “Proposed Regulated Tariff Formula (RTF) for Eligible Customers 1 April 2003 – 31 March 2004”, CER/03/031, pg. 2/3.
the incumbent supplier held a 52% market share. In Europe, according to settled case law, a 40% market share, only in the presence of significant barriers to entry, can constitute a position of dominance\(^\text{18}\). The implication being that a 40% market share may warrant the necessity for price/product regulation such as the RTF product; however there are effectively no barriers of entry to the retail gas market in Ireland as:

- The CER has successfully removed any presence or perception of such barriers to entry in the Irish natural gas transportation market since overseeing regulation of Bord Gáis Networks division.
- BGES purchases its RTF gas requirements from the same wholesale market as alternative suppliers where a transparent trading environment determines market prices for all participants.
- Full market opening was implemented in July 2007 which effectively reduced the possibility of a protected BGES subsidising the RTF sector.

**Purpose**

The RTF was intended to serve two purposes\(^\text{19}\):

1. To provide a transparent market-reflective pricing mechanism for the pricing of customers, thereby creating a clear target for competing suppliers.
2. Allow BGES to operate in an eligible market sector where sustainable competition has yet to develop.

It is now clear that the RTF has served the purpose of enabling the development of a competitive market for customers consuming in excess of 5.3GWh per annum. Its success can be numerically, and principally, demonstrated in the current market environment. The former by the consistent and reduced market share of this market held by BGES (now less than 35%); the latter by the fact that the CER has since introduced a similar product for approximately 1,650 Non Daily Metered (“NDM”) which was implemented on October 1\(^{\text{st}}\) 2007.

**Competitive Market Environment**

BGES believes that appropriate trading conditions and operating rules have been in place for some time which has allowed the development of an effective competitive market. Unfortunately, it now appears that the rules and regulations attached to the RTF product has resulted in significant customer dissatisfaction and is conversely limiting the further development of a true and efficient competitive market.


The current market has the following characteristics:

- The established presence of (two) alternative suppliers
- Equitable access to equitably operated wholesale markets and transmission systems
- A reduction in the BGES RTF market share to less than 50% of the total market

All of the above could be considered reasonable parameters to determine a market to be competitive. After almost 5 years of the RTF regime, all three of these constituents have now been achieved. As a compliant market participant operating in a competitive market, it is unreasonable that BGES should be treated inequitably, in comparison to alternative suppliers. BGES is currently restricted from offering RTF customers a range of products which might better suit the individual needs and requirements of customers in today’s market where energy costs are of the utmost and growing importance to the competitiveness of the economy as a whole. Given the competitive market conditions that are now openly available to all suppliers, anti-competitive restrictions, which have served their original purpose, should be readdressed thus providing for improved customer service and overall sector efficiency.

BGES recently commissioned ( ) to undertake a customer survey of the RTF product on our behalf. The survey was distributed to approximately 200 current and past BGES RTF customers to ensure that a comprehensive range of views on the product was gathered. The survey questions were designed to be neutral and to encourage customers to give additional feedback where possible. A total of 47 responses were received and it was followed by a number of telephone interviews with randomly selected respondents.

Two of the main findings of the survey results are that:

- In general, respondents do not believe the RTF product is flexible or competitive
- There is frustration with the RTF product and in particular the restrictions and inflexibility it imposes in relation to pricing, contract terms and contract length options.

Almost 60% of respondents disagreed with statements that the RTF was flexible and competitive. Almost 70% of respondents believed that BGES’ key weakness in the Energy Market was the lack of a flexible product offering; 62% felt it was price. Both of these aspects are controlled by the rules and regulations of the current RTF structure. Of the non-BGES customers, the main reason for leaving BGES was price related (72%) while various contract related reasons (inflexibility, contract terms, length etc) equated to 73%. Others stated that BGES were unable to issue a consolidated quote or meet tendering requirements. A number of respondents stated that they no longer even request a quote from BGES as:
From this we believe it is reasonable to assert that RTF customers would receive greater benefits from a truly competitive market within which a number of Suppliers could offer greater product flexibility and pass on efficiency savings to customers. This requires removal of the restrictions surrounding RTF product offers.

As the requirements for the introduction of the RTF have now been satisfied it is appropriate that the RTF price setting arrangements be removed. While we appreciate a review process may be undertaken in relation to this issue, in light of the negative impact of the current product offering available to customers we believe it is in customers interests that the current restrictions on the type of products offered should be immediately lifted. As part of our survey, BGES requested feedback on alternative RTF product offerings and a significant interest was expressed. The additional products which could be offered to customers include:

<deleted>

BGES believes these additional products could be implemented within a short space of time; however their introduction does not negate the requirement for all price related restrictions to be removed from the RTF product as soon as possible.

Comparisons between Electricity and Gas Market

There is a strong tendency by all involved in the energy sector to make comparisons between the gas and electricity industries given that we are involved in both industries. BGES feels it is important that the distinct differences between the two industries are not overlooked. The natural gas supply market does not operate in an integrated environment as the electricity market does. This is an important and substantial distinction which needs to be recognised when making comparisons between the two sectors. For one, BGES is not a vertically integrated organisation with an upstream business unit. For another, BGES operates in an environment with competing fuels. It is in everyone’s interests that full efficiency benefits are passed onto customers to maintain the competitiveness of natural gas in the heating fuels market. Failure to do so will inevitably lead to lower utilisation of network assets making natural gas even less competitive vis-à-vis other fuels. In this regard BGES
recognises the critical requirement to maintain competition within and external to the industry. On this basis we welcome competition within the sector.

**Conclusion**
As the BGES customer base in the RTF market is less than 35% it is now a matter of urgency to reconsider the continued appropriateness of price regulation for this market sector in the gas supply market. It could be argued that failure to remove the imposition of strict operational rules on BGES are not only inequitable on BGES as a supplier in the gas supply market but are now impeding the proper development of an efficiently competitive market for consumers.

BGES believes that the intended outcome(s) for introducing of the RTF in 2003 have now been achieved. The market should now be allowed to develop on a commercial basis providing the best returns to customers.

Taking on board the comments that resulted from the <deleted> customer survey it would appear that the RTF is seen as a product which does not deliver price or operational benefits for customers. Given, that there are now two well established suppliers in the natural gas retail market, BGES believes the time has now come whereby it should be able to pass on efficiency savings to customers and offer a comprehensive range of procurement products to customers currently designated as RTF eligible.