16th April 2010

Fergus O'Toole,
Commission for Energy Regulation,
The Exchange,
Belgard Square North,
Tallaght,
Dublin 24

RE: Draft Decision on the ESB PES's Revenue Regulation Framework

Dear Fergus

Bord Gáis Energy (BG Energy) is surprised and very concerned by the Commission for Energy Regulation's (CER) proposed revenue regulatory framework for ESB Customer Supply (ESB CS).

BG Energy cannot stress strongly enough the negative impact these proposed changes will have on its business as a new entrant to the domestic market and on the future development of competition in the retail energy markets in general.

As the CER knows BG Energy fully supports the view that regulation should be removed "*once sufficient competition has developed*" in the relevant markets. As a regulated incumbent in the retail gas market and a competing new entrant in the retail electricity market, BG Energy recognises the criticality of a competitive market in delivering real choice to customers in a market. Fully functioning competition cannot in the long-term co-exist with regulated end-user energy prices. However, this is first and foremost predicated on the "*establishment of the necessary conditions for a well functioning market*"[1].

The CER will soon issue a decision on those markets which it deems to be sufficiently competitive to operate absent regulation. However, the remaining markets, to which this framework will apply, will be deemed **not** to be effectively competitive and therefore will still require regulation to aid the competitive process. It is critical that the regulatory framework encompassing these market segments is appropriate to

[1] ERGEG Position Paper: '*End-User Energy Price Regulation*', July 2007.

further the development of competition and to facilitate the movement towards deregulation.

Competition, particularly in the domestic space, is in its infancy. As the CER is well aware new entrants have entered the market, with its encouragement, offering prices discounted against ESB CS prices. The extent and speed of the proposed changes to the regulatory regime will have a detrimental effect on the ability of emerging competitors to complete their entry strategy and gain a foothold in the market such that they can continue to challenge the incumbent in the long-run. In short, BG Energy does not believe the market structures are sufficiently robust and competition sufficiently developed at this time to further develop under the CER's proposed regulatory framework.

The CER says the importance of providing a stable and predicable regulatory environment is a primary concern and that it wishes to address the potential of the k-factor to create an undesirable level of uncertainty for independent suppliers and impact on competition in the market. It seems extraordinary then that the framework favoured by the CER, and in particular the proposed timing of its introduction, will serve only to undermine the CER's stated aim, increase exponentially the uncertainty for independent suppliers and as a result reduce competition.

BG Energy recognises that the CER's proposals still apply some level of regulation to the incumbent, however BG Energy believes that the proposed regulation will be wholly inadequate and has serious concerns about the impact the new regulatory regime will have on the market.

1. <u>Transparency and Abuse of Information Asymmetry</u>: The complexity of the framework proposed by the CER not only erodes the general intended benefits of price cap regulation but augments the issue of information asymmetry in the market. In recommending the introduction of price cap regulation, proponents view it as a simpler means of regulation, avoiding issues such as information asymmetry and regulatory capture. However, in its introduction to the UK utility markets in the 1980's, Stephen Littlechild cautioned that these properties could be eroded if not implemented effectively. The complex arrangements proposed by the CER will actually increase the level of information asymmetry between all parties in the market, augmenting the principal-agent problem and also the potential for abuse. **Greater levels of transparency, market oversight and**

regulatory enforcement is needed if competition is to function appropriately.

2. Regulatory Controls and Oversight: The CER proposes to give "*considerable deference to the judgment*" of the regulated entity. This is unacceptable. The CER will not have sufficient means to monitor and review the proposals of the regulated entity, yet the market is to be assured that the tariffs are cost reflective. **This reliance on the incumbent, its assumptions and inputs, increases the information asymmetry between the regulator and the regulated entity and therefore enhances further still the principal-agency problem within the regulatory framework.** This jeopardizes the CER's ability to conduct its ex-post regulatory role ensuring that tariffs correctly reflect the actual market costs, and also diminishes confidence in the market.

3. Suggested Timings: The CER is proposing to implement very significant changes to its regulatory structure involving legislative change within a timeframe which does not give market participants adequate notice to enable them to prepare for those changes. This is unfair and unreasonable. The new tariff year begins in less than six month time. The CER is well aware that new entrants have offered prices that are at a discount to ESB CS prices, and indeed this is a common entry strategy in other markets. It is also well aware that market participants are already seeking, subject to the limits of liquidity in the hedging market, to hedge their pricing for next year and that such arrangements are critical to the operation and viability of their businesses. It is simply not possible for new entrants to accommodate and make provisions for the now proposed degree of regulatory uncertainty. The CER has not allowed sufficient time for the appropriate and timely implementation of the proposed changes. Such a hasty approach is injudicious and places risks on all participants. **Given that the hedging auctions have already begun, the CER cannot seek to implement the proposed framework in October 2010.**

4. Assessment of impact on competition and competitors in the market: In its review of the various options, the analysis does not appropriately consider the impact the proposals will have on the market in the short-term. Competition in the segments to which this framework will apply is only in the emerging stages. **Radical and rapid changes in the regulatory framework and the behaviour of the incumbent without the required liquidity to manage risk effectively**

will diminish the ability of suppliers to compete against the incumbent, offer choice to customers and develop innovative product offerings. Allowing the incumbent to make any number of impromptu changes to prices without appropriate notice will concentrate the focus of the market on managing this risk as opposed to the introduction of new strategies and products.

BG Energy is therefore strongly opposed to the proposed regulatory framework at this time. However, this is not to suggest that BG Energy is opposed to changes in the regulatory framework. Change is emerging in the market and the regulatory framework must adjust accordingly, but such change should be managed in a timely and transparent manner with a solution that is fit for purpose. For that reason, **BG Energy suggests that instead of approving a 'maximum allowed revenue', the CER approves a 'maximum price' for the different regulated market segments.** A 'maximum price' would provide a framework that better mitigates the risks identified above. It will improve transparency and reduce the volatility risks for new entrant suppliers while also protecting consumers against spiralling prices. A 'maximum price' would represent a smaller degree of change for suppliers and given the timescales proposed by the CER would represent a more manageable stepping stone towards deregulation for the market.

In summary, BG Energy believes it would be completely inappropriate and unreasonable to adopt a framework which represents a seismic shift in the regulatory and market environment less than 6 months before the tariff year begins and after the commencement of the hedging rounds for the related tariff year. A more proportionate and reasonable approach for all parties given the desired timescales and current market environment would be to set a 'maximum price' for each of the regulated market segments. BG Energy therefore strongly cautions the CER against making such radical changes to the market for the coming tariff year at this late stage.

Yours sincerely,

Pádraig Fleming
Head of Pricing and Regulation
Bord Gáis Energy

APPENDIX

The process to set a maximum price for the market can be premised on the same formula proposed by the CER in its consultation paper. To that end, BG Energy answers the questions below with reference to the setting of a maximum price and the transparency that would be needed to facilitate that process.

1. The Commission's proposed decision allows for pass through of hedge contract settlements at a 50% hedge target. Are you in favour of allowing CfD prices to be reflected in PES tariffs?

BG Energy is in favour of the proposal to include provisions for hedge contracts within the energy cost component of the regulated tariffs. Hedging contracts are an essential requirement for prudent suppliers to manage risks to a reasonable level. Without providing for such hedges, the regulatory framework would place 100% of the price volatility risk on the customers of the regulated entity. **This is not done in any other market and would clearly not be in the interests of consumers**. If the framework is to act as a proxy for a competitive market it should provide for reasonable hedging strategy.

2. Is a hedge target of 50% of forecast PES load a reasonable amount of contract cover? If not, what level do you think is appropriate?

The level of hedge contracts struck by an entity is directly proportional to its appetite for risk. ESB CS's previous hedging policies have been to hedge approximately 85% of their forecasted portfolio for a given year. The target of 50% suggested by the CER infers that the risk appetite of ESB CS has changed or will change under the new regulatory framework. BG Energy does not believe this to be the case and indeed European best practices suggest that retailers should seek to hedge up to 90% of their price risks.

The suggested 50% threshold would pass-through more spot price risk to Irish consumers relative to their European counterparts and would require a greater number of tariff changes within year to reflect changes in spot prices. **ESB CS will need to hedge substantially higher than 50% of its portfolio energy requirements if it is to minimise the number and magnitude of tariff changes within year and between tariff years.**

For these reasons and to avoid multiple tariff changes within year, which is generally not favoured by customers and also given the current bullish view of the market over the coming year, BG Energy firmly believes that the energy costs within the regulatory framework should retain the current hedging provisions and account for a hedging strategy of between 85%-90% of the forecasted portfolio.

3. The Commission's proposed decision allows PES to define a set of contracts to meet the hedge target of 50% of forecast PES load on an energy and/or capacity basis for regulated customers. Are you in favour of the Commission's proposal to allow PES the flexibility of combining base load, mid-merit and peak contracts to create a portfolio that meets the 50% target for regulated customers?

Hedge contracts are designed for two principle purposes: a) as a means of protecting customers from price volatility and b) as a mechanism for suppliers to shape or re-profile their portfolio of customers as it deviates throughout the year. For this reason, it would seem reasonable to provide the suggested flexibility of combining base load, mid-merit and peak contracts when setting the 'maximum price'. However, transparency of how this is established is essential if the risks of abuse are to be prevented.

BG Energy is concerned that the oversight of the proposed framework relies heavily on the forecasts of the regulated entity. **If market participants are to have confidence in the framework, and thus the market itself, they must be enabled to contribute to the oversight of the framework and challenge areas where asymmetries and inaccuracies occur.**

The CER should publish the assumptions and inputs used to calculate the 'maximum price' and allow market participants to comment on its reasonableness for the period in question. Without this level of information and transparency, the information asymmetry in the market could risk destabilising the emerging competitive forces and confidence in the market.

4. It is ESB PES' current practice to shape contract costs in each half-hourly period to reflect the shape of the SEM half-hourly price curves prior to attributing contract costs to customer tariffs. Are you in favour of this practice?

Until such time as smart meters are rolled out universally across the system providing individual customer usage, shaping contract costs using load profiles for each half hour period seems to be a reasonable approach to the costing of the remaining un-hedged proportion of the energy costs.

5. The Commission is proposing that ESB PES have full flexibility to set tariffs at the levels it deems appropriate. The CER would only intervene if it observed abusive pricing practices by ESB PES. Are you in favour of the Commission's proposal?

Allowing ESB CS to set tariffs at any level it deems appropriate is the prerogative of a fully competitive and deregulated market. The lenient approach proposed by the CER does not apply sufficient enforcement or control mechanisms on the regulated entity, particularly considering the incumbents market power in the wholesale market**. BG Energy is concerned that the CER's proposed framework will offer the incumbent a scale of flexibility which will allow them to thwart the business strategies of the new entrants to the market. This coupled with their ability to abuse its dominant position in the wholesale market by indirectly cross-subsidising between the generation and retail markets will ultimately be to the detriment of smaller retailers and competition in both the retail and wholesale markets.**

A framework based on a 'maximum price' would limit their ability to disrupt the product offerings of the new entrants and the emerging competitive forces and therefore would be a better solution as an interim step towards deregulation.

6. The Commission is also proposing to require ESB PES to adjust tariffs if outturn costs and revenues or forecast costs and revenues diverge by fixed threshold. Are you in favour of this approach, which would require ESB PES to change tariffs when they are no longer cost-reflective?

Currently competitors to ESB CS discount their tariffs against the incumbent in a bid to gain market share. This is not an ideal form of competition but is necessary until such time as the appropriate technology and level of wholesale liquidity is available to enable suppliers to offer customers more innovative and flexible product options.

Given the current levels of liquidity in the wholesale market, competitors will simply not be in a position to manage the risk associated with the suggested number of tariff changes within the tariff year. BG Energy acknowledges the recent announcement for further and more frequent auctioning of Non-Directed Contract (NDC) for the coming year. While this is a welcome initiative, the auctions have yet to be established, the volumes and prices fixed and take-up observed. It cannot be determined therefore at this stage that liquidity in the wholesale market is sufficient to enable independent retail suppliers to mange the risk of multiple tariff changes within year.

Furthermore, the ability to determine when price changes will actually take effect provides a competitive advantage to the incumbent, particularly in the design of an effective hedging strategy. If sufficient liquidity does develop in the wholesale market, competitors would need at least 2 months notice of any perspective tariff changes so that they could adjust their hedging portfolio accordingly.

In setting a 'maximum price' against which competitors can compete, the CER would reduce the number of tariff changes within year, thereby reducing the volatility and risks faced by market participants. This is not to say that tariffs cannot change within year. The framework permits changes to tariffs both above and below the 'maximum price' but in a manner that does not risk destabilising the current and future market positions of new entrants to the same extent.

7. The Commission's proposed decision provides for asymmetric k-factor recovery outside of a tolerance band, while providing PES an opportunity to minimize any k-factors through full pricing flexibility. Are you in favour of asymmetric recovery?

The provision of within year tariff changes is aimed at reducing k-factors, therefore the provision of asymmetric k-factors seems counter-intuitive to the ongoing application of the formula.

Given the proposed 50% hedging threshold the likelihood of k-factors being outside of the 3% tolerance threshold is high, as the risk of spot price variability is considerably higher than 3%. BG Energy is concerned that the formula and the level of discretion and information asymmetry will permit ESB CS to manipulate costs up or down in a bid to frustrate competition. The proposed asymmetric k-factor recovery outside of the tolerance bands is therefore not appropriate and perversely incentivises below-cost selling by the incumbent.

The 'maximum price' solution proposed by BG Energy would remove this risk. Setting a 'maximum price' as opposed to a 'maximum revenue' reduces the impact of demand destruction and customer switching on k-factors. Changes in energy costs can be more readily accommodated within year and ESB CS would be permitted to account for these changes on an on-going basis. Therefore k-factors at the end of the year should be minimal.

8. The Commission's proposed decision fixes the tolerance band at +/-3%. Do you believe that this is a reasonable range for the band? If not, what level do you think is reasonable?

BG Energy's 'maximum price' framework would not contain any tolerance bands. ESB CS would be given complete freedom to set tariffs below the maximum price but any changes above the maximum price would be subject to consultation for implementation within the tariff year.

9. The oversight process proposed by the Commission anticipates a limited ex ante review of PES tariffs, quarterly reports from PES to the Commission, a review by the Commission of any changes made to the tariff, and a detailed ex post review. Are you in favour of the Commission's proposal? If not, what alternatives would you propose?

The quarterly review process proposed by the CER does not include consultation with market participants or provide sufficient time for competitors to adjust their hedging strategies accordingly. BG Energy does not believe there is sufficient transparency and oversight in this proposal to mitigate the risks and concerns of market participants.

In setting a 'maximum price' any changes above the maximum price would be subject to full review and consultation with all market stakeholders. This will give greater oversight to market participants and improve their ability to react to changes in a more timely manner. It will also provide a competitive environment, brining the market closer towards deregulation which will in turn provide choice and flexibility to customers.

10. Are the data sets that the Commission proposes to review in detail in its ex post review appropriate? If not, what alternatives would you propose?

Again, oversight by market participants is paramount in aiding the CER in its implementation and monitoring of the proposed framework. Market participants are best positioned to review and assess the cost inputs of the regulated incumbent. As part of the review process in setting the 'maximum price' the CER must publish the market assumptions and inputs submitted by ESB CS. This includes outturn figures and forecasts for the data set outlined by the CER in section 6.4 of its consultation but also for demand forecasts and hedging contract volumes. This level of transparency is needed to avoid; augmenting information asymmetry in the market; the potential for abusive behaviour, and eroding further stakeholders confidence in the market.

11. The Commission's proposed decision provides that differences between *ex post* allowed revenues and revenues collected from customers be applied to future period MARs. This means that the tariffs for future periods will carry over a small amount of prior period k-factors. Are you in favour of the Commission's proposal to apply differences to future period MARs? Would you favour a one-time charge or credit? Would a one-time charge or credit be administratively feasible?

If the suggested framework is applied, k-factors should be minimised at the end of the year.

12. The Commission proposed a tolerance band of +/-3% as a measure for the treatment of over- or under-recoveries. This is proposed as a transitional tool, giving PES pricing flexibility and incentives to keep prices at the cost-reflective level. Do you think the 3% is appropriate? If not, why not?

Please refer to question 8 above.

13. Would you be in favour of an alternative treatment of over-recoveries that allows PES to retain revenues in excess of MAR within the 3% tolerance band? If so, why or why not?

The aim of the proposed regulatory framework is firstly to act as a transitionary mechanism towards a deregulated market and to provide a mechanism which will ensure tariffs are reasonably cost reflective. Reasonable adjustments throughout the year, combined with market and regulatory oversight into the forecasting of ESB CS should ensure that prices are cost reflective and that revenues earned reflect the costs incurred. BG Energy believes that the implementation of the proposed 'maximum price' framework would be the best approach in the current environment for customers and market participants alike.