Roadmap for Deregulation in the Non-Daily Metered Retail Gas market

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Abstract:

The Commission for Energy Regulation (CER) has decided on the circumstances under which the revenue and price controls should be removed from Bord Gáis Energy in the retail Non-Daily Metered sector. The CER has also decided on what other actions should be taken, apart from the removal of price control, in order to ensure a fully competitive deregulated gas retail market.

Target Audience:

This paper is for the attention of members of the public, the energy industry, and all other interested parties.

Related Documents:

- CER/10/212: Proposals on a Roadmap for Deregulation in the Non-Daily Metered Retail Gas Market.

Further information on this decision paper; please contact Stuart Coleman (scoleman@cer.ie) at the CER.

Glossary

FVT - Fuel Variation Tariff
GPRO – Gas Point Registration Operator
I&C – Industrial and Commercial
NDM – Non Daily Metered
Res - Residential
RTF – Regulated Tariff Formula

Executive Summary

The Irish gas retail market has undergone considerable competitive changes in the last 18 months. Recognising these changes the CER set out in CER/10/212[1] a number of proposals on the deregulation of the Non-Daily Metered (NDM) Retail Gas Market.

The consultation paper set out proposals on the development of competition in defined relevant markets. Those defined markets are the Fuel Variation Tariff (FVT) market, NDM Industrial and Commercial (I&C) market and the NDM Residential market. Barriers to entry, expansion and exit were examined. Thresholds for market concentration were proposed for the determination of the level of competition in a specific market. The consultation also sought the views of stakeholders on the proposals for the mechanisms of review, the sequence of deregulation where it applies to different markets and the interim arrangements that would apply until such time that all market sectors were deregulated.

Following extensive review and all comments received having been carefully considered, the CER has decided the following criteria must be met in order for a defined market sector to be deregulated:

I. There are at least three suppliers active in the relevant market; and

II. There is a minimum of two independent suppliers, each of which has at least 10% share of volume consumption for the FVT and NDM I&C markets or 10% share by customer numbers in the Residential market.

III. For the FVT and NDM I&C market sectors Bord Gáis Energy's (BG Energy) market share by volume must be less than 50%. For the NDM residential sector a final decision is not being taken for the moment, but, the market share threshold for tariff deregulation will almost certainly be 60% or lower. The CER is minded to conclude that the market share threshold for tariff deregulation should be lower if the BGE brand is to reside in the company's retail rather than networks business, but, again, a final decision on this issue is not being taken for the moment.

There is one additional requirement for the domestic sector. The annual switching rate must be greater than 10%.

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[1] CER/10/212 Proposals on a roadmap for Deregulation in the Non-Daily Metered Retail Gas Market. Published 26th November 2010

While there has been no final decision made regarding rebranding of BG Energy's retail business it may have potential implications for market share thresholds for liberalisation. The CER consider this to be a prudent measure considering active competition is only beginning to emerge in the domestic sector. A further market survey may be carried out later in the year and a decision will be made following this. The CER acknowledges that the issue of rebranding of the BG Energy business is in some respects more complex than it was in the electricity sector. The CER is minded to conclude that the retention of the brand by the retail business would warrant a lower market share threshold for de-regulation than if the brand was removed. For the moment, however, the CER considers it prudent to await future developments, including the setting up of the Independent Transmission Operator (ITO) before making any final decision on the matter.

In order to keep the suppliers to customers informed on market movements the CER will carry out and publish the findings of competition reviews quarterly. These reviews will determine the state of competition in the markets and indicate whether a deregulation threshold has been met. If a market sector satisfies the criteria for deregulation that market sector will be deregulated at the next available opportunity.

The competition review will examine historic data only. The review will indicate possible timelines for deregulations of market sectors; however deregulation will not occur until the criteria have been fully met. In order to give the market an indication of when deregulation is likely the CER will include a forecast (for indicative purposes only) using historic data. The Q1 2011 review will be published in parallel with this decision, with further reviews each quarter. The competition reviews will replace the current gas market updates.

Subject to these reviews, should the CER conclude that market dynamics have changed such that competition and consumers in a given market have been negatively impacted, the CER will take steps to remedy those market failings. In the first instance the CER will adopt a relatively light-handed approach, but consideration will be given to full tariff re-regulation, or the use of price caps, of any market where it is deemed appropriate.

Full market liberalisation will not, by itself, necessarily result in lower tariffs for all, or indeed any customers. Gas prices prevailing on international markets will continue to be the determining factor. Liberalisation should, however, drive greater efficiencies and, thus, over time, lower tariffs than under a regulated tariff regime.

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1.0 Introduction

1.1 Purpose of this paper

The purpose of this paper is to outline the CER decision with regard to CER/10/212: Proposals on a Roadmap for Deregulation in the Non-Daily metered Retail Gas Market. The CER carried out a public consultation on this topic between 26/11/10 and 28/01/11 and has considered fully the comments and submissions received. The CER has also met with many of the respondents to discuss their submissions. Issues raised throughout the consultation process will be addressed in the paper, as well as outlining the final decision.

1.2 Comments received

The CER received six submissions to the consultation. Submissions were received from the following organisations:

Respondents	**Reference**
Airtricity	Airtricity
Bord Gáis Energy	BG Energy
Bord Gáis Networks	BGN[2]
ESB Energy Solutions	Electric Ireland
Flogas	Flogas
Viridian Power & Energy	VPE

1.3 Structure of the paper

- **Section 2.0** provides background about the roadmap consultation paper and its proposals.
- **Section 3.0** addresses respondents comments on the questions posed in the consultation document and give the CER decision.

[2] BGN was responding to section 6.2.4 of the consultation document only.

- **Section 4.0** outlines interim arrangements
- **Section 5.0** outlines the conclusions
- **Section 6.0** looks at the next steps

2.0 Background

2.1 Introduction

The issue of deregulation of gas retail tariffs should be seen in the context of recent developments in the electricity sector and the drive for such deregulation at EU level.

In recognising the increased levels of competition and changing market dynamics in the electricity market, the CER published on 2nd December 2009 a consultation paper CER/09/189 titled; “Review of the Regulatory Framework for the Retail Electricity Market: Proposals on a roadmap for Deregulation”. This paper examined the then current state of the Irish electricity retail market and made a number of proposals regarding deregulation. Following consultation with industry the CER published their decision CER/10/058 on 21st April 2010. This decision laid out the roadmap for the circumstances under which price controls would be removed from the public electricity suppliers ESB Customer supply.

Although considered different markets, the electricity roadmap laid the foundations for determining the criteria for a competitive market. The wave of customers switching supplier in the past two years indicates how easy it is for customers to switch, thus setting up a kind of momentum factor that is pervading the gas market. The introduction of dual fuel offers as a means to entice customers is becoming more prominent and may indicate the future market for new entrants.

On 26th November 2010 the CER published the consultation paper titled: “Proposals on a Roadmap for Deregulation in the Non-Daily Metered Retail Gas Market”. That document consulted on the circumstances under which price and revenue controls should be removed from BG Energy and related matters. This paper addresses the questions raised in the consultation document and provides a number of decisions which will define the work programme towards deregulation of the NDM retail market. Below is a summary of the proposals in the consultation paper.

2.2 Roadmap Proposals

In its paper “End-user Energy Price Regulation”[3] ERGEG stated that all markets should move towards removing price controls and that regulators should publish a ‘roadmap’

[3] ERGEG: “End-user energy price regulation An ERGEG Position Paper”: E07-CPR-10-03

outlining how they intended to do so. ERGEG stated that end-user price regulation in electricity and gas markets can frustrate the functioning of the market and even jeopardise both security of supply and the efforts to fight climate change. Therefore end-user price regulation should be removed, or where appropriate, brought into line with market conditions. This roadmap should contain specified and attainable steps to establish the necessary conditions for a well functioning market with no need for end-user price regulation. Where appropriate a transition period towards well functioning competition (for the co-existence of regulated and market prices) may be necessary to protect customers from potential abuses of dominant positions.

In response to this, the CER published a consultation CER/10/212 “Proposals on a Roadmap for Deregulation in the Non-Daily metered Retail Gas market”. This paper examined the current state of the Irish gas retail market and put forward a number of proposals regarding deregulation.

The paper discussed the regulatory regime, its origins and the CER regulatory controls in place.

In defining the roadmap in the consultation paper the CER concluded that the geographic scope for deregulation was limited to the gas retail market in the Republic of Ireland. The paper also set out definitions of the relevant product markets for deregulation. These were defined as:

- Fuel Variation Tariff (FVT),
- NDM Industrial & Commercial and
- NDM Residential.

Having established these, the CER analysed the level of competition in each of the individual market sectors. In doing so the CER proposed a range of quantitative and qualitative measures to assess whether competition had developed in a particular relevant market, or the market as a whole.

The CER also set out a range of thresholds for the establishment of an effectively competitive market in terms of volume consumption. The thresholds were 45-55% in the FVT and NDM I&C markets and 55-60% in the residential market. The CER stated that the thresholds were only indicative and may change as a result of the consultation. The issue of branding could also play a factor in defining the ultimate threshold for deregulation.

The paper considers also changes to the regulatory framework with respect to the removal of price controls. The order in which deregulation occurs was also discussed. Finally interim measures were discussed with the idea of moving to a price cap regime for the NDM I&C and Residential customers.

Finally, the CER noted while the existence of price regulation can act as a constraint to the development of full competition, the removal of such regulation cannot be done without careful consideration.

2.3 Customer Survey

The CER has recently completed a survey of domestic gas customers. The results of this survey and the results of surveys passed onto the CER from market participants has helped form the basis of some of the decisions in this paper. Some of the key conclusions are listed below.

- Satisfaction with switching process is high and unlikely to inhibit future switching
- The lack of awareness of alternative suppliers is a critical inhibitor to greater competition in the current residential market.
- Most current inhibitors of competition are under the control of the competitors
- Over 50% of respondents recognise the difference between BG Energy and BGN.
- BG Energy is less associated with gas than ESB is with electricity
- Some confusion exists around the separation of BG Energy and BGN.

The authors of the customer survey suggest the following measures may be appropriate;

- Period of reflection – observe and assess the impact of new market entrants and associated increase in competitive activity of existing suppliers on customer understanding and switching activity over the coming 6 to 12 months
- Supplier action – request all suppliers to reinforce the distinctive roles of networks and suppliers through education and active advertising

- Network action – request Network Company to engage in a programme of customer education as to its role *vis-a-vis* all suppliers in the market.
- Rebranding – request either BGN or BG Energy differentiation through rebranding

3.0 Responses

3.1 Development of Retail Competition

Given that all segments of the gas market have been open to competition since 2007 and the fact that there has been a significant increase in the level of market activity, particularly so in the last year, the CER considers that it is timely to review how the regulatory framework should evolve in a more competitive environment.

Q. Respondents are invited to comment on CER's proposed overall approach to market analysis and proposal to define a roadmap for deregulation of the retail gas market. Are you in favour of the proposal? Do you think this is the right time? Outline reasons for agreement or disagreement.

All respondents agreed with the proposal to define a roadmap for deregulation of the retail gas market and believed it was timely. **Airtricity** believed that the issues of network capacity charging, branding and the future role of the regulator need to be addressed before a final decision on the future of price regulation can be made. **Flogas** consider that the base principle whereby the incumbent is deemed to have a dominant position if their market share exceeds 40% should be adhered to.

Electric Ireland felt that the depth of research and analysis applied in the electricity roadmap was not applied in the gas roadmap. They place particular reference on the research on consultation carried out for the Maximum Allowable Revenue (MAR) formula and branding and felt the same effort was not put in the gas with regard to the price cap and rebranding. **Electric Ireland** also believes the paper does not address significant barriers to entry relating to BG Energy's unique cost advantages (a combination of factors including, dominance across entire customer portfolio which allows it minimise its exposure to daily imbalance prices, access to large storage facilities and advantageous wholesale contracts) in the retail market. **BG Energy** felt the roadmap gives insufficient attention to factors other than market share in assessing dominance in the retail gas market.

CER Response

The CER welcomes the respondents' submissions and their positive response to the concept of having a roadmap for the deregulation of the Irish retail gas market.

The issue of rebranding is a significant issue and will be discussed in detail later in the paper.

Pre-requisites put forward by **Airtricity** such as network charging are not in the scope or the remit of the roadmap consultation. However, this issue will be dealt with as part of the GMARG forum.

The CER does not agree with **Electric Ireland's** statement that depth of research, analysis and consultation was lacking in the gas consultation paper. Considerable time and effort went into the layout and details in the gas consultation paper. The CER carried out much of this research in the electricity roadmap consultation and following learnings in this process there was no need to replicate it. Electric Ireland's comment relate mainly to a consultation process carried out in electricity with regard to the MAR, part of this was to address issues relating to PES cost recovery, similar issues do not arise in the current form of gas regulation (the RCF).

The CER does not agree with BG Energy that insufficient attention to factors other than market share was given. The consultation may have placed emphasis on market share (this is a well used metric) but other factors such as barriers to entry/exit, switching and access to the wholesale market and networks were also discussed.

CER Decision

Decision 1 – The CER have defined a Roadmap for the deregulation of BG Energy.

3.2 Single Market for Electricity and Gas

Q. Respondents are invited to comment on the concept of a “dual fuel” market. Should this market be the one used to decide on deregulation in the domestic gas market? Outline reasons for agreement or disagreement.

Flogas and **Electric Ireland** did not believe there is a single market for gas and electricity. **Flogas** considered that gas can clearly not in the majority of cases be substituted for electricity and stated “it is perverse to argue that participation in one market demands participation in another”. **Electric Ireland** argued that “duel fuel” offering, with gas and electricity product bundles, did not imply gas and electricity could be considered in the same market.

BG Energy and **VPE** considers there to be clear evidence of the presence of a dual fuel market (particularly in the residential market) as part of a broad retail energy market that includes both retail gas and electricity. **BG Energy** believe that in a very small market, dual fuel offerings provide economies of scale opportunities as to certain costs which will benefit customers in both market segments. **BG Energy** also believe that the ability of an independent supplier who makes a dual fuel offer to a customer bestows a significant competitive advantage and as such customers are more susceptible to being directly targeted and acquired and are also more likely to switch. **VPE** contend that any proposals on deregulation criteria and thresholds must be extended to include the dual fuel market. This is particularly important given the dominance of **BG Energy** in the dual fuel market, a position it has developed through leveraging its dominance of the NDM residential retail market.

Airtricity did not comment specifically on a single market for gas and electricity, they did mention dual fuel in the concept of synergy benefits accrued by BG Energy.

CER Response

The CER agree that virtually all or possibly all gas customers are dual fuel customers. However, it does not agree with the concept that the gas and electricity markets can be considered the one product market. There is no dual fuel market in the conventional sense i.e. that one product can be readily substituted for the other by the consumer to meet the same basic need, at least on any significant scale. There could be a dual fuel market – at least conceptually if customers could only source their energy needs from a dual fuel supplier. This is not the case. Moreover, the gas supply licence prohibits the tying of the supply of gas with other products.

The CER consider electricity and gas retail markets to be separate markets and for the purpose of calculating market share, the retail gas market will be considered as a standalone market.

Notwithstanding this it is important to recognise that there are some significant linkages between the two markets. Noting that half of the customers surveyed in the gas survey have dual fuel accounts, the CER acknowledges that dual fuel marketing is becoming more important from a supplier viewpoint. Therefore it is likely that in order to attract the entire population of gas customers, the next new entrant into the residential gas market will likely be a dual fuel supplier rather than a gas only supplier.

CER Decision

Decision 2 – The CER does not utilise the concept of “dual fuel” as an explicit metric for determining a competitive market. Retail gas and electricity markets will be reviewed as separate markets for the purpose of calculating market share.

3.3 Relevant Retail Markets for Gas by Customer Category

In analysing any market by customer sectors there is a need for clear definition. The CER considers the gas retail market to be defined by demand/consumption. The CER continues to consider that there are three specific market sectors that remain regulated in the retail gas market, those being the FVT, NDM I&C and the NDM Residential.

Q. The above are the current defined relevant retail markets. The CER see no reason to move away from these retail markets. Do you agree? If not what do you propose?

All respondents accept the CER defined three NDM market sectors. Respondents also support the geographic market definition as outlined in the consultation paper. Some respondents also point out that in light of CAG the definitions may need to be revisited.

CER Response

The CER will continue to use the three defined relevant retail markets. In light of any decision following in CAG the definition may be revisited.

CER Decision

Decision 3 – The CER has decided that the NDM gas retail market will be defined by three relevant markets; FVT, NDM I&C and NDM Residential. For the purposes of this review the NDM retail gas market will be defined at national boundaries.

3.4 Relevant Market Analysis

In assessing the level of competition the CER considered the quantitative metrics including the number of suppliers active in each of the relevant markets and market share trends as well as market concentration.

Q. Respondents are invited to comment on the proposal to assess the level of actual or potential competition in the retail gas market using the factors outlined. Are you in favour of the proposal? Outline reasons for agreement or disagreement.

Respondents agreed generally with the factors set out in assessing the level of competition in each defined market. **Electric Ireland** believed it is of critical importance that the CER take a balanced holistic view of all factors and indicators, and must not place undue reliance on any single factor or target which could inhibit the speedy development of full competition and the delivery of customer benefits.

VPE contend that the analysis was incomplete and should be supplemented by equivalent analysis of the market for dual fuel products. **VPE** also suggested the SSNIP[4] test as measure to test market dominance. **VPE** further suggested in the interest of developing the roadmap that the CER formally invite the views and involvement of the Competition Authority.

BG Energy believe the roadmap consultation provides little analysis of the unique characteristics of the market (such as, characteristics of competitors and customers as well as economies of scale) which in turn results in incorrect conclusions being drawn regarding BG Energy's ability to exercise market power in the retail gas market.

Flogas believed that in assessing market share data the relevant examination should be by customer numbers as opposed to volumes.

CER Response

The CER consider the analysis provided in the consultation paper to be relevant and within the scope of this exercise. Several learning's from the electricity consultation process have been applied.

[4] Small Significant Non-transitory Increase in Price

The SSNIP test (more commonly used in merger cases) consists of observing whether a small price increase (say 5 to 10%) would provoke a significant number of customers to switch/substitute it with another product. The SSNIP test is useful in calculating the elasticity in demand and whether a dominant firm can profitably raise prices and *de facto* “get away with it”. However, applying a SSNIP test would be difficult in this market and unlikely to yield meaningful results.

The CER consider market share by volume to be the correct metric for measuring market share in the business market sectors. Using market share by customer numbers for the residential may be more appropriate considering the range in consumption of customers in the sector is not substantial and the impact of seasonality is greater.

CER Decision

Decision 4 – The CER will use market share by volume as the metric for measuring market share in the business sectors and will use market share by customer numbers as the metric for measuring market share in the domestic sector.

3.5 Other Criteria for Determining a Competitive Market

Market share data alone does not provide indisputable evidence or dominance, or lack thereof, so market share could be considered in context. In considering the case for full deregulation the regulatory authority must also take account of the broader market conditions which would enable the development of effective and sustainable competition. Other aspects to be considered include barriers to entry, branding, network access, switching etc.

Q. Respondents are invited to comment on the assessment of the barriers to entry, exit and expansion within the retail NDM gas market including the branding issue.
Comparing gas to electricity, is the higher level of liquidity in the gas market sufficient reason to have a higher deregulation percentage threshold than in electricity?
To what extent does the smaller scale of the market in gas suggest thresholds should be lower percentage thresholds in gas than in electricity?
Is branding as big an issue as it was in electricity? Should there be a different threshold for deregulation depending upon whether BG Energy changes its brand or not, and if so, what difference should it be?
Outline any suggestions to improve the situation for existing suppliers and new entrants.

Airtricity consider rebranding the BGE supply business a pre-requisite for deregulation. Other pre requisites such as changing the network capacity charging recovery methodology, synergy benefits BG Energy enjoy as a dual fuel company and retail market failures (i.e. distribution methodology of free gas allowance) are mentioned.

BG Energy does not believe it appropriate to make direct comparisons between the gas and electricity markets. They state that the gas market has a more liquid wholesale market, is more competitive and is more attractive to new entrants.

BG Energy does not believe that its brand causes an impediment to market entry or to sustainable competition. Market research carried out by BG Energy and empirical evidence produced by BG Energy in their response from other liberalised and competitive markets supports this view. On this basis **BG Energy** believe the BG Energy brand should not be relevant to any discussions or triggers for deregulation of the retail gas market. **BG Energy** does not consider that recognition of its brand is sufficiently powerful to warrant rebranding.

Prior to the Big Switch campaign the BG Energy brand was not readily recognised amongst energy customers. They propose that any proposition to rebrand at this stage will devalue the investment BG Energy has made in its brand and the cost of rebranding will ultimately be levied on the customer either in terms of higher costs, confusion or reduced value.

Electric Ireland consider BG Energy's unique cost advantage (i.e. access to Inch to mitigate price spikes, dominant market position used to leverage supply contracts, exclusive long term supply arrangements) act as a barrier to entry. Electric Ireland agrees with the CER view that sunk costs, switching and access to networks are not barriers to entry.

Electric Ireland feel rebranding should be a condition for deregulation of the gas market. **Electric Ireland** stated a survey carried out by them clearly shows that the Bord Gáis brand, and its association with the monopoly gas network, is perceived as being even stronger that ESB's brand perception within the electricity market. There is no doubt that a complete brand change would significantly increase the likelihood of switching and should be considered as the best option for facilitating a more competitive gas market.

Finally **Electric Ireland** disagrees that the higher market liquidity or smaller market size in the gas market versus the electricity market should have any effect on the thresholds for deregulation.

BGN believe that meeting their pending legal obligation in regard to the Third Package Directive would be best done by building on the current high awareness of Bord Gáis Networks in the marketplace and by the continued education of gas users in a targeted manner, rather than in changing the brand/name. BGN believe this would be more effective and offer much better value for money for customers.

Flogas believe the issue of branding is very important. They believe the incumbent enjoys enormous advantage built up over many years arising from the fact that both the system operator and gas supply sides of the business utilise identical branding. This branding advantage in their view hinders fair competition. **Flogas** expect the CER to require BG Energy to change their branding prior to deregulation.

VPE consider the size of the Irish gas market a barrier to entry, with the Irish market being a low margin business driven by commodity prices in Great Britain. Once in the market the position of the incumbent represents the greatest barrier to expansion. Customer acquisition costs likely prevent efficient market exit. VPE consider it necessary that BG Energy rebrand for compliance with the Third Package Directive and to mitigate the company's market power.

Finally **BGN** believe the issue of gas safety is of critical importance, this given the nature of the product and the risk to the public, as well as gas users. It is vital that consumers are clear who to contact when they smell gas.

CER Response

As can be seen above the majority of respondents placed particular emphasis on the importance of branding and how other factors such as barriers to entry/exit and scale are linked to branding in some form.

The CER recognise the importance of branding and the power in customer persuasion it holds. BG Energy as a brand in itself has been around since 2009. Although inextricably linked with Bord Gáis Eireann, it may not necessarily hold the same affinity with consumers as the ESB brand does.

In the Electricity Deregulation Roadmap decision (CER10/058) results from a joint NIAUR and CER customer survey in 2010 found that 28% of domestic customers believed that their supplier was responsible for power failure repair and 25% believed their supplier was responsible for grid maintenance. The CER stated that this demonstrated some confusion persisted among domestic customers as to the responsibility for basic service provisions.

The CER has since carried out a follow up survey for electricity in 2011 which has seen a significant improvement in the level of understanding for ESB Networks maintenance and repair role. The level of understanding on who is responsible for the networks role has gone from c56%[5] in 2010 to c72%[6] in 2011. This demonstrates the level of confusion has diminished significantly and what must also be remembered is that no rebranding had taken place at this time.

In those two periods over 900,000 (40% in total) electricity customers have switched supplier. Of these 519,121 (23%) electricity customers switched prior to the CER electricity roadmap decision in April 2010, and following this a further 384,986 (17%) customers had switched by the end of February 2011. This all happened in the absence

[5] In 2010 survey 56% were correct, 27% believed it was current suppliers responsibility and 17% didn't know

[6] In 2011 survey 72% were correct, 23% believed it was current supplier's responsibility and 5% didn't know.

of any new supply brand for ESB. As a result of the overall success in electricity it is reasonable to expect that confusion in gas will also reduce as switching continues. Gas customers are all electricity customers, and with a large portion of them already having already engaged in switching supplier, energy customers should be pre disposed to continue switching.

The CER have conducted a similar survey of gas customers and found that 24% of domestic customers believed their supplier is responsible for repairing gas leaks and 19% believed their supplier was responsible for maintaining the network. Although these figures are lower than with those in the electricity survey of 2010 there are marginally more “don’t know” in the gas survey. What the survey also shows is that the number of customers who recognise the correct answer is over 50% (c55%[7]). Given this information and the trend shown in awareness in the electricity surveys it is not necessarily true to say rebranding the supply company to address confusion is required. Considering the results from the electricity survey, it is reasonable to expect as switching progresses and customers become more aware of competing suppliers this level of confusion will reduce. The gas survey showed that 56% of the respondents had changed their electricity supplier (i.e. were with other than Electric Ireland). This suggests that whatever confusion/uncertainty existed around the respective roles of suppliers and network operators has been overcome at least in electricity. The question then becomes do these customers believe that the situation is materially different in gas than in electricity?

As part of the gas survey respondents were also asked about association with the utility bill. Over 50% of customers called their electricity bill their “ESB bill” (even where some are not current customers of ESB), whereas only 6% of customers called their gas bill the “Bord Gáis” bill. This suggests the BG Energy brand may not be as pervasive in gas as ESB is in electricity.

BG Energy has also spent considerable sums of money in launching into the retail electricity market in 2009 with their “Big Switch” campaign, requiring rebranding as an absolute commitment could greatly devalue the large investment BG Energy has made over the last two years. It should also be noted that ESB was not required to remove their brand from its supply business in order for the electricity market to be de-regulated – they were, however, required to remove the brand for it to be de-regulated at a threshold of 60%. Should ESB not have removed its brand, it is likely that it would have been de-regulated at a lower threshold, probably 50%.

[7] In 2011 Gas survey, 55% of respondents knew who was responsible for repairing gas leaks and maintaining the network. 22% thought it was their current supplier’s responsibility while 22% didn’t know.

Given the strength of the brand of BG Energy is less and following results from the electricity and gas surveys showing reduced confusion around roles of suppliers and networks and further seeing sustained switching rates in both gas and electricity (which have been high by international standards) the CER believes that the issue of rebranding BG Energy's retail business and what effect, if any, this should have on market share thresholds for liberalisation (see further below) is less clear cut in gas than it was in electricity. Results from the gas market survey confirm there is some level of confusion but given the trends seen in the electricity market of increased awareness over time it is reasonable to assume the same will follow in gas. The reason for the decrease in confusion could be due to:

- Continuing consumer education via advertising (in the case of electricity from the suppliers)
- The act of switching could decrease confusion or remove the fear of switching. This may apply whether or not the person has switched themselves.
- The passage of time itself may remove any uncertainty or fears around this issue e.g. a colleague or acquaintance has had a new supplier for some time without any adverse impact.

It must also be remembered that at the time of the first electricity market survey there were two well established competitors (Airtricity & BG Energy) of significant scale competing against the incumbent Electric Ireland. The same cannot be said for the gas market. Electric Ireland has only recently entered the domestic gas market. It is considered sensible to observe and assess the impact of Electric Ireland's and any new or existing competitor's impact on the market. The CER may carry out a further gas market survey at the end of the year to examine if there has been any increased awareness and understanding and any increase in switching.

Overall, then, while the CER acknowledges that the issue of rebranding of the BG Energy business in some respects is more complex than it was in the electricity sector, it is still minded to conclude that the retention of the brand by the retail business would warrant a lower market share threshold for NDM residential customer de-regulation than if it removed it. The CER consider it prudent to await future developments including the setting up of the ITO[8] before making any final determination on branding.

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[8] The European Directive 2009/73/EC contains unbundling provisions designed to separate the supply and networks activities of Vertically Integrated Utilities (VIUs), such as BGE, in order to facilitate non-discriminatory access to gas transmission networks. The Directive outlines a number of models by which Member States can achieve compliance with the unbundling requirements and the Minister for Communications, Energy and National Resources has chosen to implement the ITO (Independent

CER Decision

Decision 5 – The CER is minded to conclude that the market share threshold for tariff deregulation in the NDM residential sector should be lower if the BGE brand is to reside in the company's retail rather than networks business. A final decision on this issue is not, however, being taken for the moment.

Transmission Operator) model in respect of BGE. Under the ITO model, a legally separate and highly ring-fenced independent subsidiary of BGE will own and operate the gas transmission system.

3.6 Triggers for Deregulation

The CER proposed that in coming to a view that a particular market is competitive, it must meet a number of specific requirement, including the following;-

- Number of suppliers in the market
- Independent supplier market share
- Incumbent supplier market share
- Switching rates

The CER considered that not one, but all, of the requirements set out above should be met before price controls could be removed.

Q. Do you agree that switching rates should only be considered as a threshold for deregulation in the residential sector? Respondents are invited to comment on the proposal of a price cap as an interim measure. CER seeks views regarding the timing and practical aspects of deregulation.

Airtricity believe that the market share thresholds provided in the consultation are on the low side and raise serious concerns as to whether Bord Gáis will still be dominant in the relevant markets. **Airtricity** propose that the thresholds should be in line with ERGEG guidelines and should by 35% for the FVT, 35-40% for the NDM I&C and 40-50% for the residential sectors. **Airtricity** also believe that there should be a minimum three independent suppliers each with a minimum market share of 10%. Airtricity believe more emphasis should be placed on the HHI.

In terms of assessment **Airtricity** recommend the CER use historical assessments as the means to measure competition. To do otherwise could result in the premature removal of price regulation. **Airtricity** agree with twice yearly reviews and welcome the proposal for a price cap as this form of regulation would ensure that the regulated incumbent is facing the same competitive forces as independent suppliers, while ensuring that customers continue to pay a cost reflective and fair price for their competition.

BG Energy considers the proposed triggers for deregulation are not appropriate considering the low barriers to entry and the level of competition already in the market. **BG Energy** contend that with low barriers to entry and access to a highly liquid market combined with the size and scale of their competitors and the presence of a dual fuel market distinguishes the gas market from the electricity market. Therefore they believe the thresholds for deregulation should be 55% for the FVT and NDM I&C sectors and between 60-70% for the residential sector.

With respect to the number and market shares of independent competing suppliers, **BG Energy** believes that the CER's proposals are unrealistic and again do not reflect the nature and characteristics of the retail market. The requirement for two independent suppliers, each with a market share of more than 10%, will adversely affect competition in the market and unfairly discriminate against BG Energy. **BG Energy** believe any concerns the CER may have with this, they propose that this can be addressed through provisions made in the licence conditions on codes of practice.

Finally, **BG Energy** disagrees with the proposal that the removal of price controls in a given market should only occur from the start of the following tariff year. Any market sector meeting the relevant conditions should be deregulated as soon as possible to enable customer to avail of competitive contract offers at the earliest point especially ahead of the winter months. BG Energy also believes market reviews should be conducted quarterly.

Electric Ireland agree that all conditions outlined in the paper should me met including, in the residential sector, a switching rate of greater than 10%, and that rebranding should also be made a condition of deregulation. They do not agree with the proposal of moving to a price cap. **Electric Ireland** has concerns that there would be no price floor which would effectively leave BG Energy unregulated and the fact that there is no price to beat would not allow competitors to come into the market. Electric Ireland considers the MAR formula used in electricity to be the best approach for the gas market.

Finally **Electric Ireland** believe the precedent was set out in the electricity roadmap where a decision was made to carry out market competition reviews on a quarterly basis and the use of six month prospective assessments as provisional indicators and signals to market participants that deregulation was likely. One month before deregulation a final decision would be signalled. They see no reason to move away from this procedure in the gas market.

Flogas believed the requirements mentioned above to be fair and reasonable. They agreed that there should be a minimum of three active suppliers serving a market. **Flogas** considered a 10% market share too low, and felt a 15% share would be more appropriate as 10% could indicate a supplier was still in developmental stage. **Flogas**

felt the market share thresholds proposed by the CER were too high and there was no clear rationale for choosing such thresholds. They believe it is appropriate for the incumbent market share to be set at 40% and may be lifted to 50% in the event branding is dealt with. **Flogas** confirmed that the annual switching rate for domestics seemed reasonable.

With regard to the practical aspects of deregulation **Flogas** stated that existing suppliers should be given 12 months notice of any deregulation. This, however, does not apply to the FVT. **Flogas** considered all market reviews should be based on historic data and finally did not agree with the proposal for a price cap. They believe that if the CER considers that a market sector has met all the criteria and should be deregulated, this should occur without any interim measures such as a price cap.

VPE supports the views in the CER consultation regarding requirements for deregulation. **VPE** questions the definition of an independent supplier; they believe that the supplier must be independent both of the incumbent's organisational structure and more importantly the incumbent's shareholder.

On the practical aspect of deregulation **VPE**'s view is that the analysis of the thresholds and criteria contained in the final roadmap decision should be historical with the market exhibiting all of the relevant thresholds being breached in two consecutive quarters, they believe this approach to be prudent and consistent with the definition of other statistical/real world phenomena.

VPE did not comment specifically on the proposed thresholds but did note the importance of not considering items such as market share in isolation. VPE do not consider a price cap appropriate in the current market. While opposing the price cap, **VPE** do recognise the importance of removing K factors and as such believe a MAR type formula as an interim measure may be appropriate.

CER Response

Considering the views of the respondents above the CER will carry out quarterly competition reviews. These reviews will use historic actual data. This approach mirrors that in electricity, however the use of historic data for gas is more relevant as competition is much less established and trends and forecasts may prove unreliable. The competition review will give a forecast of likely deregulation periods given previous switching patterns and consumption. Deregulation will occur once the competition review shows that all thresholds are met and will be effective immediately.

The CER does not agree with the Flogas comment that a 10% market share indicates a competitor is necessarily in a developmental phase. The CER has monitored market shares for some time and consider a 10% share to be sufficient in terms of scale and should mean this competitor can compete with larger market participants effectively. The CER therefore considers that there should be a minimum threshold set whereby at least two independents suppliers in the market must have a 10% market share by volume.

There are differing views on thresholds. The CER does consider the gas market to have lower barriers to entry than the electricity market However, there is the fact that there are fewer customers in the gas market making it smaller so this negates any need for higher thresholds as there could be a limit to the amount of competitors than could reasonably operate profitably in the market. On balance, however, the former effect is likely to be stronger than the latter, so in theory the de-regulation threshold should perhaps be higher in gas. But the CER is of the view that de-regulating a market at a level of greater than 60% would be unwise, and could lead to competition problems in the future. It is not making a final decision on de-regulation in the NDM residential sector now, but unless some highly compelling new evidence is brought forward, it would not see de-regulation occurring at a level greater than 60%. Thus, the threshold for deregulation should be 50% for the FVT and NDM I&C sector, and almost certainly less than or equal to 60% for the residential sector. A 10% annual switching rate is also required for the residential sector.

The threshold measure in the NDM residential sector will be by reference to customer numbers rather than volumes (as is the case for the FVT and I&C sectors) in the year to date. This is essentially on the ground that gas consumption is far more seasonal and temperature sensitive than, say, electricity so that, depending on when during a gas year a customer has switched supplier, data on consumption over a given period can be quite misleading on the state of play on competition at the date of regulation.

Regarding Airtricity's comment on the use of HHI, the CER notes that the maximum HHI criteria set out by the CER for business markets would allow for 3,750 (based on market shares of 50%, 25%, 25%) and for the residential sector would allow for 4400 (based on market shares of 60%, 20%, 20%. When taken into account with a suitable level of switching, the CER believes this HHI to be a sufficiently low indicator of market concentration. If a deregulation threshold was set to reach a HHI of 1800[9] the deregulation thresholds required would likely be unobtainable as they may never be reached (e.g. if the threshold was set at 40%, then there would need to be 18 others with 3.3% market share or some other such combination to reach a HHI of 1800).

[9] General rule of thumb is that a HHI of greater than 1800 indicates a concentrated market

The CER would note that, while the purpose of the criteria is to provide clarity going forward for suppliers and consumers, there may be a possibility of suppliers trying to manipulate the criteria to control the specific time at which de-regulation occurs. If CER is of the view that this has occurred, the CER reserves the right to make decisions re the precise time for deregulation to occur, thus the criteria should ultimately be seen as indicative rather than fully binding.

With regard to the next steps for the RCF, the CER have examined several options including the option of a price cap as proposed in the consultation paper. A decision can be found later in section 4.

CER Decision

Decision 6 – The CER has decided that regulatory price controls will be removed when competition is reached in a particular market where all the following criteria have been met; -

- **I.** There are at least three suppliers active in the relevant market; and
- **II.** There is a minimum of 2 independent suppliers, each which has at least a 10% share of load (GWh) for the FVT and NDM I&C markets and a 10% share by customers numbers for the Residential market; and
- **III.** For the FVT and NDM I&C markets, the percentage market share is 50%. In the Residential market, the percentage is likely to be 60% or less, with the actual level to be decided later in the light of developments on the branding issue.
- **IV.** For the residential sector an annual switching rate of 10% or higher is also required prior to deregulation.
- **V.** The CER will publish quarterly competition reviews (April, July, October, January).
- **VI.** The rate of switching will be calculated on a historical basis – the rolling average switching rate over the last 12 months.

VII. Supplier market share will be assessed on the latest available data from the GPRO. If a market sector is found to have passed the criteria set out above then it will be considered deregulated immediately.

3.7 Proposed changes to the regulatory framework – removal of price controls

As market structures evolve and competition matures the approach of regulation should also move and change.

Q. Respondents are invited to comment on how the price controls should be removed in the context of only a portion of the relevant markets reaching the threshold for the removal of the price control. Is there another course of action that you would be in favour of? Outline reasons for agreement or disagreement.

In light of only a portion of the relevant markets reaching the thresholds for removal of regulation the following comments were made.

BG Energy considers that the FVT and SME sectors should proceed to full deregulation immediately. They believe the continued form of price regulation will be to the detriment of choices and prices offered to customers.

Electric Ireland did not comment specifically on the question but did state they believe that there is essentially one business market, the FVT and NDM I&C and they should only be deregulated after they both reach their respective thresholds.

Flogas consider market sectors should be deregulated based on the assessment and not with any regard to the size of customers within the sector. They also indicate that suppliers should receive adequate notice of any decision to deregulate a market sector as any lack of notice could seriously prejudice the interests of suppliers.

VPE's view is that a stepwise reduction in market share thresholds in subsequent quarters following a review may work as one may reasonably assume that the number of independent participants in both markets would be the same. However, VPE did state that for deregulation the relevant sector should only be deregulated upon reaching the set thresholds for all relevant criteria over two consecutive quarters based on a historical assessment.

VPE also consider that the CER should retain the right to re-regulate the market if ex-post analyses of market outcomes evidence a need for this course of action as the legal avenue is costly and time consuming.

CER Response

At the time of writing the consultation paper it was considered likely that a situation could arise where the NDM I&C market could have been deregulated before the FVT market sector. Considering the information in the Q4 Gas Market update and the Q1 competition review it is now clear that this situation has not arisen. However given the question was asked and participants responded their answers are displayed above.

The question above may be still relevant with regard to the residential sector. As competition is relatively immature in the residential market sector and with the entrance of a new market participant the split up of market shares is not easy to predict. The CER will continue to monitor the market closely and following the decision on branding may redefine the deregulation criteria for the residential market sector.

4.0 Interim Arrangements

4.1 Introduction

As part of the roadmap to deregulation in the NDM retail gas market, the question of how to regulate the NDM Residential and I&C tariffs in view of upcoming deregulation was posed, with a specific option of a price cap being suggested.

The current RCF formula is often criticised for not reflecting market conditions and this is largely due to the inclusion of K factors. With the advent of increased competition in the anticipation of deregulation of the NDM sector in time, an interim measure which eases the transfer to full competition is discussed. Three options are considered. Although other options could have been considered, the three chosen below were examined due to the ability to easily and cost effectively transfer to them. Designing a totally new tariff structure with the advent of deregulation would be wasteful.

- Price Cap
- MAR
- Quarterly RCF

4.2 Price Cap

Moving to a price cap could be considered the next logical step on the road to full deregulation. The concept of the price cap was proposed to allow for the abolition of K/Z factors within the year. The price cap could consist of the same inputs as the RCF except there would be no K/Z factors. An updated cost to serve and an increased margin to reflect increased risk being taken by BG Energy would have to be considered. The price cap would set a tariff which BG Energy would not be allowed to price above.

One of the perceived benefits of a price cap is that it could force BG Energy to be more competitive and innovative as they would no longer have the security of the knowledge they would be kept whole through correction factor.

The majority of respondents (including BG Energy) were not in favour of the idea of moving to a price cap, primarily, it has to be said, due to the fear that BG Energy would be tempted to sell below cost to keep market share. In this regard it is important to note that BG Energy is bound by conditions in their license to not sell below cost.

BG Energy's primary objection was to a price cap combined with the removal of correction factors was that it would expose them to vastly increased risk if the existing benchmark was maintained. In their view this increased risk would need to be allowed for in a higher margin or they would have to be allowed to deviate from the benchmark without penalty.

BG Energy has been purchasing gas for 2011/12 taking cognisance of the benchmark. Moving BG Energy to a price cap would alter their risk profile (for both price and volume) and it would be both reasonable and rational for BG Energy to hedge their purchases differently to the benchmark in the event of the regulation not having any K factor. In the event that futures gas prices rose to the extent that the weighted average cost of gas rose above the cost allowed for in the price cap, BG Energy would look to lock in prices for the remainder of the year. This would be the rational step to take in order to avoid losing money. To attempt to price this risk into the margin would be difficult given the current volatility in energy prices.

If, following this event prices later fell one option would be to pass the lower benchmark prices onto customers ignoring the fact that the gas would have been bought at higher prices. Allowing for this increased risk would mean setting a margin substantially in excess of the current rate of 2%.

Retaining the benchmark and allowing for correction ex post would allow this reduction to be passed on to customers.

The CER have ruled out the option of a price cap with no correction factors for the reasons listed above.

4.3 MAR

Some respondents to consultation were in favour of removing the k factors and suggested a Maximum Allowable Revenue (MAR) type form of regulation similar to that designed for ESB PES.

The CER has examined the option of introducing a MAR type formula.

While moving to the MAR may remove/reduce the effect of having K&Z factors, there are issues with it in gas that are not present in the electricity.

The majority of gas customers by their nature are highly temperature sensitive and their consumption levels vary widely between winter and summer (over 50% of the annual gas consumption occurs in the four months between November and February). This does not happen to the same extent in electricity. In the event that, say, an over recovery occurred in the first six months and needed to be given back in the second six months, this could lead to significant tariff volatility as there would be less than 30% of the gas volumes remaining over which to return the over recovery. An additional impact of this is the tariff in the second six months would have significantly deviated from the true prevailing tariff at the time.

To overcome this potential issue, the concept of a rolling 12 month MAR (whereby each quarter the forecast looked 12 months ahead) was considered. This could potentially remove the volatility issue mentioned above. It was considered that this objective could be met by implementing a minor modification to the existing RCF, this is discussed below.

4.4 Quarterly RCF

The final option considered is a quarterly review of the RCF. Instead of the current twice yearly reviews the review would now take place each quarter. The quarterly reviews will include a 12 month look ahead (each time) with volumes and customers numbers being constantly updated. This should temper the effect of seasonality and temperature sensitivity somewhat.

Moving to quarterly reviews will also facilitate the minimisation of the impact of K&Z factors while ensuring tariffs more accurately reflect market conditions at that time. Reviewing on a quarterly basis rather on a twice yearly basis will further limit the size of any K factors by correcting for volumes and customer numbers more frequently. This is especially relevant in a market that is becoming more competitive where accurately forecasting customer numbers is increasingly difficult. Continually looking 12 months ahead is a refinement of the policy commenced with CER/10/003 where the CER sought to achieve three aims:

- to keep the gas tariff more cost reflective;
- to minimise the effect of K factor between periods and
- to reduce tariff volatility for the end customer.

This should assist independents in their planning and purchasing as they should not be blindsided by large under/over recoveries whilst protecting consumers from unnecessarily volatile tariffs.

4.5 Interim Arrangements Decision

Following examination the CER has decided the RCF will continue in its current form, albeit with a new supply cost formula to be introduced in order to better reflect the actual cost to serve and remove the need for a cost to supply Z factor. This will be explained in more detail in the summer consultation.

The RCF will be set initially at the start of the 2011/12 gas year. Following this BG Energy will submit revised updates every three months (September, December, March and June). These submissions will not be consulted upon given the timeline required. The CER will examine the submissions and either approve or disallow any tariff changes. Tariffs may change on 1st October, 1st January, 1st April or 1st July.

5.0 Conclusions

Decision 1 – The CER have defined a Roadmap for the deregulation of BG Energy.

Decision 2 – The CER does not utilise the concept of "dual fuel" as an explicit metric for determining a competitive market. Retail gas and electricity markets will be reviewed as separate markets for the purpose of calculating market share.

Decision 3 – The CER has decided that the NDM gas retail market will be defined by three relevant markets; FVT, NDM I&C and NDM Residential. For the purposes of this review the NDM retail gas market will be defined at national boundaries.

Decision 4 – The CER will use market share by volume as the metric for measuring market share in the business sectors and will use market share by customer numbers as the metric for measuring market share in the domestic sector.

Decision 5 – The CER is minded to conclude that the market share threshold for tariff deregulation in the NDM residential sector should be lower if the BGE brand is to reside in the company's retail rather than networks business. A final decision on this issue is not, however, being taken for the moment

Decision 6 – The CER has decided that regulatory price controls will be removed when competition is reached in a particular market where all the following criteria have been met; -

- **I.** There are at least three suppliers active in the relevant market; and
- **II.** There is a minimum of 2 independent suppliers, each which has at least a 10% share of load (GWh) for the FVT and NDM I&C markets and a 10% share by customers numbers for the Residential market; and
- **III.** For the FVT and NDM I&C markets, the percentage market share is 50%. In the Residential market, the percentage is no higher than 60%, with the

actual level to be decided in the light of developments on the branding issue.

IV. For the residential sector an annual switching rate of 10% or higher is also required prior to deregulation.

V. The CER will publish quarterly competition reviews (April, July, October, and January).

VI. The rate of switching will be calculated on a historical basis – the rolling average switching rate over the last 12 months.

VII. Supplier market share will be assessed on the latest available data from the GPRO. If a market sector is found to have passed the criteria set out above then it will be considered deregulated immediately.

6.0 Next Steps

The decisions detailed in this paper, set out the criteria required for gas market sector deregulation. Until such time that the required criteria are satisfied the current FVT and RCF price and revenue forms of regulation will continue.

The Q1 2011 Competition review concluded that the FVT and NDM I&C market sectors have met the criteria for deregulation. The domestic sector is still some way from reaching the required criteria and will be kept under review. The deregulation of the FVT and NDM I&C market sectors is effective from 1st October 2011. The next competition review will be published in late July 2011.

The CER will keep industry participants fully informed throughout the process of deregulation.