Proposals on a Roadmap for Deregulation in the Non-Daily Metered Retail Gas market (CER/10/212)

Airtricity Response to

Commission for Energy Regulation

January 2011

Introduction

Airtricity welcomes the opportunity to comment on the Commission for Energy Regulation's (CER) consultation paper on the "Proposals on a Roadmap for Deregulation in the Non-Daily Metered Retail Gas market"

It has always been our belief that effective competition is the best mechanism for bringing benefits to energy consumers. This competition will hopefully bring with it improved product innovation, choice, quality and effective competitive consumer pricing.

While this competitive market is developing we believe that the aim of regulation is to correct for instances of market failure. Once competition is deemed to be well established in a market we envisage that the role of a regulator should move from that of revenue and tariff setting to one of conduct regulation and compliance monitoring within the market.

It is essential that both suppliers and customers have a clear understanding of how this transition will be managed, and we welcome this consultation as a first step in this process. It is also imperative that regulatory controls are not removed prematurely, as to do so could severely damage if not destroy the competition that has already started to develop.

It is with this in mind that we have reviewed the consultation paper and request that the CER take the following comments/response into account before making a final decision on the future of the price regulation in the Irish retail gas market.

General Comments

It is imperative that the transition from a market with regulated prices to one without is handled with extreme care. If the process is rushed it will most likely undermine the early stage competition that has begun to develop. We welcome this consultation on the CER's initial thoughts on this process and see it as a welcome first step on the path to a fully competitive retail gas market.

In previous responses we have highlighted our belief that the CER should lay out a clear vision of what the competitive market, which is starting to develop, will look like and what regulatory structures need to be put in place to support it.

While we believe that this current consultation goes someway to addressing these issues we believe that there are further issues that need to be explored before a final decision on the deregulation of retail tariffs in the gas market can be reached.

We have broken our response into two parts, the first deals with the issues we feel need to be addressed before the deregulation process can begin and the second part of our response deals with our views on the criteria as set out by the CER within the current consultation document.

Pre – requisites to Deregulation

There are a number of current issues within the Irish Gas market, which we believe the CER must address before the process of deregulation can begin.

In particular we believe 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.

We also believe that the CER needs to give further consideration to the issue of the dual fuel nature of the BG Energy business and how to deal with the treatment of the resulting **synergy benefits** accruing to the BG Energy supply business. This is an issue that must be fully resolved before deregulation can take place.

Given the current uncertainty surrounding the future ownership of the state companies such as Bord Gáis, it is imperative that the CER do not allow deregulation to happen at a threshold that would lead to concerns around the issue of dominance.

It is our opinion that the following issues must be addressed before any deregulation of the gas market.

- **Re-branding of BGE supply business** – The issues of branding in relation to the BGE supply business must not be underestimated. It is well established that from a consumer perspective, within the Irish gas market, that the Bord Gáis brand is a household name and as stated in the consultation is synonymous with the supply and transportation of natural gas, . In particular there is a clear association from a customer's perspective between the Bord Gáis brand and gas safety. For most consumers there is little or no understanding of the separation, which has already taken place, of the constituent parts of the BGE group and the different brands associated with each.

  We have recently commissioned a survey on brand recognition. The results of this survey showed that ~95% of consumers polled named Bord Gáis, spontaneously, when asked to name a gas supplier. This clearly shows the connection from a consumer perspective between the Bord Gáis brand and the supply of natural gas.

  As highlighted in the consultation the 3rd Package is clear that brand separation is a requirement for vertically integrated distribution system operators and the supply branch of such undertakings. This has particular resonance in the Irish market where the vertically integrated undertaking is also state owned and as such there is a perception among consumers that the undertaking is actually state sanctioned in its offerings. **<u>We therefore see that the rebranding of the BGE supply business is a prerequisite for deregulation.</u>**

  To be clear it would not be acceptable for the BGE name or logo to be used in any way in this rebranding. For example we believe that when ESB IE was established it was inappropriate that they were allowed use the ESB name and brand.

- **Network Capacity Charging** – Under the current charging arrangements arrangements capacity charges are recovered at a flat rate over the gas year. However the current structure of retail tariffs is such that both the fixed capacity element and the commodity element of transportation charges are recovered on a c/kWh basis. This issue has particular impact on the NDM sector of the market where customers are more temperature sensitive and do not have long term capacity contracts in place.

The high degree in seasonality in customers' gas demand leads to situation where for certain months, namely the summer months, of the year the revenues recovered from a suppliers retail tariffs are not sufficient to cover the cost incurred for transportation tariffs for supplying the customer. Simply put, under the current tariff arrangements, suppliers will over recover these costs in the winter months to make up for the shortfall in the summer months.

Unless a supplier enters the market from the beginning of the gas year, and can guarantee that they will have the customer for the full year, they cannot guarantee that the revenues recovered from customers would be adequate to cover the costs incurred for use of the transportation system.

If a supplier was to offer the same rates as the incumbent, they would need to have signed the customer up by the beginning of January in order to cover the transportation charges for the May – September period of the following calendar year.

Given this failing of the current tariff structures we believe that the current arrangements for the way in which transportation charges are recovered for the NDM sector of the market represents a barrier to entry and needs to be examined.

There are a number of ways in which the tariffs could be restructured which would allow them to be recovered in line with consumption:

- **Tariffs could be set on a c/kWh basis, thereby recovering revenues in line with actual consumption.**
- **The capacity/commodity split could be examined, with a move away from such a high percentage recovered from the fixed capacity element, perhaps a 50:50 split would work.**

- **The Capacity charge could be profiled in line with demand rather than having a flat annual rate.**
- **The Capacity charge could be restructured to contain both a fixed and variable element. For example a flat rate baseload element and a variable seasonal component.**

- **Role of the Regulator** – We believe it is imperative the there is a clear understanding of the role and responsibilities that the regulator will take once the market has been deregulated. It is essential that market participants, in particular consumers, have an understating of the structures and regulations that will be in place in this deregulated market. The current consultation does not go into enough detail on this, **we would therefore ask that CER clearly lay out what roles they see the regulator carrying out in this new market and also the structures that will be required to support these roles.**

- **Synergy Benefits –** BG Energy's role as a dual fuel supplier has resulted in the accrual of a large number of synergy benefits. We see no problem with an independent supplier realising efficiencies by virtue of being a dual fuel supplier, however where the supplier concerned is a regulated monopoly in one of the retail markets there are serious concerns that need to be addressed. The CER need to address the issue of electricity customers freeloading on guaranteed regulated income accrued from gas customers by measures such as:

  - **cut price postal advertising**
  - **building and electricity business on established dominant regulated brand**
  - **marginal cost market entry – unfair competition**
  - **instant business capability - paid for by all gas customers**

  The economic value of these business synergies belongs to all gas customers and as such should be repaid as a once-off rebate through the networks to all gas customers.

- **Retail Market Failures -** A number of structural failures of the retail market require remedy before deregulation can take place.
  For example as highlighted in the consultation the current market processes prohibit recipients of the free gas allowance from switching suppliers while receiving their payments in the same manner that they are used to while BG Energy customers. **It is our belief that this must be addressed satisfactorily by the CER before any level of deregulation may occur.**

Criteria for Deregulation

Once the above prerequisites have been achieved we believe the following are the appropriate criteria for the CER to apply in assessing the level of competition within the relevant market segments:

- **At a minimum, independent suppliers, and by this we mean suppliers that are not in the ownership of the same shareholder, must have a market share not less than 30%.**
- **There must be at least 3 suppliers, two of which must be independent, again not in the ownership of the same shareholder, operating within the market before deregulation could be considered.**
- **The incumbent suppliers market share must be less than 40%**
- **That 3 independent suppliers, referenced above, must individually have a minimum market share of 10%**

In our opinion not enough weighting is given to the more qualitative market issues when considering the criteria under which to assess the level of competition in the relevant markets, and as such we believe that the above prerequisites are essential before deregulation can take place.

Market share Thresholds

It is our belief 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.

Taking into consideration factors such as the overall size of Bord Gáis, the vertically integrated nature of Bord Gáis, the privileged access to capital that is afforded to the BGE group, and its state ownership, the market share targets need to be more aggressive. Our proposal is that the following market share thresholds should apply:

- **FVT – 35 – 40%**
- **NDM I&C – 35 – 40%**
- **NDM Residential – 40 – 50%**

This would then bring the targets in line with the ERGEG guidelines, as referenced in the consultation, which suggest that any market share higher than this is likely to lead to issues of dominance.

Given the current uncertainty surrounding the future ownership of the state companies such as Bord Gáis, it is imperative that the CER do not allow deregulation to happen at a threshold that would lead to concerns around the issue of dominance.

HERFINDAHL-HIRSCHMAN INDEX

We are disappointed with the weighting give to the importance of the Herfindahl-Hirschman Index (HHI) as a measure of market concentration.

It is widely accepted that a level of 1,800 is considered acceptable when assessing the level of concentration within a market, and that any score above this is likely to raise issues of dominance.

The consultation cautions the use of the HHI as a measure. While we acknowledge the scale of the Irish market makes it extremely difficult to reach the desired target of 1,800 we do not believe that the CER should dismiss its relevance.

We find this dismissal of the HHI score due to market size particularly confusing when the HHI measure is a key part of the assessing dominance in the SEM as part of the market power mitigation strategy.

We believe that rather than dismiss the HHI as a measure of market concentration the CER should propose an acceptable level of HHI score and then try and address the issues that are preventing us from reaching this level.

It is obvious that in the domestic gas market in particular there is still plenty to do with a HHI score that is currently over 9,000.

TIMELINES

It is our belief that it would be inappropriate for the CER to use forecasts when carrying out its assessment of competition in a relevant market sector. As competition is developing we are likely to see significant shifts in market shares, and as such we believe forecasts would at best be uncertain and we would strongly recommend that the CER use historical assessment as the means to measure the level of competition.

To do otherwise could result in the premature removal of price regulation in the retail market, with potentially disastrous results accruing for customers.

For example over the last two years BG Energy forecasted large losses in customers, when setting their annual revenue requirement, which have not materialised. If these forecasts had been used for the purposes of deregulation, the market would have been deregulated prematurely.

RELEVANT MARKETS

We are in agreement with the CERs proposal to define 3 relevant markets for the supply of retail gas.

The proposed breakdown also reflects the breakdown that is currently used by most suppliers when defining product offerings for potential customers and as such will be relatively simple for customers to understand.

Notwithstanding this the CER must remain cognisant that the gas market is different to the electricity market. While there may be acceptance that there are 3 relevant markets the nature of the gas market is such that there is a high degree of crossover/interaction between these relevant markets and this needs to be taken into account when setting the appropriate thresholds.

TRANSITION TO DEREGULATION

We believe that the removal of end user price regulation should only be contemplated in any of the relevant markets once:

- the pre-requisites highlighted above are met;
- the number of independent suppliers active in the market have reached the required levels;

- both the independent suppliers and the incumbent have reached the required market share thresholds. As stated previously we believe that this must be on an historic basis rather than based on at best subjective and most likely inaccurate forecasts;

We do not believe that these criteria are met for any of the relevant markets at this time.

Customer Communication

As was the case in the electricity market that it is imperative that as part of this transition to a fully competitive market that the regulator carries out an information campaign for customers, in particular domestic and small I&C customers. This campaign should make consumers aware of the potential suppliers in the market and how to contact them; it should also provide customers with details of their rights within the market and the role the regulator in this new market.

Review Timelines

We think it is appropriate, particularly in the current market environment where switching levels are at an all time high, for the CER to carry out its review of competition twice a year.

However as we stated above we believe that the CER must use actual historic data when carrying out this review, as to use forecast could result in the premature removal of price regulation in the retail market, with potentially disastrous results accruing for customers.

In terms of the timelines around deregulation itself we would caution that competition in the domestic market is still less than a year old and could easily be undermined if deregulation takes place prematurely.

As can be seen with both the RTF and FVT segments of the gas market once competition starts to happen in a market segment it usually takes 2 – 3 years before it becomes properly established, and the new market entrants build up reasonable market shares. As has been seen it is at least year 2/3 before customers become fully aware of the options offered by new suppliers and the market starts to see the incumbent lose significant market share.

The CER should allow competition to establish itself in the NDM domestic market before they deregulate, otherwise the competition that is starting to emerge will be undermined.

Regulatory Safeguards

If price regulation was to cease in any particular market we would find it hard to see how the regulator could step back in and reregulate prices. This is one of the reasons that we support the CER view that it is best to deregulate the market segments one at a time rather than in one big bang, as it would enable the CER to assess how the deregulation process was working on one market segment at a time, and rectify any issue before the deregulation of the next.

We therefore also believe that it would be appropriate for the CER to enshrine the maximum market share as decided upon as a licence condition. This would ensure that the Bord Gáis supply business would be incentivised not to breach this target, as they would then be in breach of their licence.

Interim Regulatory Arrangements

We do not believe that accounting separation will work as a mechanism for dealing with the issues of the relevant market segments reaching the threshold for the removal of price regulation according to different timescales

We believe that the migration of the deregulated customers to a new supply company, as was proposed in the CER decision on the deregulation of the electricity market, would ensure that all suppliers in the market are treated equally.

However this would only work if this new supply company had an independent brand, specifically without reference to the Bord Gáis name or brand. If this is not possible it would seem that the only remaining option would that all BG Energy customers would stay on regulated tariffs until such a time as all market sectors reach the required thresholds and meet the necessary criteria.

We therefore believe that as the relevant markets become deregulated these customers should be migrated over to this independent supply business.

Price cap regulation has been used successfully in the GB market to overcome the problems caused by the use of k-factors and the unfair protection that is afforded they provide the regulated incumbent. We believe that this form of regulation also address valid concerns about how to address falling market demand as well as customer churn due to increased competition.

We welcome the proposal to use Price Cap regulation as an interim measure, 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 consumption.

MARKET DATA

As a virtue of the dominant monopoly position of Bord Gáis in the Irish Gas market they have had access to large volumes of historical customer related market data and information, such as historic consumption data, which independent suppliers have not.

This information provides an unfair competitive advantage to BG Energy in its role as both an electricity and a gas supplier, and we believe it should be shared with all market participants as part of the deregulation process.

CONCLUSION

Airtricity welcomes this consultation from the CER as a first step in the process of removing regulated end user prices in the retail gas market.

However as stated above we believe that the removal of end user price regulation should only be contemplated in the relevant markets once:

- the pre-requisites highlighted in our response are met;
- the number of independent suppliers active in the market have reached the required levels;
- both the independent suppliers and the incumbent have reached the required market share thresholds. As stated previously we believe that this must be on an historic basis rather than based on subjective and potentially inaccurate forecasts;

We do not believe that these criteria are met for any of the relevant markets at this time, and we believe that it is unlikely that they will be met in 2011. We would therefore encourage the CER to work on the issues raised within this response ahead of deregulation.

This will ensure that the competitive markets that are now developing will continue to go from strength to strength and will also go some way to addressing the concerns/issues we have raised above.