

Stuart Coleman,
CER,
The Exchange,
Belgard Square North,
Tallaght,
Dublin 24.

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ESB Energy Solutions - Response to Consultation CER10-212 - Proposals on a Roadmap for Deregulation in the Non-Daily Metered Retail Gas Market

Dear Stuart,

ESB Energy Solutions is pleased to have this opportunity to respond to this very important consultation paper and acknowledges the positive action of CER in bringing it to consultation with the industry. It is a very significant step towards developing a fully competitive retail gas market in the Republic of Ireland.

We are in favour of the proposal to define a roadmap for deregulation of the retail gas market and we believe that it is timely. We agree with the arguments CER used originally in its electricity roadmap paper and again in this gas roadmap paper, that deregulation is supported by policy coming from the EU, including the European Commission, Member States and the Regulators, which suggests that effective competition is likely to be superior to regulation and thus, where markets are effectively competitive, the replacement of end user retail tariff regulation in electricity and gas markets is a desirable outcome.

Gas, as with electricity, is an important commodity for modern day living and effective retail competition will contribute to the delivery of an efficient, reliable and secure energy supply for all customers, and will support the future growth and stability of the national economy.

We believe that the depth of research, analysis and consultation applied in the electricity roadmap paper, to inform opinion, was extremely helpful to respondents. We feel however that the same rigorous approach was not applied in the gas roadmap paper. We refer in particular to the issue of interim regulation, where lengthy Skyplex research and CER consultation led to the regulatory MAR formula, and to the issue of brand, where CER/NAIUR commissioned a survey to determine customer attitude to brand. We feel that both these issues need to be given the same degree of scrutiny and analysis in advance of CER making any decision on interim Price Cap regulation and on whether or not Bord Gáis Energy needs to be re-branded.

We also believe the paper does not address significant barriers to entry relating to Bord Gáis Energy's unique cost advantages in the retail market in Ireland. These are made up of a combination of factors including, dominance across the entire customer portfolio which allows it to minimise its exposure to daily imbalance prices in the market, and access to large storage facilities which allows it to mitigate against price spikes in the market.

The CER capacity discounts imposed on Bord Gáis Energy inadvertently prevents new entrants from competing effectively in the gas market. This anomaly also needs to be addressed.

Again we propose that CER research these issues and neutralise these advantages by putting in place proportional mitigants if it is to succeed in opening up the market to real and enduring competition.

We have outlined these concerns in more detail in the attached response.

Yours sincerely,

Shane Boland
Manager,
Regulation & Back Office, ET&R,
ESB Energy Solutions

Q1 - Development of Retail Competition

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.

Response - Q1

We are in favour of the proposal to define a roadmap for deregulation of the retail gas market and we believe that it is timely. When this paper issued on the 26th November 2010, Bord Gáis Energy's share of the NDM Residential market in quarter 3, 2010 was 97%. We understand that this share has reduced since then and believe it is time to establish, with clarity and regulatory certainty, a roadmap for the deregulation of the retail gas market.

We agree with the arguments CER used originally in its electricity roadmap paper and again in this gas roadmap paper, that deregulation is supported by policy coming from the EU, including the European Commission, Member States and the Regulators, which suggests that effective competition is likely to be superior to regulation and thus, where markets are effectively competitive, the replacement of end user retail tariff regulation in electricity and gas markets is a desirable outcome. It considered that a fully competitive retail market can bring real benefits to consumers in terms of the choice and quality of the offers available from suppliers, improved value-add services and potentially lower prices.

Gas, as with electricity, is an important commodity for modern day living and effective retail competition will contribute to the delivery of an efficient, reliable and secure energy supply for all customers, and will support the future growth and stability of the national economy.

We believe that the depth of research, analysis and consultation applied in the electricity roadmap paper, to inform opinion, was extremely helpful to respondents. We feel however that the same rigorous approach was not applied in the gas roadmap paper. We refer in particular to the issue of interim regulation, where lengthy Skyplex research and CER consultation led to the regulatory MAR formula, and the issue of brand where CER/NAIUR commissioned a survey to determine customer attitude to brand. We feel that both these issues need to be given the same degree of scrutiny and analysis in advance of CER making any decision on interim Price Cap regulation and on whether or not Bord Gáis Energy needs to be re-branded.

We also believe the paper does not address significant barriers to entry relating to Bord Gáis Energy's unique cost advantages in the retail market in Ireland. These are made up of a combination of factors including, dominance across the entire customer portfolio which allows it to minimise its exposure to daily imbalance prices in the market, and access to large storage facilities which allows it to mitigate against price spikes in the market.

The CER capacity discounts imposed on Bord Gáis Energy inadvertently prevents new entrants from competing effectively in the gas market. This anomaly also needs to be addressed.

Q2 – Relevant Market Definition

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.

Response - Q2

This has already been discussed and decided on in the electricity roadmap paper. CER considered that gas and electricity were separate products and not within the same relevant market. It argued that “dual fuel” offerings, with gas and electricity product bundles, did not imply that gas and electricity could be considered in the same competitive market. In its decision paper it decided, since customers cannot readily switch between electricity and gas without significant expenditure, that retail gas and electricity markets would be reviewed as separate markets. Therefore we do not see the rationale in revisiting it in this paper.

Q3 - Relevant Retail Markets for Gas by Customer Category

The FVT, NDM I&C, NDM Residential are the current defined relevant retail markets defined by customer demand/consumption.

The CER see no reason to move away from these retail markets. Do you agree? If not what do you propose?

Response - Q3

ESB Energy Solutions agrees with this proposal. We accept CER’s rationale for defining 3 relevant markets for the purposes of this analysis at this juncture, but due to the very close link between the FVT and NDM I&C markets in terms of customers therein, their behaviour, the products they require, etc it is argued to be inappropriate to consider deregulating either in isolation, and should thus be considered as one market for the purpose of analysis with a view to deciding if deregulation is appropriate or not. While accepting CER’s position as aforementioned we believe it would be prudent to be prepared to reconsider the situation again in the future if there is evidence of altering market conditions/footprint to warrant a review of

market definition. The recent update on the Common Arrangements for Gas Project states that the RA's have confidence that the arrangements being put in place now will deliver a successful project going forward into 2011. Any implications will need to be taken into account.

CER must also be open to re-evaluation in the event of competition developing in the NI domestic gas market despite current limitations. From a competitive perspective the conduct of all participants in a market is disciplined by the extent of prospective competitor developments in a neighbouring market, and this is stronger in adjoining markets when the respective regulators have a joint commitment to retail harmonisation of those markets, as is the case in the electricity and perhaps ultimately gas market between ROI and NI.

Q4 – Relevant Market analysis

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 i.e.

- number of suppliers active in a particular market
- individual market shares of the incumbent and independent suppliers
- potential barriers to entry, expansion and exit

Are you in favour of the proposal? Outline reasons for agreement or disagreement.

Response - Q4

ESB Energy Solutions agrees with this proposal. We believe that it is of critical importance that CER takes a balanced holistic view of all the 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.

Factors such as number of suppliers and market share are merely a snapshot view at a point in time and, while necessary, do not convey any information on the dynamic conditions of the market or how well the market is working. As CER already decided in its electricity roadmap paper, switching rates are dynamic indicators that reflect the degree of customer response to supplier offerings and the underlying interaction between the participants.

Evidence from the business sectors, and more recent experience in the domestic sector, shows that there is an increasing level of switching. It is likely to continue at an ever increasing rate similar to what has been experienced in the electricity market.

Q5 - Other Criteria for Determining a Competitive Market

5(a) - 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.

5(b) - 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?

5(c) - To what extent does the smaller scale of the market in gas suggest thresholds should be lower percentage thresholds in gas than in electricity?

5(d) - Is branding as big an issue as it was in electricity? Should there be a different threshold for deregulation depending upon whether Bord Gáis Energy changes its brand or not, and if so, what difference should it be?

5(e) - Outline any suggestions to improve the situation for existing suppliers and new entrants.

Response - Q5 (a) – Barriers

Bord Gáis Energy's unique cost advantage - A significant barrier to entry, not addressed in this paper, is Bord Gáis Energy's unique cost advantages in the retail market in Ireland due to a combination of factors:

- Dominance across the entire customer portfolio allowing it to minimise its exposure to daily imbalance prices in the market which is a very material benefit
- Access to large storage facilities such as Inch which allows it to mitigate against price spikes in the market
- Exclusive long term supply arrangements from the North-West pipeline and South-North pipeline in Northern Ireland allowing it to grow its supply business in another market today that will form part of the same retail market once CAG is implemented.

For real and enduring competition, this roadmap must address these unique advantages that Bord Gáis Energy currently enjoys so as to minimise their effects and allow an open, fair and transparent market to exist where new gas suppliers can enter without undue barriers or disadvantages.

CER Imposed Capacity Discounts - The continued application of capacity discounts imposed by CER on Bord Gáis Energy in various retail gas market sectors, while understandable from a customer cost point of view, continues to create a distortion in the market, and a material barrier to entry for new competitors. New Competitors with smaller and less diverse customer portfolios than Bord Gáis Energy will not be in a position to compete with these discounts without suffering financially themselves and hence inadvertently imposing a market distortion and barrier. A mechanism should be found to ensure customers pay for their capacity as appropriate, so that all competitors can charge this and not make a loss. Instead of the way the capacity discount is currently applied, it could be altered in such a way that any excess profit Bord Gáis Energy makes from its capacity excess could be allocated to reduce transport costs for all customers in the market place.

Sunk Costs - ESB Energy Solutions agrees with CER's view that sunk costs are not a barrier to entry. Like the electricity retail market, entry into the gas retail market does not constitute a major financial investment. Also the gas spot and forward markets are extremely liquid so no extra hedging by capital investment in upstream generation is needed. Coupled with this is the fact that many entrants are leveraging off systems & processes developed elsewhere and thereby have a minimal cost of market entry as they only face low incremental costs.

Switching - We agree with CER's view that the switching process is not a barrier to entry. We recognise that the low level of switching in the NDM Residential market was due to low competitor activity at the time of the report and not down to process inefficiencies. We understand that this market share has come down significantly since then.

Non discriminatory network access - We agree with CER's view that access to the networks used to transport gas is based on transparent and regulated terms and prices and that there is no discrimination amongst shippers by the network operator.

Response - Q5 (a) & (d) - Branding

We feel that rebranding of Bord Gáis Energy should be made a condition for de-regulation of the gas market. We believe that brand confusion, between gas supply and gas networks, is a serious impediment to competition. In this paper, lack of research or supporting evidence to inform opinion, is inconsistent with the approach taken by CER in the electricity roadmap paper. In its electricity roadmap decision paper CER drew on the results of a survey on electricity customers it had jointly commissioned with NIAUR, to decide that ESB rebranding should be a pre-condition for de-regulation. In preparation for the gas roadmap no such survey was carried out on gas customer attitudes.

In the absence of such a survey ESB Energy Solutions commissioned our own survey to ascertain customer attitude to brand in the gas market. This was carried out by The Research Perspective Ltd, during January 2011. Extracts from the survey are detailed in Appendix 1.

In summary the results of the survey shows that:

- **Brand Awareness** - Two thirds of those surveyed were unaware of suppliers other than Bord Gáis Energy
- **Role Confusion** - Confusion around gas supplier/network roles significantly impacts the decision not to switch for one fifth of consumers
- **Negative Impact on Switching** - Likewise the reliability of supply and/or responsiveness in case of gas leak is a primary reason for not switching among one fifth of consumers.

Our survey clearly shows that the Bord Gáis brand, and its association with the monopoly gas network, is perceived as being even stronger than ESB's brand perception within the electricity market. There is therefore 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.

Additionally we are of the opinion that the current advertisement campaign on safety being conducted by Bord Gáis Networks while essential, will also further reinforce the Bord Gáis brand and its association with safety. This will also act as an impediment to customer switching.

We therefore believe that rebranding be made a condition for de-regulation of the gas market.

Response - Q5 (b), (c) – Market Liquidity & Smaller Scale of Gas Market

ESB Energy Solutions disagrees that higher market liquidity or smaller market size in the gas market versus the electricity market should have any effect on the threshold for deregulation. In fact in this the paper CER itself does not provide supporting analysis or arguments for or against the propositions.

Response - 5(e) – Improvements for existing suppliers and new entrants

See our answers to Q5(a) barriers to entry.

Q6 - Triggers for Deregulation

6(a) - Do you agree that switching rates should only be considered as a threshold for deregulation in the residential sector?

6(b) - Respondents are invited to comment on the proposal of a price cap as an interim measure.

6(c) - CER seeks views regarding the timing and practical aspects of deregulation.

Outline reasons for agreement or disagreement.

Response - Q6(a) – Switching Rates

In this section key proposals on market share thresholds have been outlined but surprisingly respondents have not been invited to comment on them. CER invites comment only on switching rates. For comparison purposes, in the table in Appendix 2, we have outlined the deregulation thresholds for the gas market as proposed in this paper, and for the electricity market as proposed in the roadmap consultation and the decision papers. We agree that all the conditions outlined in this paper should be met including, in the residential sector, a switching rate of greater than 10%. **Again however, as we argued in detail in our response to question 5(a), rebranding should also be made a condition for de-regulation.**

Response - Q6(b) – Interim Price Cap

We do not agree that CER should move to an interim Price Cap form of regulation without thorough research, analysis and consultation. We re-iterate that there is no analysis, evidence and research to support this proposal in this paper. In fact the description of the Price Cap takes up one paragraph and gives no detail on how it would be monitored and kept cost reflective. We would also point to CER's view, in its decision paper on ESB PES's Revenue Regulation Framework, where it rejects a Price Cap because it views a Maximum Allowed Revenue (MAR) as more appropriate due to the fixed nature of many of the input costs.

In particular we have major concern that a Price Cap without a Price Floor leaves Bord Gáis Energy, in effect, immediately deregulated and free to prevent competition through unreflective below cost tariffs, through cross-subsidisation, vertically from its network business and horizontally from its electricity business. To open up the market competitors need a price target to beat this is not accommodated under this proposal.

In informing opinion on the MAR form of regulation for the electricity market, CER/NIAUR commissioned research and consultation by Skyplex in 2009, resulting in a lengthy information paper followed by further CER consultation and decision papers in 2010. None of these papers discussed in any detail a Price Cap option. These 2 years of research and consultation concluded that the MAR regulatory formula was the best approach.

We request that the CER apply the same rigour it applied to the electricity market, in informing opinion and reaching its conclusion on the MAR formula, by carrying out a thorough research and consultation on the Price Cap proposal.

Response - Q6(c) – Timing and Practical Aspects

The precedent for this 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. We see no reason to move away from this procedure in the gas market.

Q7 - Proposed Changes to the Regulatory Framework – Removal of Price Controls

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?

Response - Q7

We believe that, because they are essentially one business market, the FVT and the NDM I&C markets should be deregulated only after they both reach their respective thresholds.

Q8 – Consumer Protection

CER is proposing that for vulnerable and or other groups of residential customer, as defined by CER, Bord Gáis Energy and any other supplier may be required (through licence) to offer tariffs on principles acceptable to CER. CER is not, in this paper, attempting to analyse this issue in detail or suggest specific proposals.

It does wish, however, to raise the issue for comment and consider any responses on it. Any specific proposals in this area will be consulted on and developed in the future.

Response - Q8

We will respond with our views on consumer protection in the separate CER consultation on social protection (consultation paper ref. CER10-241).

**Conclusions of Research on Gas Market Residential Customers
Prepared by The Research Perspective Ltd in January 2011****Overall Awareness**

- The research has established that brand association and knowledge has an impact on customer decisions on switching within the gas market.
- This impact is similar to that measured in the electricity market in 2010 – using the same methodology.
- Furthermore, the effective level of competition remains low in residential natural gas market as measured by awareness of suppliers with 2/3 unable to name a supplier other than Bord Gáis.
- Lack of awareness of any other competitors reduces the likelihood of switching among most of the market.
- Consumer awareness of gas suppliers remains low and much lower than awareness of electricity suppliers in the electricity market 12 months ago [Unprompted awareness of Airtricity for Gas at 33% compared with CER 2010 electricity market survey where 69% could name Bord Gáis and 57% Airtricity].

Role Confusion

- There is a lack of awareness of the separate businesses (Bord Gáis Energy and Bord Gáis Networks) and lack of understanding of the roles of these organisations. This lack of awareness and understanding is greater than existed in the electricity market 12 months ago as measured by CER research.
- 43% of consumers had not heard of Bord Gáis Networks and therefore are unlikely to be aware of the different roles [compared with CER 2010 electricity market survey where 22% had not heard of ESB Networks].
- A quarter of consumers believe Bord Gáis Energy is responsible for repairing gas leaks (27% don't know which entity is responsible).
- Confusion around gas supplier/network roles significantly impacts the decision not to switch for 20% of consumers and is at a similar level to that measured in the electricity market in the 2010 CER electricity market survey (22%) – measured using the same methodology.

Impact on Switching

- Even among consumers who have switched, 41% have not heard of Bord Gáis Networks and 35% don't know which entity is responsible for repairing gas leaks and 22% believe it is their current supplier.
- The reliability of supply and/or responsiveness in case of gas leaks is a primary reason for not switching among 20% of consumers (following the methodology used for electricity in the CER 2010 electricity market survey) [comparable figure in CER 2010 electricity market survey was 22%].

- Thus the switching experience and current market efforts do not appear to be improving this knowledge gap – therefore a complete brand change should be considered as the best option for enhanced role knowledge and thus a more balanced market.

Deregulation Thresholds – Gas Market versus Electricity Market

For deregulation - **All** of the following criteria must be met:

	Thresholds	Bord Gáis Consultation	ESB Consultation (Equivalent Markets)	ESB Decision (Equivalent Markets)
1	Number of active suppliers in each market	Minimum of 3	Same	Same
2	Individual suppliers market share	Minimum of 2 others each with at least 10%	Same	Same
3	Incumbent market share:			
	• FVT	45% – 55%	40% – 50%	<= 50%
	• NDM I&C	45% – 55%	40% – 50%	<= 50%
	• NDM Residential	55% – 60%	Same but subject to 5 below	<= 60%
4	Switching Rates (Residential)	Minimum of 10%	None	Minimum of 10%
5	Brand (Residential)	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?	If ESB did not rebrand the lower threshold of 55% in 3 above would apply. "If the ESB brand was not present, conditions in the supply market could improve and the Commission could take a view that the higher end of the thresholds be chosen."	Became a condition: Decision 9 – The Commission has decided that the domestic market will not be deregulated until there is a commitment in place from ESB which will address, to the satisfaction of the Commission, the rebranding of the ESB supply businesses, including any appropriate transitional arrangements.