Response by Viridian Power & Energy to CER Consultation Paper CER/10/212

Proposals on a Roadmap for Deregulation in the Non-Daily Metered Retail Gas Market

January 2011

1. Introduction

Viridian Power and Energy (VPE) would like to take this opportunity to respond to the CER's consultation paper on proposals on a Roadmap for Deregulation in the Non-Daily Metered (NDM) retail gas market (CER/10/212). This is an important consultation with the timely underlying objective of determining a suitable Roadmap to the deregulation of the NDM retail gas markets in Ireland. VPE welcomes this consultation and is supportive of the removal of price regulation in the retail NDM gas market once current market structure and other issues are addressed to ensure customers are not adversely affected by a premature or inappropriate removal of price regulation.

This response is structured so as to provide an overview of VPE's key points in response to this consultation paper, with a detailed response to the consultation questions contained in the appendix to the submission.

2. Summary of response

VPE welcomes the timely publication of this important consultation for the retail NDM gas market in Ireland. VPE is supportive of the removal of price regulation for this sector of the retail gas market and consider the proposals forwarded by CER to be a good first step to addressing features of the market, and issues therein, that reasonably prevent the removal of price regulation at this time. The failure to correctly characterise and address these issues risks a premature and/or inappropriate removal of price regulation and this would have significant adverse effects on customers in the market. The central points of this VPE response can be summarised as follows;

- There is a dual fuel market in the Irish retail energy sector, particularly in the residential market, that has emerged recently and is dominated by BGE. VPE considers the market definitions forwarded in the consultation paper to be appropriate for the NDM retail gas sector. However, these definitions, subsequent analysis, and any proposals on deregulation criteria and thresholds, must be extended to include the duel fuel market. This is particularly important given the dominance of BGE in the dual fuel market, a position it has developed through leveraging its dominance of the NDM residential retail gas market.
- The BGE brand is a strong brand and for customers, the brand is at least as synonymous with gas as ESB is with electricity. Both companies were, until relatively recently, the incumbent monopolists in their respective sectors in Ireland, a position that has afforded them significant competitive advantage in the market since liberalisation and continues to act as a barrier to entry and expansion in the retail gas market. In addition to this, there is clear confusion for customers between the Network and Supply businesses of BGE and in response to the EU Third Energy Package, the only reasonable approach to

addressing the provisions of the relevant Directive is for the BGE supply business to rebrand. There is precedent for this approach from CER in the Roadmap for Deregulation (Electricity). In instances where BGE's supply business were to retain its brand, it would require significant adjustment to the deregulation thresholds, as proposed, to address the anticompetitive impacts of the brand which is widely associated with its previous position as the incumbent monopoly supplier.

Other issues addressed within this response include;

- The current structures and financial reporting of BGE are not transparent. This lack of transparency refers both to BGE as a group and to BG Energy, wherein there is no transparency over the separation of the regulated and unregulated activities. This lack of transparency gives rise to issues of cross-subsidisation which are already explicit in the companies dual fuel offer with additional discounts for existing gas customers who switch to electricity supplied by BG Energy.
- In addressing the barriers to entry, exit and expansion, CER should consider not only the gas commodity market in Great Britain but also the gas capacity market. It is VPE's considered view this aspect of the market will have a significant bearing on the conclusions drawn in this section of the paper given access to the market is not simply determined by the liquidity of the commodity market alone.
- Another barrier to entry and expansion for independent suppliers is the relative size of the Irish gas market. It is a small market and as such sets a high threshold for potential and current independent suppliers in terms of volumes required to achieve economies of scale. In such a small market, focussing on market share or relevant market share thresholds in other markets, should be undertaken with care and may not be appropriate.
- Given the current structure of the NDM retail gas sector in Ireland, VPE do not consider it appropriate at this point in time to countenance a move to a price cap regime. The dominance of BGE in the residential market (gas market and dual fuel market), along with their dominance of the gas capacity market, strong brand and ability to leverage these positions within an opaque organisational structure with little to no transparency in relation to financial reporting, are not conditions within which CER should be considering relaxing the price regulation of BGE. Moving to a price cap would raise further questions in relation to cross-subsidisation and raise significant concerns over below cost selling. Any short term benefits for customers arising from this situation would be overshadowed by the anticompetitive implications for the market, akin to a situation of predatory pricing. Notwithstanding this, VPE have consistently called for the removal of the K-factor from the market and measures need to be adopted to see this anticompetitive feature of the market removed and/or its impact greatly reduced.

- As a general point, VPE have not commented on the proposed thresholds contained in the paper at this point. Our views on these, as well as the relevant threshold criteria, will largely be dependent on the decisions taken by CER in relation to the issues outlined herein (e.g. dual fuel market proposals and branding). It is therefore considered important that CER finalise their proposals on the Roadmap for Deregulation (Gas) and consult on these as part of a further consultation or a proposed decision.

The appendix of this submission contains a detailed response to the specific questions contained in the consultation paper.

APPENDIX

A.1 Detailed Response to Consultation Questions

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.

Firstly, it is important to state that VPE supports the price deregulation of the NDM retail gas market. In light of recent developments in the NDM retail gas market and the publication of the Roadmap for Deregulation in Electricity, we also consider it to be an appropriate time to consider proposals for the price deregulation of this market.

However, in relation to timing it must also be recognised that competition in this market is relatively new, product development and new product offerings have affected the nature of competition, and accordingly any such proposals must both be reflective of these conditions and appropriate for the market. Furthermore, one must also be careful when referencing and/or relying on international studies and reports, that such comparisons are appropriate given the size and structure of the Irish market.

On CER's proposed approach to market analysis, this is considered to be somewhat subject to the comments received as part of this consultation where market participants have been asked to comment on these issues. Nevertheless, at a high level VPE broadly considers the proposed approach outlined by CER to be reasonable, namely; the use of competition analysis; the determination of relevant threshold criteria; and the setting of thresholds for the relevant criteria. Elsewhere in this response detailed comments are included on each of these aspects of the approach but three overarching issues deserve fore mention at this point. The issues are;

- The emergence and growth of a dual fuel product category and its associated implications for competition in the retail market;
- The level of transparency in relation to the current structure and reporting of BGE; and,
- The strength of the BGE brand in a relatively small market.

The majority of our comments on the dual fuel issue are reserved for the response to this specific question, however BGE are the dominant player in this new segment of the residential market and are leveraging their position in the gas market to gain additional market share in this new area. It therefore is considered to have important implications for a relevant market analysis, as well as criteria and threshold setting exercise.

The level of transparency across Bord Gáis' business units is most appropriately described as opaque. Despite the formal separation of BGE and Gaslink by means of a CER approved operating agreement, this falls far short of the arrangements in the electricity market. As a result of these arrangements, independent market participants are provided with little comfort, information or oversight (in the form of transparency) in relation to appropriate separation and reporting of business units.

These issues identified for the broad corporate structure of BGE are exacerbated if one considers just the BGE retail business. In this context, regulated and unregulated business units operate alongside each other with little to no separation or transparency of operation or financial reporting. This gives rise to concerns over the cross-subsidisation of costs, particularly with evidence already in the market place of cross-subsidisation of revenue with existing gas customers offered additional discounts on electricity as part of a dual fuel offering.[1] This behaviour serves to highlight the importance of the dual fuel product in any assessment of this market but also indicates the disparity in approach to the regulation of regulated and unregulated business entities in the electricity and gas markets.

Finally on the issue of BGE's brand, it is a nonsense to try and argue that the position of BGE is any different from that of ESB; both were vertically integrated monopolies that dominated the gas and electricity markets, respectively, in Ireland until very recently. Again the majority of our comments on this issue are reserved for a subsequent question but there are 2 high level points can be made on this;

1. The size of the gas market and the market share required for a new entrant to acquire critical mass is such that BGE's brand will represent a significant barrier to entry and will effectively deter entry into the retail gas market, as defined. Entry by a supplier into the dual fuel market is a different commercial proposition wherein typically it is the supplier's presence in the electricity market, a significantly larger market, that is leveraged when entering the dual fuel market. Such instances would incorrectly be considered to be entry into the retail gas market, as defined.
2. Given the strength of the BGE brand and the general unawareness of the public in relation to the separation of the networks and retail businesses, notwithstanding previous comments on this, one should only be advancing proposals for the rebranding of the retail business. Not only is there a precedent for this approach in the electricity market but it also minimises potential risks to gas safety.

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.

VPE considers there to be very clear evidence of the presence of a dual fuel market as part of a broad retail energy market that includes both retail gas and electricity markets. Nevertheless, we concur with the findings of the Roadmap on Deregulation (Electricity) that the retail gas and electricity markets constitute separate markets, however we would now contend that there is also a new market for dual fuel

[1] BGE are offering existing gas customers an additional 2% discount on electricity as part of a dual fuel product offering.

products. The separation of electricity and gas markets is consistent with the approach adopted in the OFGEM Retail Market Probe (2008) and by the German Federal Court of Justice (2008). We further note that the OFGEM Probe considered the market structure and competition within the retail electricity, gas and dual fuel markets.

In the context of this consultation paper VPE consider it appropriate for CER to adopt a similar approach, with analysis focussing on both the gas and dual fuel markets. This approach is appropriate for the NDM Residential market, although recognised as less so for other markets. Importantly, it is not our contention that the dual fuel market alone should be the relevant market for criteria and thresholds to be set determining deregulation of the domestic gas market. Rather it is considered important that this market be considered alongside the gas market with appropriate supplementary criteria and thresholds set to ensure the determinants of competition in the gas market are correctly captured. Failure to do so may prematurely or erroneously bring forth price deregulation and potentially expose customers to anticompetitive practices, or at least practices not consistent with participants' behaviour in a competitive market. We consider this approach to be particularly prudent given the relative dominance of BGE in the residential dual fuel market.

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?

VPE agree with the defined relevant retail markets as outlined in the consultation paper and see no reason to move away from these retail markets at this time.

VPE also supports the geographic market definition as outlined in the paper, including the proviso to reconsider this in light of future developments in relation to CAG.

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.

In response to this question VPE will focus on what CER have referred to as the empirical evidence of competition, with the qualitative aspects addressed in response to the subsequent question.

VPE consider the approach outlined by CER to review the market share of the incumbent and other market participants in each of the relevant retail markets, and furthermore to review the level of concentration in these markets, to be both a standard and prudent approach to assessing competition. However, as the analysis is outlined in the consultation paper, it is our considered view that this analysis is incomplete and should be supplemented by equivalent analysis of the market for dual fuel products.

One aspect of standard competition analysis that is regularly used in investigations of abuse of dominance or merger inquiries to determine whether the entity being investigated is dominant is the SSNIP test. This test considers whether the entity under investigation could profitably implement a Small but Significant and Non-transitory Increase in Price (SSNIP) in the relevant market. This test, more so than measures of market structure (market share, HHI), is regularly relied upon by competition bodies in assessments of dominance. As such it may be preferable for CER to undertake such an assessment in relation to BGE. However, we note that such an approach may be difficult given the regulated tariffs offered by BGE as opposed to commercially set tariffs.

In addition to this, as well as our arguments in favour of including consideration of dual fuel products in the market assessment, it is considered important from a competition assessment perspective for CER to also consider the cross-price elasticity relationship between retail gas and electricity. It is assumed that the CER previously found there to be no considerable effect arising from a change in price for gas and consumption of electricity and as such this contributed to a determination that gas and electricity markets were separate markets in the Road for Deregulation (Electricity). However, in light of the significant emergence of dual fuel products, this relationship should be revisited with a view to determining the relative impact of a change in the price of one product on the demand for the other. Alternatively, one could consider whether significant discounts for electricity by a supplier induce customers to purchase gas from the same supplier and as such one would investigate the competitive constraints a separate market (electricity) has on the gas market. in the context of this consultation, such a relationship would be instructive as to the manner and form of additional thresholds that may be required as part of the Deregulation Roadmap arising from BGE dominant position in the dual fuel market.

Finally, it is important to address the note of caution issued by the CER in relation to the use of HHI. Firstly VPE agrees that HHI cannot be used in isolation. However, this is a proven and generally accepted standard measure of competition and as such cannot be dismissed. All of the relevant markets in Ireland covered by this consultation are characterised as being highly concentrated. Despite the other measures and market characteristics that merit consideration alongside the HHI, the HHI itself indicates that there is a high degree of concentration in the markets, particularly the residential market, and from a competition policy perspective this is likely to require significant policy intervention (i.e. price regulation) in order to address issues of dominance and market power. Significant structural change is required before this view can reasonably be reversed and to a large extent this is irrespective of other measures, such as the level of switching.

Given expertise and experience of the Competition Authority in analysing and providing recommendations on issues of competition policy and dominance, including remedies, VPE recommend that CER formally invite the views and involvement of the

Competition Authority in developing the Roadmap. The Competition Authority could assist the CER in developing the competition assessment aspects of the Roadmap, make recommendations and generally lend their expertise to compliment those of the CER to best develop the future competition policy for the retail gas market in Ireland, for the benefit of customers.

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.

The response to this question will be considered in three separate parts;

- An assessment of the barriers to entry, exit and expansion (excluding branding and liquidity in the gas commodity market);
- Importance of the level of liquidity in the gas commodity market, vis-à-vis the electricity market; and
- Importance of the BGE brand.

Firstly, it the considered view of VPE that size of the Irish retail gas market is a significant barrier to new entry, notwithstanding the additional barrier to be expanded on herein. Retail gas supply in Ireland is a low margin business driven by commodity prices in Great Britain. The relative size of the Irish market, vis-à-vis even the comparable retail electricity market in Ireland, presents a significant barrier to any firm and their ability to achieve a critical mass of customers and sales to ensure their entry is commercially viable and sustainable. Once in the market, the position of the incumbent represents is the greatest barrier to expansion.

The issue of sunk costs in the consultation paper is somewhat confused with the issue of liquidity in the commodity market for gas. One of the most significant sunk costs facing new entrants in the retail gas market in Ireland is the cost of customer acquisition, costs incurred in both the marketing and promotion of a new product offering and in the tariff structure required to attract new business (customer switching). Considering the examples forwarded in the consultation paper (long term contracts and/or long term investment), it is not immediately apparent that these represent greater sunk costs as such costs have realisable values upon exit. Furthermore, not only may sunk costs (such as customer acquisition costs) prevent efficient market entry, they are equally, if not more, likely to prevent efficient market exit.

Following on from this, the cost of customer acquisition can also rightly be classified as a cost of switching to the supplier. Although the cost to the customer of switching supplier in the retail gas market is considered to be zero, there is potentially a significant cost to the supplier and as already noted, such a cost is a sunk cost and is likely to act as a barrier to entry, exit and expansion in the market. The relative magnitude of this sunk cost and/or cost of customer switching for the supplier is exacerbated by the low margin nature of the retail gas market in Ireland. This increases the barrier to entry, exit and expansion in a relatively small market dominated by an incumbent supplier, which in turn dominates access to gas capacity on the interconnector, and possesses a strong brand identity that is used to leverage its position in the new dual fuel market.

In addition to this cost, there are further issues and cost encountered by suppliers in trying to enter the market and/or expand their customer base. As noted in the consultation paper, the treatment of Free Energy Allowances (FEAs) is one issue currently being considered by the CER but alongside this there are further issues with prepayment meters, the timeline associated with submission of meter reads prior to a switch, as well as the significant issue of debt hopping. VPE notes that the CER are currently considering the later issue but all of these issues represent potential costs for suppliers and affect efficient market entry and exit decisions. Similarly, the timeline from initiation of a licence application and approval from CER is considerable and may limit potential entrants from acting on efficient market signals.

VPE acknowledges the non-discriminatory network access provision. Nevertheless, given the dominance of BGE in the retail gas market, this translates into dominance of the gas capacity market. It is therefore necessary to temper the arguments put forward in the consultation paper on the relative merits of the liquidity inherent in the GB gas commodity market by acknowledging the issues inherent in the capacity market from a competition perspective and as a barrier to entry and expansion for potential and existing market participants. it is therefore imperative that CER consider the position of BGE in the gas capacity market when formulating the thresholds to be contained in the final Roadmap for deregulation. The absence of this issue from the proposals in the consultation paper represents a significant omission and as such fails to address of a significant issue in the market and how CER propose dealing with it as part of the Roadmap, wherein further relevant thresholds are considered to be appropriate. Currently, VPE has considerable issues with capacity in both the RTF and FVT markets. This is despite the emergence of short term capacity products recently but both the price and quantity of these products have made them relatively unattractive for independent suppliers.

BGE's brand represents a very significant barrier to entry and expansion for potential new entrants and existing market participants, respectively. BGE have a very strong brand. As the incumbent and until recently the monopoly supplier of gas in Ireland, BGE has amassed significant brand value and association that is at least as strong as the ESB brand. As a vertically integrated gas company, there is also significant confusion for customers between the supply and network business. In considering measures to mitigate the strength of the BGE brand, and to comply with the EU

Directive under the Third Package, VPE consider it the only practical, responsible and reasonable approach to re-branding is for the supplier to undergo this change. For issues of gas safety, it is essential that the strong brand association the public have with BGE as a catch-all for the supply and network businesses, is not compromised. Furthermore, CER's interpretation of the relevant section of the Third Package Directive is considered to be both one-sided and far from clear that the onus rests on the DSO to avoid confusion among customers. We note there is also precedent in the electricity market for supplier rebranding, as directed by CER.

As part of a strategy to leverage their position in the retail gas market, BGE have undertaken a significant marketing exercise to become the dominant player in the dual fuel market. This strategy has included BGE spending multiples of other competitors to acquire electricity customers, conservative estimates indicate this to be four to five times all other market participants. As already noted, it is imperative as part of this consultation that CER revisit the dual fuel market and consider both the dominance of BGE in this market and relevant thresholds to be included in the Roadmap for Deregulation, as notwithstanding the issues already highlighted, this strategy is a further barrier to entry and expansion for potential and existing market participants, respectively.

On the issue of branding and advertising spend, one should also note that BG Networks have also spent considerable sums on gas safety advertising, an issue that relates to the previous point made in relation to possible rebranding and gas safety.

The reference in the consultation paper to the launch of the new ESB brand and possible benefits arising from this that may minimise customer confusion is merely hearsay, as the position of this new brand is unknown and is likely to be so for the foreseeable future. We would therefore caution the CER in relying on such arguments and instead base the Roadmap for Deregulation on the market and reasonable, evidenced proposals for its likely future development. In light of this and cognisant of the arguments presented heretofore, it is VPE's considered view that the rebranding of BGE's supply business is necessary for compliance with the Third Package Directive and to mitigate the company's market power as part of a Roadmap to Deregulation. There is also precedent for this approach from CER's Roadmap for Deregulation (Electricity). Should the CER decide on a different course of action that meant BGE retained their strong brand, VPE consider it necessary that the thresholds for deregulation are therefore adjusted downward significantly (possible halved) to mitigate its effects in a price deregulated market.

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.

Firstly, VPE supports the view forwarded by CER that all of the requirements for deregulation, (indicating a competitive market), are met before price controls can be removed. The proposal to consider the switching rates of the residential NDM sector only is not found to be objectionable on the grounds that it is put forward. However, one important aspect is unclear from the consultation paper, namely the definition of an independent supplier. It is VPE's contention that for a supplier to be considered to be an independent supplier in the market, it must be independent of the incumbent, both the incumbent's organisational structure and importantly the incumbent's shareholder.

On the practical aspects of deregulation, it is VPE's view that 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. The historical approach is consistent with the Roadmap for Deregulation (Electricity) and the extension to two consecutive quarters addresses a considered failing of the electricity market thresholds that represent a snapshot as opposed to a discernable trend in the market. A consecutive two quarter approach is both prudent and consistent with the definition of other statistical/real world phenomena (e.g. definition of recession).

On the proposed thresholds for the percentage of market share, it has been noted herein that these proposed thresholds may not be appropriate given outstanding decisions that are yet to be made in relation to other aspects of the Deregulation Roadmap (branding, role of dual fuel market, etc). We do however note the importance of not considering items such as market share in isolation and this should be part of a wider competition analysis as outlined in response to a previous question. The deregulation of prices will not deliver benefits for customers if it is introduced prematurely into a market that is unable to function competitively or in a market where not all important competitive constraints, and their effects, have been considered.

On the CER proposal to change the price regulation approach from a Revenue Control Formula (RCF) approach to a price cap approach, it is VPE's considered view, for many of the reasons outlined herein, that such an approach would not be appropriate in the current market. A non-exhaustive list of reasons include;

- BGE is the dominant firm in the retail gas market in Ireland and only competes with a small number of competitors;
- BGE is the dominant firm in the new dual fuel market and competes with an even small number of competitors in the relevant residential market;
- BGE is the dominant firm in the gas capacity market;

- BGE has a very strong brand identity that is used to leverage its dominance in the gas market in the new dual fuel market and also acts as a barrier to entry in both the retail gas market and dual fuel markets; and,
- BGE's organisational structure is unclear and indicates significant opportunity for cross-subsidisation of costs and revenues.

To implement a price cap in a market exhibiting these characteristics would harm competition by creating an opportunity for the dominant incumbent to sell below cost, and cross-subsidise regulated and unregulated product offering. Although this may have short term benefits for customers, the long term implications are anti-competitive and ultimately to the detriment of customers.

In stating our opposition to a price cap in the current market, we recognise that such an approach to price regulation would remove the role of the often criticised K-factor from the retail gas market in Ireland, the anti-competitive effects of which we have long been critical of. Nevertheless, given the structure of the retail gas market in Ireland and the current dominance of BGE, greater controls are needed to mitigate the market power of this incumbent than are afforded to the market under a price cap regime. With a view to minimising the role of the K-factor and acknowledging the market power of the incumbent, and the need to mitigate it to achieve a quasi-competitive outcome, we would recommend to the CER that they consider an approach similar to the Maximum Allowable Revenue (MAR) approach adopted in the retail electricity market with suitable provisions to address the specificities of the retail gas market.

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 the proposals forwarded, and notwithstanding the points raised herein in relation to their suitability, the issue as outlined in the question is most likely to arise between the NDM I&C and FVT markets, given the thresholds and current structure of the NDM Residential market. In such an instance, it is VPE's view that only the relevant portion of the market be deregulated (i.e. NDM I&C) upon reaching the set thresholds for all relevant criteria over two consecutive quarters based on a historical assessment. If in the following period the other relevant market (i.e. FVT) was not to satisfy the thresholds for the relevant criteria, then one could institute a stepwise reduction in the market share thresholds in subsequent quarters as one may reasonably assume that the number of independent participants in both markets would be the same.

It is VPE's considered view that 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. Recourse to competition law is an avenue that is always available to the CER but such an approach can be significantly time consuming, costly, may introduce significant delays, and in eventuality the Court may defer to the expertise of the CER as the authorised regulator. Irrespective of these issues, the issues that develop in the market may not be remedies with recourse to competition law.