



# Submission by the Competition Authority to the Review of the Regulatory Framework for the Retail Electricity Market

Proposals on a Roadmap for Deregulation

February 2010

S/10/001



**The Competition Authority**  
An tÚdarás Iomaíochta

## SUMMARY

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1. The Competition Authority welcomes the opportunity to contribute to the CER's proposal to conduct a review of the electricity sector in order to define a roadmap to regulation.
2. The review is timely given that competition in retail electricity supply has become a reality with the entry of Bord Gáis and Airtricity into a market which was previously dominated by the ESB as a monopoly supplier.
3. The CER has consistently stated its objective of adapting its regulatory approach as conditions in electricity evolve toward a competitive industry structure. In seeking to identify the next steps towards a truly competitive market, the Competition Authority wishes to note that the implementation of single trigger or threshold mechanisms as means of establishing whether regulatory controls should be removed must be carefully managed. Market shares are merely indicative of market power, and are not in themselves determinative. In other regulatory environments multiple triggers are stipulated, to allow for a staggered approach to deregulation consistent with levels of market power.
4. By adopting an overly formalistic approach that relies heavily on market share measures there is a risk that other factors such as entry conditions, switching behaviour and the emergence of smart metering technology may be overlooked as constraints on the behaviour of firms to act anti-competitively.
5. Competition does not obviate the need for strong regulatory oversight as there is a delicate balance to be struck between ensuring that well-informed consumers derive the benefits of competition while also ensuring that vulnerable consumers are protected.
6. Consumers' interests are not served by the setting of price caps in a competitive market. The re-imposition of regulated tariffs post deregulation should be avoided as reregulation would discourage consumers from switching to a cheaper supplier and the competition process itself would be seriously damaged if a firm was in some way punished for gaining market share through improved performance.
7. Consumer protection is better served by investigating reasons for consumer inertia and taking consumer information initiatives to facilitate switching behaviour.
8. While there appear to be few *structural* impediments to competition on the supply side, the CER should conduct further study of consumer attitudes and switching behaviour to ascertain whether other factors which may be *behavioural* in nature may inhibit consumers from switching supplier even when it is beneficial for them to do so. For example, the CER should also consider whether the strength of the ESB brand which permeates the electricity sector creates the false perception among consumers that the quality of their electricity supply would suffer if they switched to one of ESB's rivals.

## RESPONSES TO SPECIFIC QUESTIONS

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### Question 1

**Are you in favour of the proposal to review the market and define a roadmap for deregulation of the retail electricity market? Do you think this is the right time? Outline reasons for agreement or disagreement.**

1. The Competition Authority is in favour of the proposals to facilitate more competition among electricity retail suppliers and believes it to be timely. The Authority also welcomes the opportunity to comment on the CER's proposal to conduct a review of the electricity sector in order to define a roadmap for deregulation.
2. All stages of the electricity production process, from generation, through to transmission and distribution and finally retail supply have undergone considerable change since the Electricity Regulation Act 1999 liberalised what was previously a highly protected monopoly. While much of the CER's work in restructuring has up to now concentrated on supply side issues which have gone largely unnoticed by the general public, the relatively recent decision by Bord Gáis and Airtricity to compete directly with ESB for domestic customers is beginning to deliver the tangible benefits of competition to domestic consumers.
3. Large Energy Users and commercial customers have already benefitted from competition between competing suppliers and the number of household domestic customers who have already switched to Bord Gáis and Airtricity since early 2009 demonstrates the desire among Irish consumers for choice and value for money.
4. The review is also timely for another reason and that is the need to address the growing public concern about the cost of energy and the cost of electricity in particular. A public perception has developed that the current high cost of electricity in Ireland is due to ideologically driven policies to induce competition by maintaining artificially high prices to encourage new entry. This perception is not supported by any factual evidence. The reality is that the price of electricity in Ireland is determined by the complex interaction of factors, the most important of which are the price of oil, coal and natural gas. This situation is likely to continue for the foreseeable future. Competition does not guarantee low prices, what effective competition between competing retail suppliers delivers is prices that reflect the costs of efficient production i.e. prices that are as low as they can be given that other cost factors are determined externally. Competition also provides retailers with the incentive to provide products and prices which reflect consumer preferences.
5. As has been shown from Scandinavia to Australia, a well designed competitive framework, which takes into account local market conditions and more general market power considerations, is the best means of driving efficiency throughout the electricity system while at the same time ensuring that consumers and not producer interests capture the efficiency gains.

6. Competition at retail level can only work effectively if well informed consumers are able to firstly, identify when their supplier raises prices to a level which is unacceptable to them, and secondly, switch easily to another supplier. While up to now the CER has quite rightly focused its resources on ensuring that the structural elements of the market are in place so that all market participants on the supply side compete on a level playing pitch, these demand side issues deserve similar attention.
7. Effective competition at the retail level will also further drive competition in electricity generation. This dynamic effect will further ensure that businesses and households will enjoy the benefits of a competitive electricity sector and our economy will be more competitive.

## Question 2

**In relation to Proposal 1, Section 4.5, respondents are invited to comment on the proposal to define 4 relevant markets for the supply of retail electricity. Are you in favour of the proposal? Outline reasons for agreement or disagreement.**

## Question 3

**In relation to Proposal 1, Section 4.5, respondents are invited to comment on whether public lighting should be considered as a relevant market. How should it be treated in a deregulated environment? Outline reasons for agreement or disagreement**

## Question 4

**Are all domestic customers part of the same retail market. Are you in favour of the proposal? Outline reasons for agreement or disagreement.**

8. There is insufficient information in the consultation document for the Competition Authority to come to any definitive conclusion regarding market definition.
9. However, the CER's *general* approach to market definition appears to be based on EU guidance on market definition. In the EU Commission Notice on the definition of relevant market for the purposes of Community competition law a relevant product market is defined as follows:  
  
*"A relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use."*<sup>1</sup>
10. There is a distinction between the concept of relevant market used by a competition agency for the purposes of competition analysis and merger assessment and that which is used by a regulator for the purposes of ex-ante regulation.

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<sup>1</sup> EU Commission Notice on the definition of relevant market for the purposes of Community competition law, *Official Journal C 372*, 09/12/1997 P. 0005 - 0013

11. For the purposes of this consultation, the CER's approach may well be appropriate for establishing the appropriate domain for ex-ante regulation.
12. Markets are typically defined on a case-by-case basis by the Competition Authority and while there has been a convergence in the methodology applied by competition authorities throughout the world when defining a market, it should be borne in mind that market conditions change over time. For example, changes in consumer preferences and technological progress may affect the dynamics of demand side substitutability. For instance, smart metering technology and increasing public awareness of switching may mean that the existing market definitions used for the purposes of this consultation - Large Energy Users, Medium Sized Businesses, Small Businesses and Domestic Users - may need to be revisited in the future. Similarly the definition of the geographic market as the State may evolve over time to encompass at least the island of Ireland.
13. One other observation about the CER's approach is that countervailing buyer power is not normally considered at the stage of market definition but is instead more commonly used in the assessment of market power once the market has been defined. A strong buyer can act as a constraint on the ability of any supplier to raise its price independently of its competitors and as such countervailing buyer is an important factor in assessing dominance in a defined market rather than defining the market itself.
14. In relation to public lighting, the characteristics of public lighting: a public good with inelastic demand and unmetered supply would indicate that public lighting is likely to be a distinct market from domestic retail domestic supply.

## **Question 5**

**Respondents are invited to comment on the proposal to assess the level of retail competition using the factors outlined in Proposal 2, Section 5.2. Are you in favour of the proposal? Outline reasons for agreement or disagreement.**

15. The factors for an assessment of the level of competition outlined in Section 5.2 are consistent with the standard analytical toolkit applied by competition authorities in the course of their work. It is particularly welcome that the CER is mindful of both quantitative and qualitative measures when assessing the level of competition among retail electricity suppliers. A static approach to competition analysis which relies too heavily on quantitative indicators at the expense of qualitative criteria before taking the next steps to deregulation runs the risk of needlessly dampening competition. A delay in what could be a competitive market denies consumers the real benefits of competition and undermines the performance of the economy as a whole.
16. All market share thresholds are to some extent arbitrary and are not in themselves a reliable indicator of the state of competition. Competition can be vigorous in highly concentrated markets or indeed in markets where incumbents retain high market shares. Other more dynamic factors such as switching, barriers to entry, branding and access to

wholesale supply should also be taken into account before reaching any conclusion regarding the state of competition.

### **Number of suppliers**

17. At present three retail suppliers compete for domestic consumers and whether more decide to enter is a purely commercial decision. However the experience of energy markets internationally suggests that entrants prefer to establish a market presence by acquisition of an incumbent rather than by organic growth. In the context of Ireland, the small size and dispersion of the population and the lack of economies of scale would suggest that in the short term at least, the number of retail electricity suppliers is unlikely to increase beyond the current number. However a small number of suppliers in a market does not indicate a lack of competition provided customers can switch easily between supplier, face real choices of products/services and barriers to entry are minimised.

### **Market shares of incumbent and rivals**

18. Measures such as the HHI are useful as indicators of concentration but are considered only as a first screening device in any competition assessment. The HHI is limited in so far as it does not take into account the level of spare capacity nor can it predict the strategic behaviour of competitors. It is possible under the conditions that prevail in electricity (a homogenous good, little threat of entry and repeated interaction between competitors) that after an initial phase of competition characterised by high consumer mobility, the market shares will settle down into a pattern where ESB will retain a substantial share of consumers while its rivals struggle to add to their initial gains.
19. Therefore high market share, while a useful screening indicator of competition, does not by itself provide sufficient evidence that there is a competition problem. Persistently high market shares of incumbent suppliers are a common feature of many countries where competition in electricity supply has been introduced.
20. The experience in the UK indicates that incumbent retail electricity suppliers have retained high market shares despite charging significantly higher prices than their new rivals.<sup>2</sup> This may indicate that switching costs, whether they are real or perceived, have a significant effect on the behaviour of electricity consumers and on the dynamics of competition.
21. The CER is correct in its approach of looking beyond the static measure of market share to place more emphasis on the emergent trend in market share. The decline in ESB PES's market share should be assessed not just by reference to the number of customers and volume of electricity (GWh) but also in terms of revenue per customer. As the final retail price comprises a fixed cost element relating to network charges, which is a set charge applied by all suppliers, new entrants compete by discounting the variable cost element relating to the cost of energy. As early switchers tend to be high energy users the new

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<sup>2</sup> Waddams Price, Catherine, (2008), "The Future of Retail Energy Markets". *The Energy Journal*, special edition in honour of David Newbery, pp125-147.

entrants are making less per unit of energy sold than the incumbent. Thus the two-stage cost structure of the price of electricity may overestimate the gain in market share of entrants if market share is measured solely in volume terms without taking into account market share measured in revenue.

### **Sunk costs**

9. The most significant sunk costs facing a company intent on supplying electricity to Irish domestic household customers relates to the cost of establishing a brand presence in a country where the ESB brand is synonymous with the electricity industry. The challenge facing Bord Gáis in establishing a presence in electricity is somewhat mitigated by its recognition among consumers as a gas supplier. Prior to its entry into retail electricity supply, awareness of Airtricity was largely limited to its activities in renewable electricity generation. Retail electricity supply is not as capital intensive as generation although establishing a billing system requires considerable investment while licensing and approval requirements may add to the cost of new firms establishing themselves here. As discussed earlier the demographic characteristics of Ireland suggest that entry by an overseas firm is unlikely except by acquisition. The lack of any credible threat of entry may dampen the level of competition among the local firms.
10. The limited ability of a purely retail supply company without its own generation capacity to hedge its supply commitments may discourage new entrants. It is therefore noteworthy that the liquidity situation has improved with the launch of a forward contract trading platform.

### **Switching systems**

11. The objective of switching systems is to minimise the cost of switching to consumers. Switching costs are costs which a consumer expects or perceives to be incurred by changing to another supplier and can be avoided by staying with his/her current supplier.
12. Consumers may measure switching costs in financial terms if there is a cost to changing supplier or in temporal terms if the search and switching process is lengthy and time consuming. The cost of switching may also have a psychological dimension if consumers perceive that the quality of service will suffer if they move to a new supplier.
13. Irish domestic consumers incur no financial cost when they switch suppliers and switching can be done over the phone or the internet quickly. Yet despite the apparent ease of switching a considerable proportion of the population have remained with the higher priced ESB. Given that electricity is a homogenous product and the availability of considerable price discounts which have been widely publicised, a considerable cohort of consumers have been slow to react to price incentives. For example, despite the availability of discounts of up to 14% below the ESB PES tariff, only 16% of domestic customers have moved to Bord Gáis and Airtricity. As price is the primary reason for switching between homogenous goods and given the widespread public concern at high electricity prices, the reluctance of domestic consumers to switch retail suppliers would appear to indicate that there is a behavioural dimension to the degree of consumer inertia in retail electricity. The current switching rate, when observed along with

high price disparity, may indicate that the power of the ESB corporate brand among the public is a barrier to switching.

14. Research conducted in the UK by Ofgem found that search costs were a barrier for many electricity consumers, particularly those who had little or no switching experience in other markets; and switching costs were perceived to be high (relative to the reality) in terms of the time it would take.<sup>3</sup>
15. These findings were substantiated by consumer surveys conducted by Giuletti *et al* which found that some consumer groups, such as pensioners and those using prepayment meters, were less likely to be aware of the possibility of switching, as were people living in rural areas.<sup>4</sup> Giuletti posited consumers stay with the higher priced incumbent in the expectation that the incumbent will at least match the entrants' prices when the tariff regulation is removed.
16. Such a public perception may confer considerable market power on the ESB as an incumbent. But the confidence in the ability of the ESB to undercut its rivals' prices may be misplaced as retail electricity prices are ultimately determined by wholesale prices and by the special responsibilities of a dominant firm prescribed under competition law which prohibit predatory behaviour. In reality the cost of imported fuels will continue to be the key determinant of domestic retail electricity prices.
17. As competition develops and product offerings become more diverse, the CER should ensure that consumers can fully understand the various product offerings and to make informed choices as to what product best suits their needs. The CER should continue to monitor compliance with the switching protocols currently in place and it should consider offering a clear and understandable price comparison website to better inform consumers who are considering switching supplier.<sup>5</sup>

## **Branding**

18. The strength of the ESB brand among Irish consumers and the common branding of the 13 subsidiaries within the ESB Group, despite the efforts at ringfencing, may contribute to the erroneous perception among consumers that the quality of service delivery may suffer if they switched to a supplier other than ESB PES. The strength of the ESB brand is therefore a barrier to entry. Many consumers are not aware that any connection problems are the responsibility of ESB Networks which is "functionally separate" i.e. ESB Networks is owned by the ESB but it is ringfenced from the other companies within the ESB Group to ensure that it fulfils its mandate of offering non-discriminatory access to the electricity distribution network to all retail suppliers.

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<sup>3</sup> Ofgem, (2008), "Energy Supply Probe - Initial Findings Report", Available to download from [www.ofgem.gov.uk](http://www.ofgem.gov.uk)

<sup>4</sup> Giuletti, Otero and Waterson, "Pricing behaviour under competition in the UK electricity supply industry", *Oxford Economic Papers* (2009).

<sup>5</sup> Comreg already operates an interactive cost comparison website: <http://www.callcosts.ie> and an independently run website [www.moneyguideireland.com](http://www.moneyguideireland.com) offers price comparisons across a range of goods and services.



19. For the reasons outlined above, the findings of the upcoming consumer survey should inform the CER's decision making regarding the ESB brand.

### **Non discriminatory network access**

20. In order for competition to work properly, the Distribution System Operator, (DSO), and the Transmission System Operator, (TSO), have to grant access to the transmission and distribution network to all suppliers on non-discriminatory conditions. All suppliers have to get access to the same information at the same time.
21. When an incumbent supplier also owns the distribution and transmission network, even when the functions are operationally ringfenced, as is the case with Eirgrid's operation of the transmission grid, there is a threat that the incumbent could distort the network company's incentives to provide customer related information to independent retailers in a non-discriminatory manner. As a result, independent retailers may have difficulties related to entering the market, leading to ineffective competition.
22. Directive 2003/54/EC obliges Member States to introduce a regulated third party access regime under which third parties have a right to access the network in a non-discriminatory manner based on published tariffs. National regulators have to monitor the overall activities of the network companies, deal with complaints, and control network tariffs. The Directive requires legal unbundling, as well as accounting and management unbundling, between network activities (transmission and distribution) and all other activities.
23. It is important to stress the importance of legal unbundling between network activities and activities which are exposed to competition, but this requirement is not sufficient to ensure that the DSOs act in a neutral manner. Under legal unbundling, it is of great importance that there are functional requirements which prevent discriminatory behaviour and that the national regulators have adequate means to penalise any such behaviour which may take place.
24. However, ownership unbundling is the most efficient way of preventing any discriminatory behaviour because it relies on incentives rather than external monitoring and *ex post* penalties, and is therefore the market structure most favoured by competition authorities and the EU Commission.
25. Unbundling between network activities (which are natural monopolies) and activities which are exposed to competition is important for a truly competitive market to work for the benefit of consumers. The Competition Authority is not convinced that the current system of legal unbundling is sufficient to ensure that the TSOs and DSOs act in a neutral manner nor that this arrangement ensures that the necessary network investment can be carried out at the lowest cost. The most efficient way to prevent any discriminatory behaviour would be ownership unbundling.

### **Access to wholesale product**

26. The price paid by consumers in the retail market depends on how efficiently both the wholesale and the retail markets function. Even if

competition is strong and profit margins are relatively small in the wholesale market, the price paid by consumers may be high if competition is weak at retail level.

27. At present, all retail suppliers purchase electricity on the wholesale market through supply contracts whose price is derived from the System Market Price (SMP). The current availability of forward contracts necessary for suppliers to hedge their financial exposure to the price volatility of the SEM is quite limited due to the small size of the Irish generation portfolio and the limited degree of interconnection with a larger UK market. However this situation is expected to improve significantly following the completion of the East West Interconnector while the development of a hedging market should provide a means for retail suppliers to manage their financial exposure to the SEM.

## **Question 6**

**For each of relevant markets discussed in Section 5.3, 5.4 and 5.5, respondents are asked to consider if there is sufficient activity to consider the removal of the regulatory controls in that market. Outline reasons for agreement or disagreement.**

28. There appears to be significant switching activity by Large Energy Users and Small Business Customers and the significant market share gains by Energia and Bord Gáis suggest that larger customers in the commercial sector are benefitting from competition between rival suppliers. Larger Energy Users are able to exercise their considerable buyer power and procurement expertise to negotiate favourable contract terms.
29. Individual domestic consumers on the other hand possess no such buyer power and despite the advertising campaigns by Bord Gáis and Airticity it is not surprising that ESB Customer Supply continues to hold such a large market share.
30. As stated earlier the persistence of large market share is not by itself an indication that the market is uncompetitive but the level of switching activity by household customers over the past 12 months suggests that consumers are becoming increasingly aware of their options in choosing an alternative supplier.
31. Nevertheless, it is not yet clear that there is sufficient switching activity in the domestic market to consider the removal of regulatory controls. More information is required regarding the consumers' views of the options available to them.

## **Question 7**

**Respondents are invited to comment on the assessment of the barriers to entry, exit and expansion within the retail electricity market outlined in Section 6. Do you agree or disagree with the preliminary conclusions?**

**Are there other issues which have not been discussed which would prevent or undermine the development of a competitive market? Outline any suggestions to improve the situation for existing suppliers and new entrants.**

32. The Competition Authority disagrees with the preliminary conclusion in Section 6.3 (page 58) that low barriers to switching, non discriminatory network access and the availability of wholesale energy means that all the conditions are place for a competitive market to develop. While this may be true from a structural perspective, the reluctance or inability of some customers to switch supplier may mean that there are behavioural factors at play.
33. This situation could be improved by:
- Removing any remaining search costs;
  - Removing the perception that switching from ESB may jeopardise service quality;
  - Raising awareness of the ease of options for switching;
  - Ownership unbundling of the network from the supply business; and
  - Rolling out smart metering.

### Question 8

**In relation to Proposal 3, Section 7.2, respondents are invited to comment on the proposal for the thresholds for the removal of regulatory controls in the relevant retail markets for electricity. Are you in favour of the proposal? Outline reasons for agreement or disagreement.**

### Question 9

**Respondents are invited to comment on the options for the review of market conditions in March and October outlined in Section 7.3. Are you in favour of Proposal 4?**

**Should the reviews be historical or prospective? What actions do you think the Commission should take if competition tests fail in subsequent market reviews? Outline reasons for agreement or disagreement.**

34. The CER has set out a schedule of proposed market share thresholds which must be met before regulatory price controls are removed. It should be noted at this point that a high market share is not in itself a problem from a competition perspective provided that it has been attained by a firm operating more efficiently, or meeting consumer demand more effectively, than its rivals. Competition law enforcement is concerned with instances where a firm abuses its dominance by either acting unilaterally or by acting collusively with other competitors with the object or effect of harming consumers by distorting the competitive process.
35. Market share is acknowledged as an important, but not by itself a sufficient, indicator of dominance in competition law cases. Since the earliest competition law cases the European Court of Justice (ECJ) has indicated that a number of factors must be considered in assessing dominance. In its judgment in *Hoffman La Roche* the ECJ stated "*The existence of a dominant position may derive from several factors which*

*taken separately are not necessarily determinative but among these factors a highly important one is the existence of very large market shares”.*

36. In *United Brands* the defendant was found to be dominant with market shares of around 40-45% while in *Akzo* the ECJ stated that a market share persistently above 50% is an indication that a firm is dominant in the absence of evidence to the contrary.
37. In its guidance note on enforcement priorities in applying Article 82 to exclusionary conduct by dominant firms, the EU Commission indicates that market shares of below 40% are unlikely to raise concerns of dominance.<sup>6</sup> However for reasons set out by the CER in Section 7 of the consultation document the market share threshold of 40% may be an unrealistic threshold given the particular characteristics of retail electricity supply.
38. By adopting an overly formalistic approach that relies heavily on market share measures there is a risk that other factors such as entry conditions and the emergence of smart metering technology may be overlooked as constraints on the behaviour of firms to act anti-competitively.
39. There is a concern that the market share thresholds as set out in Section 7.2 may not be met and competition reaches a stalemate whereby the smaller rivals, realising they cannot reach the 10% market share target discontinue their discounting of the ESB PES tariff and instead pursue a strategy of price following.
40. Ongoing market monitoring is therefore an essential feature of all electricity regulation regimes as the physical and economic characteristics of electricity require ongoing supervision of market participants in order to mitigate the threat of any single supplier or a group of suppliers acting collusively to the detriment of consumers.
41. In this respect, the Competition Authority wishes to note that the implementation of single trigger or threshold mechanisms as means of establishing whether regulatory controls should be removed must be carefully managed. Market shares are merely indicative of market power, and are not in themselves determinative. Firms may hold market power whether or not they are dominant; accordingly, the level of market power enjoyed by a firm just over the dominance threshold may not differ appreciably from the market power enjoyed by a firm just under the dominance threshold. This may lead to uncertain outcomes for market participants and consumers alike.
42. If and when ESB PES falls below the designated market share threshold, it will then, in theory, operate in a deregulated market and will be free to compete absent regulatory interventions. However, if ESB PES begins to compete aggressively on price at just under the dominance threshold, the risk arises that participants will complain that ESB PES is engaged in predation, despite a finding that it is no longer dominant. Moreover, if any such pricing campaign were

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<sup>6</sup> Communication from the Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings available to download at: <http://ec.europa.eu/competition/antitrust/art82/index.html>

sufficiently successful, ESB PES would then find itself rising back over the dominance threshold, and accordingly having its commercial freedom to act restricted by regulation if the CER plans to re-regulate in this situation. This is not a positive outcome for consumers.

43. In order to forestall this possibility, threshold measures must be carefully designed. In other regulatory environments (eg. interconnected US regional power generation markets) multiple triggers are stipulated, to allow for a staggered approach to deregulation consistent with levels of market power. To veer on the side of caution, a low market share threshold may be appropriate. A complementary threshold figure, such as a HHI, may also be useful as a means of capturing not only the effect of ESB's market share, but also allowing for the multiplicity (or not) of other players in the market.
44. An alternative approach would involve, rather than establishing a single trigger which automatically leads to deregulation, the trigger leading instead to an assessment by the CER of market power. This would allow for a higher market share threshold based on a more comprehensive analysis of market conditions. In this respect, the CER is well-placed to determine where to strike the balance between the richness of analysis and the height of the market share threshold figure.
45. In order to facilitate any such review once it has been triggered, there should be close ongoing monitoring of key market behaviours, such as switching. The Competition Authority would be pleased to advise the CER on its assessment at this stage.
46. Where the possibility of deregulation (or re-regulation) arises, the Competition Authority may have a role in assessing whether the standards established for dominance under competition law and economics are met. The ongoing market monitoring mentioned above would, in those circumstances, be of critical importance in assessing dynamic shifts in market share over time. The Competition Authority accordingly considers that it would be of benefit for the CER to collect and analyse market share data which allows for effective comparison of critical data on an ongoing basis. In the event that abuse of dominance allegations are made, this would facilitate the rapid assessment of the CER's analysis by the Authority. Monitoring would include a mix of quantitative and qualitative observations such as market shares, barriers to entry, or switching.
47. The approach as outlined in Proposal 4 whereby the CER would review market conditions on a bi-annual basis by using forward looking market share estimates is an appropriate one given the stage that competition has reached in retail supply. This approach is more likely to capture the rebalancing of market share which is occurring in the fast changing retail market as consumers switch from ESB Customer Supply to Bord Gáis and Airtricity.
48. However the CER should carefully analyse competitive conditions before taking remedial action as drastic as the reintroduction of price controls on recently deregulated suppliers (as discussed on page 70 of the consultation paper) as such actions could undermine confidence among independent suppliers in the certainty of regulatory decision making. The competition process itself would be seriously damaged if a

previously regulated supplier such as ESB was in some way punished for regaining market share post deregulation if those gains were due to improved performance.

49. There is the possibility that once the market share thresholds are reached and tariff regulation is removed, ESB PES may offer selective discounts to win back consumers who have switched. There is no presumption under competition law that discriminatory pricing is abusive. It is generally accepted that price discrimination has ambiguous effects on competition and consumer welfare. Therefore price discrimination must be judged on a case-by-case basis.<sup>7</sup>
50. The principal concern is that an over reliance on arbitrary market share thresholds as an indicator of competition may lead to a situation where legitimate price cutting strategies are unnecessarily prohibited with the consequence that consumers may be worse off as a result.
51. Taken in isolation, market share can give a misleading impression of the dynamics of how competition actually takes place. If customer mobility is confined to certain customer segments such as early adopters and the technologically adept, market share indicators fail to identify more serious problems relating to consumer protection. The experience in the UK has shown that not all consumers are comfortable with switching which may lead to the situation where competition becomes confined to attracting the most profitable consumer segments while more vulnerable consumers - such as pensioners, rural dwellers and lower income groups - become marginalised.
52. All firms attempt to exercise some degree of market power and increasing market share is a legitimate business strategy. The achievement of high market share and indeed profit margins by outperforming competitors in a competitive market is a very different matter than abusing the market power bestowed on a firm by virtue of it having a legacy of dominance.
53. Section 5 of the Competition Act 2002 prohibits the abuse of a dominant position. It is important to recognise that it does not prohibit dominance - only its abuse. Therefore the actions that the CER should take in the event of a failure of the competition tests will depend on whether a firm has abused this dominant position. However the EU Commission has recently reiterated its view established in competition case law that a dominant firm may have a "special responsibility" in its conduct and so aggressive commercial practices which might be permissible when conducted by its competitors might not be permitted when conducted by the dominant firm.<sup>8</sup>

## Question 10

**Respondents are invited to comment on the options outlined in Section 8.2 for how the price controls should be removed in the context of only a portion of the relevant business markets reaching the threshold for the removal of the price**

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<sup>7</sup> Stole L., (2007), "Price Discrimination and Competition", in *Handbook of Industrial Organization*.

<sup>8</sup> See Guidance note on enforcement priorities in applying Article 82 EC <http://ec.europa.eu/competition/antitrust/art82/index.html>

**control. Should the de-regulated customers be transferred to ESBIE? Should ESB PES be allowed to serve regulated and unregulated customers or should the price control remain in place until all markets have reached their thresholds? Is there another course of action that you would be in favour of? Outline reasons for agreement or disagreement.**

54. As already stated above adherence to static market share thresholds for the purpose of measuring competition in the retail electricity supply may prolong the transition to full and open competitive markets. This delay is at the cost of consumer welfare and overall economic efficiency as domestic consumers and small businesses will have no alternative but to pay higher prices for a longer period than would be the case under competitive conditions.
55. In practice, national regulatory authorities carry out separate market reviews for separate markets, as set out, for instance, in the EU telecoms regulation framework. This approach allows for the consideration of markets on their own merits and the application of suitable and targeted remedies, where appropriate. This may mean that some markets are opened more slowly than others, leading to increased regulatory costs; however, provided that these costs are incremental, consumers should benefit from the overall net welfare effect.

#### **Question 11**

**Respondents are invited to comment on Proposal 5, Section 8.3, to change the principles of regulation, should the criteria for deregulation be met. Are you in favour of the proposal? Are the principles outlined correct? Should any additional principles apply?**

56. The CER has consistently stated its objective of adapting its regulatory approach as conditions in electricity evolve toward a competitive industry structure. While the electricity market is open to competition the CER continues to hold statutory responsibility for approving the pricing proposals of ESB Customer Supply, the licensed Public Electricity Supplier (PES).
57. The current tariff setting principles applied to ESB Customer Supply reflect the fact that ESB Customer Supply has responsibilities as a PES which are over and above those expected of independent suppliers. These responsibilities apply largely to the obligation to supply all customers who wish to be supplied, not to discriminate between customers by their ability to pay and to facilitate greater competition in generation by procuring electricity from independent suppliers under the terms of the Economic Purchase Obligation.
58. On the other hand, it can be argued that there are some aspects of the existing tariff setting process which give ESB Customer Supply a competitive advantage over its rivals. The most contentious issue from a competitive perspective in the tariff-setting process relates to the distortionary effect of k-factors. K-factors correct for over or under recovery of an allowable cost in a given period and thus they may reduce the incentives to operate efficiently and distort competition by causing ESB Customer Supply tariffs to be out of line with costs experienced by its rival suppliers.

59. For example, if fuel costs unexpectedly rise ESB Customer Supply can request a tariff review to recover its fuel costs but if fuel prices fall, ESB Customer Supply only pays back through the k-factor adjustment at the end of the tariff year. Rival suppliers on the other hand must hedge against fuel price volatility. As a result of k-factors ESB Customer Supply is less exposed to volatility than other producers and the current limited supply of financial hedges exacerbates this problem. This is a significant competitive advantage in an environment where fuel prices are becoming increasingly volatile. Therefore any proposal to remove the price controls on ESB PES must take cognisance of the different operating conditions faced by ESB PES and its independent rivals.
60. Retail suppliers without their own generation face a high financial risk due to their exposure to the wholesale spot market on the one hand and their contractual obligation to supply electricity to customers at a fixed price on the other. It is therefore essential that a secondary hedging forward contracting market in electricity supply contracts develops which has sufficient liquidity and contract availability to meet the changing load profiles of retail suppliers and which reduces retail suppliers' exposure to spot market volatility.
61. The successful rollout of the Tullett Prebon trading platform should provide retail suppliers with greater ability to hedge their financial exposures to the SEM and this, together with the construction of additional generation capacity and interconnection which is currently under way should reduce the need for the CER to adopt the interventionist approach that was necessary during the transition from monopoly to competition.

## Question 12

**Respondents are invited to comment on Proposal 6, Section 8.4, to maintain regular monitoring to ensure that ESB PES & ESBIE continues to operate at or below the defined competitive thresholds. Are you in favour of the proposal? Should any additional monitoring apply? Will competition law be sufficient to deal with any problems?**

62. The response to Questions 8 and 9 outline the Competition Authority's views on the application of defined thresholds. Market monitoring should remain an essential regulatory function in electricity regardless of whether the stipulated competitive thresholds are met or not. The physical characteristics of electricity provide conditions conducive for tacit coordination between supposed competitors while non-storability and a low elasticity of demand amplify the market power of even non-dominant firms. These characteristics necessitate an informed approach to competitive analysis and ongoing monitoring by regulators and competition authorities on an *ex post* basis. The Market Monitoring Unit set up by the CER and NIAUR to oversee the operation of the SEM exemplifies the requirement for ongoing market supervision even when market power mitigation mechanisms have been implemented and concentration has been substantially reduced.
63. The Competition Authority is the public body with primary responsibility for enforcing both Irish and EC competition law within



the State, however it is important to note that it is the Courts and not the Competition Authority that make the final decisions regarding breaches of competition law.

64. Irish competition law as set out in the Competition Act 2002 ("the Act") contains two main prohibitions: Section 4 prohibits and renders void all agreements between undertakings and concerted practices which have as their object or effect the prevention, restriction or distortion of competition in trade in any goods or services in the State or in any part of the State. Section 5 of the Act prohibits any dominant firm from abusing its dominant position.
65. Section 4(1) of the Act lists some specific types of agreements and behaviour which are expressly prohibited. These include agreements which:
  - Fix prices,
  - Limit or control production or markets,
  - Share markets or sources of supply,
  - Apply dissimilar conditions to equivalent transactions with other trading parties, and
  - Attach supplementary obligations to a commercial contract which have nothing to do with the subject of the contract (e.g. tying).
66. The Act distinguishes between cartel agreements, which are regarded as being unequivocally harmful to consumers and other agreements, particularly offences relating to vertical agreements that are less seriously restrictive of competition. Hard core cartel behaviour is an indictable offence under Irish competition law and carries with it the possibility of a fine (for an undertaking) of €4 million, or 10% of its annual turnover whichever is the greater; the penalty for an individual is a similar fine, or five years' imprisonment, or both. The provision for a maximum five-year penalty of imprisonment makes this an "arrestable offence" as per Section 2 of the Criminal Law Act, 1997.
67. If the High Court finds that a dominant firm has abused its position, it has a number of remedies available to it. These vary slightly depending upon whether the action alleging abuse was brought by the Competition Authority or by a private plaintiff.
68. In instances where the Competition Authority brings a case, the Court may do any or all of the following:
  - Make a declaration that the Competition Act or the EC Treaty has been infringed (Section 14(6))
  - Grant an injunction directing the undertaking to take a particular course of action (Section 14(6))
  - Require the dominant position to be discontinued unless conditions specified in the Court Order are complied with; (Section 14 (7)(a)) and

- Require the adjustment of the dominant position, in a manner and within a period specified in the Court Order, by a sale of assets or otherwise, as the Court may specify. (Section 14(7)(b))
69. Where the case is brought by a private plaintiff, the Court may do any or all of the above, plus grant damages to the plaintiff for any injury suffered as a result of the abuse as set out in Sections 14(5) and 14(7) of the Act.
  70. It is clear that the Act gives the Courts considerable powers and scope to punish anti-competitive behaviour and to take remedial actions to redress any harm to injured parties. As any legal action concerning a competition law issue is evaluated on its own facts and its own specific context, it would be inappropriate to speculate as to how an Irish court would deal with a competition law case in the electricity sector or what remedial actions it would enforce.
  71. The Competition Authority is also responsible for reviewing certain proposed mergers and acquisitions in the State and bases its decision to clear or block a merger on whether the proposed merger would Substantially Lessen Competition (SLC) in the defined market. The SLC test is interpreted in terms of consumer welfare. Consumer welfare depends on a range of variables including price, output, quality, variety and innovation but in most cases the effect on consumer welfare is measured by whether the price charged to consumers will rise post merger.
  72. Competition law has a number of tools at its disposal to enforce compliance in the interests of consumers. Whether these tools are sufficient to deal with problems which arise under the monitoring proposal is open to question, however. Most importantly, if deregulation is carried out in the correct manner, it is implicitly assumed that, in the deregulated environment, the question of abuse of dominance should not arise unless market circumstances change dramatically. In this respect, merger control is the competition policy tool which is best suited to preventing the possibility of abuse of dominance arising. Should circumstances change ex-post, competition law will of course be applied to the market as appropriate. Accordingly, while competition law has the ability to address problems on an ex-post basis, in the absence of an anti-competitive agreement between undertakings in breach of section 4 of the Competition Act, competition law should not be relied on in the first instance to control market outcomes which are themselves inherently unpredictable. Similarly competition law is not designed to cover all issues relating to consumer protection.

**Should a price cap be implemented? Outline reasons for agreement or disagreement.**

73. The proposal to impose price caps should be avoided. Populist decisions to impose price caps in response to a periodic crisis soon outlive the problem they sought to address and lead to higher prices for all consumers in the longer run.
74. In this context, while a maximum price cap may seem sensible and appealing, the risks of imposing a static measure in a dynamic market need to be recognised. In particular, the imposition of a price cap in a

deregulated wholesale market may leave utilities exposed to exogenous risks which they are unable to effectively address – this was most visibly demonstrated in the 2000/1 California electricity crisis, when utilities were unable to respond in an effective manner to increased demand by implementing the simplest rationing mechanism, a price increase.

75. Prices charged by retail electricity suppliers in Ireland are ultimately determined by the price of wholesale electricity in the SEM. In the SEM prices fluctuate on a half-hourly basis and are based on the bids of competing generators. The bidding principles of the SEM require that generators cannot bid below their Short Run Marginal Cost in any bidding period. As some peaker generators only operate profitably when wholesale prices are high, a price cap would discourage investment in peaking capacity which is needed to ensure that demand is met during peak periods. Peaking capacity will play an increasingly important role in balancing electricity demand and supply as the Irish electricity system become increasingly dependent on intermittent renewable generation. A price cap on retail prices in response to an unforeseeable event such as a short term spike in global fuel prices would undermine confidence among investors to fund projects which depend on occasional price spikes to earn a return.

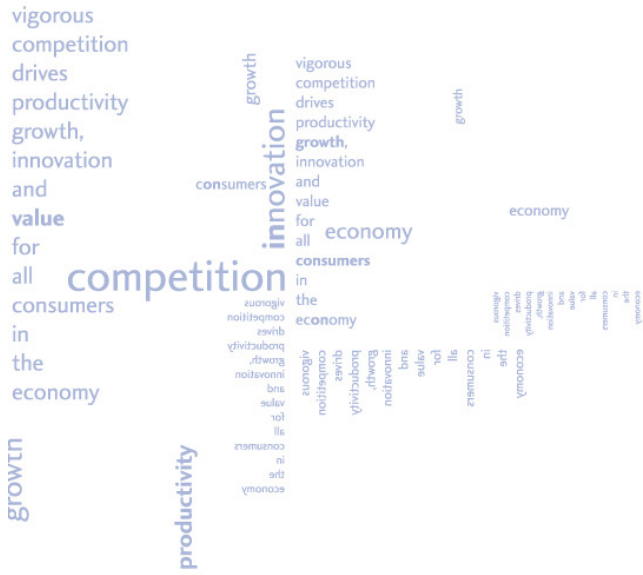
### Question 13

**Respondents are invited to comment on Proposal 7, Section 10.3, that ESB PES, ESBIE and any other supplier will be required (through licence) to offer tariffs to vulnerable and other groups of domestic customers, as defined by the Commission, on principles acceptable to the Commission. Are you in favour of the proposal? Outline reasons for agreement or disagreement. Are there any other specific consumer measures required with the removal of price controls?**

76. Fuel poverty among vulnerable groups will persist regardless of the level of competition and this problem is best addressed by direct intervention or through the provision of subsidies for those groups most at risk.
77. The experience of retail energy liberalisation in the UK demonstrates the need for ongoing monitoring and enforcement of consumer protection measures when introducing competition. Some UK consumers experienced a number of problems as some energy suppliers used aggressive selling techniques to attract new business. There were complaints concerning doorstep selling, sale agents using misleading information about the potential savings customers could achieve if they switched, and customers being switched without their consent.
78. The imposition of regulated tariffs post deregulation will create additional problems in an otherwise competitive market. Price setting in order to “protect” vulnerable consumers can provide a focal point for price coordination between suppliers, which is antithetical to competition.
79. Re-regulation of tariffs would also discourage consumers from engaging in sufficient search activity even where this would provide net benefits to them. The CER should investigate reasons for consumer

inertia and take further initiatives to encourage switching rather than imposing drastic measures which would lead to all consumers paying higher electricity prices. Such an outcome would of course be counter to the objective of consumer protection.

80. Furthermore, regulated prices tend to discourage innovation in tariff design, which can be a major source of differentiation in retail energy markets, providing consumers with products that best suit their needs and preferences.
81. The liberalisation of retail supply does not obviate the need for the CER to take an active role in regulation but rather it requires the CER to reorient its activities to address demand side issues relating to consumer protection and behaviour so that consumers can make better informed decisions in a truly competitive market.
82. The CER's Roadmap consultation paper covers a wide range of issues relating to the electricity sector and presents a welcome overview of the electricity market and the considerable progress that has been made to put in place a structure conducive to a competitive market. Many of the issues contained in the consultation paper require deeper analysis before any conclusions regarding the future direction of policy could be drawn. Such in-depth analysis would be impossible to conduct within the tight timeframe of the current consultation process. Therefore the Competition Authority is of course available to discuss the issues raised in this submission in greater depth with the CER should the CER feel the need to do so.



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