Commission for Energy Regulation

An Coimisiún um Rialáil Fuinnimh

Decision in respect of the Regulated Tariff Formula (RTF) Regime in the Gas Supply Market

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Abstract:

This decision paper outlines the Commission's position with respect to the RTF regulated pricing regime. Following consultation with industry, the Commission has decided to retain the current RTF regulated pricing mechanism but to approve certain amendments to the RTF contract offered by BGES and the Code of Practice for Customer Contact. These amendments will be effective from 1st October 2008.

The Commission also signals its intention to keep the case for the retention or removal of the RTF regime under regular review.

Related Documents:

CER/08/068 – Review of Regulated Tariff Formula Regime in the Gas Supply Market
CER/06/168 – Direction to Bord Gais Energy Supply regarding the Regulated Tariff Formula
CER/04/111 – Direction and Responses RE: Application of Regulated Tariff Formula
The RTF Contract - http://www.cer.ie/en/gas-retail-market-decision-documents.aspx?article=88b47d53-4836-4add-abb9-f541ca71bc3c
The Code of Practice for Customer Contact - http://www.cer.ie/en/gas-retail-market-decision-documents.aspx?article=ddd6015e-9f7d-4fb4-9fc3-75e86a9392f4

Executive Summary

This decision paper outlines the Commission's position with respect to the RTF regulated pricing regime. Following extensive consultation with industry, which involved the publication of a consultation paper in May 2008 and also subsequent meetings with respondents, the Commission has decided to retain the current RTF regulated pricing mechanism but to approve certain amendments to the RTF contract offered by BGES to enhance the flexibility offered to customers. The Commission also makes clear its view that the RTF regime should be seen as a transitory measure and will be removed when the Commission is of the view that competition can function effectively in this segment of the market.

The decisions taken by the Commission in this paper are premised in the interest of the customer. The Commission has received comments and has been in communication with customers in the RTF range during this consultation process. Responses have suggested that the RTF regime is inflexible, restrictive and is not in the interest of the customer. Some have called for, at a minimum, the flexibility of contracts to be enhanced, while others have called for the regime to be abolished.

Summary of Decisions

- The RTF regulated pricing mechanism will remain in place.
- From 1st October 2008 onwards, a BGES RTF customer may lock in a contract price for non-consecutive months within the period of the contract.
- From 1st October 2008 onwards BGES contract quotations will be valid until 5pm on the same business day.
- The BGES Code of Practice for Customer Contact will be amended, but the compliance, training, auditing and comments on competing offers aspects of the code will remain.
- The Commission will keep the case for retaining, or removing, the RTF regime under regular review.

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1.0 Introduction

1.1 The Commission for Energy Regulation

The Commission for Energy Regulation ('the Commission') is the independent body responsible for overseeing the regulation of Ireland's electricity and gas sectors. The Commission was initially established and granted regulatory powers over the electricity market under the Electricity Regulation Act, 1999. The enactment of the Gas (Interim) (Regulation) Act, 2002 expanded the Commission's jurisdiction to include regulation of the natural gas market, while the Energy (Miscellaneous Provisions) Act 2006 granted the Commission additional powers in relation to gas and electricity safety.

1.2 Purpose of this paper

The purpose of this paper is to present the Commission's decision with regard to its review of the Regulated Tariff Formula (RTF) Regime. The Commission published a consultation paper in May 2008 seeking views from interested parties on a number of questions posed by the Commission in this consultation paper. The Commission has considered these views and afforded each respondent the opportunity to meet with the Commission to clarify their points of concern before coming to a decision on the future of the RTF regime.

1.3 Background Information

This proposed decision paper may be read in conjunction with consultation document CER/08/068 ('A review of the Regulated Tariff Formula Regime in the Gas Supply Market') of 2 May 2008. Written and verbal submissions in respect of that paper have been received from the following parties:

- Bord Gáis Energy Supply
- Viridian Power and Energy
- Vayu Limited
- Dairygold Co-Operative Society
- Greencore

The CER wishes to thank these respondents for their input.

In reaching its decision, the Commission has taken due account of the arguments presented in each submission and representation made by the parties above. Appendix 1 summarises the responses received to the specific questions raised in the consultation. Individual responses, except those deemed commercially sensitive, will be published separately to this decision paper.

1.4 Structure of this paper

This paper is structured in the following manner:

- **Section 2.0** provides background information on the developments in the RTF regime since its establishment in April 2003

- **Section 3.0** outlines the detail of the Commission's decision with respect to the definition of the relevant market when reviewing the RTF regime, changes to BGES's RTF contract and Customer Code of Contact and providing a 'roadmap' for the removal of regulation in the gas supply market.

- **Section 4.0** outlines the conclusions and next steps with respect to the RTF regime;

- **Appendix A** summarises the responses received to the Commission's consultation and the Commission's views with respect to these responses.

2.0 Background

2.1 Background

The details of the RTF regime have been provided in previous Commission Decision Papers establishing and amending the regime since its establishment in 2003 (CER/03/079, CER/05/188, CER/06/168).

In brief, the RTF is a regulated pricing mechanism applied to BGES gas consumers consuming between 254GWh and 5.5GWh of gas per annum. Prior to its introduction in April 2003, RTF eligible customers could choose from a range of BGES published tariffs. The RTF regime introduced a price regulation formula reflective of monthly wholesale prices and the cost of delivering gas to the customer's premises.

The regime was designed at the time to serve two stated purposes:

- To provide a transparent market reflective pricing mechanism for the pricing of customers, thereby creating a clear target for competing suppliers

- To allow BGES to operate in an eligible market sector where sustainable competition has yet to develop

Essentially, it acted as a means to regulate BGES's prices in this newly created eligible sector and provided a benchmark against which independent suppliers could compete. It would be fair to say, that the creation of this regime is not an ideal "free-market" mechanism. However, in the absence of perfect competition or indeed any real competition at the time, the Commission, believed that a transitional measure, such as the RTF, would act as a stepping stone to generate competitive interest in the eligible market. In other words, it was what could be termed a "managed competition" approach, to be kept under review as the market developed. That is not to say, that a regime, which was appropriate in 2003, or even 2008, is necessarily appropriate for the market indefinitely as the environment changes and the market grows.

Of course there have been drawbacks in establishing a strict regulatory pricing mechanism for the RTF sector, such as inhibiting the flexibility offered to RTF customers of BGES. Some customers have commented that the RTF regime is not customer focused and has actually led to higher prices.

Notwithstanding these drawbacks, in the long-term interest of the Irish gas market, the Commission believes that the establishment of the RTF regime has made positive steps in reducing the barriers to entry and facilitating the development of competition in the gas supply market. For example, as shown below, the BGES share of the RTF has declined since its introduction.

Table 2.1: BGES Volumetric Market Share of RTF and CHP Market Sector

	2005[1]	2006	2007	2008
Total RTF (including CHP opt-outs) Market by volume	5,490GWh	6,323GWh	5,934GWh	5,465GWh
BGES % of RTF including CHP opt-outs	68%	59%	48%	47%

In making future decisions with respect to the RTF, the Commission must be mindful that it does not subject consumers to higher prices or inflexible product offerings over a prolonged period if the evidence indicates that the resulting benefits would accrue largely to suppliers.

Since its introduction in 2003, the overall gas retail market environment has changed considerably. Namely, the customer segments below the RTF, i.e. those consuming below 5.5GWh, have become eligible in terms of being open to competition to independent gas suppliers. In these customer segments, a regulated pricing formula has been established for the Fuel Variation Tariff customer segment[2] and cost-reflective tariff structures have been implemented in the revenue regulated Non Daily Metered (NDM) residential and business customer sector[3]. These structures have been designed to provide more cost reflective and transparent prices from which competing suppliers can benchmark against. Similar to that of the RTF, the FVT regime was established as a temporary regulatory measure to aid the transition from a rigid revenue regulated regime to a non-regulated market.

The Commission has also worked with BGES over the past number of years to reduce certain of its portfolio benefits, inherited from its previous position as the monopoly incumbent.

[1] 2004 has been excluded from this table due to some anomalies in the available data

[2] The Fuel Variation Tariff customer sector consists of those customers of BGES who consume above 73,000kWh per annum **and** who have a Supply Point Capacity in excess of 3,750kWh.

[3] The Non-Daily Metered customer segment in this instance refers to those end-users of BGES with a Supply Point Capacity below 3,750kWh and who are eligible for the revenue regulated tariff.

Combined, these structural and regulatory changes have created a market environment in which barriers to entry are low and customer switching is through a structured process, managed by an independent entity. In making its decision with respect to the RTF sector, the Commission must consider the impact of these changes on suppliers, potential suppliers and on customers in the relevant market.

3.0 Commission's Decision

3.1 The Relevant Market

The objective in defining a market is to identify all actual competitors that are capable of constraining or influencing the behaviour of the market. This includes potential new entrants and consumers. In order for this information to be meaningful, in defining the relevant market, the Commission should also consider the barriers to entry and the ability of customers to switch between suppliers in this relevant market.

In introducing the RTF regime back in 2003, the Commission was effectively recognising that customers in this particular consumption category were in a different situation to other customers for the purpose of the regulated BGES tariff regime to which they should be subjected. Otherwise the Commission would not have introduced the regime. The Commission can no longer rely simply on the concept of "eligible customer" to differentiate between customer categories for tariff regulation purposes, that concept has been overtaken by full market liberalisation and is no longer valid.

In defining the 'relevant market', the Commission is providing an operational definition, which is not necessarily a legal definition as per competition law. This reflects a number of factors, including the relatively early stage of market liberalisation and limited experience gained to date in analysing market dynamics. It is probably more realistic to view the overall customer market as a spectrum, ranging from the very large industrial and commercial customers where there is little perceived need for regulatory intervention to the domestic customer market which has proven to be largely non-contestable, at least to date. Within the overall customer spectrum – from very large down to domestics - the Commission considers that it is reasonable to consider customers in the combined RTF and FVT consumption bands as being reasonably homogenous in terms of their size, commercial and economic characteristics and their likely negotiating strength with prospective gas suppliers. This would suggest that these customers could be said to occupy a distinct market segment.

In assessing and reviewing the RTF regime, the Commission has largely looked at the levels of customer switching and market shares held by competing suppliers in the range of RTF and the FVT market sectors. That is to say, in those customers sectors where annual consumption ranges between 264GWh and 73,000kWh with a Supply Point Capacity above 3,750kWh.

The Commission has not considered the non-regulated LIEU[4] and power generation sector or the revenue regulated NDM sector in this review of the RTF. This is not to say that the development of competition in these sectors is not of relevance or, that the Commission is not seeking to promote competition in these sectors. For the purpose of this review however, the Commission feels that the inclusion of these customer sectors may distort an analysis of the relevant market. As indicated above, the RTF and FVT sectors are a largely homogenous customer segment with sufficient information and incentives to manage their gas supply contracts. The CHP units that have opted out of the RTF are also included as part of this analysis for consistency purposes. BGES distinguishes between its CHP and non-CHP customers in the RTF sector for the purpose of allowing them to opt-out of the price regulated regime[5]. Other competitors do not actively make this distinction and therefore to ensure consistency in comparison of competitors and customers, the Commission has included RTF eligible CHP units in the definition of the "relevant market" for the purpose of this analysis.

Latest data from the Gas Point Registration Operator indicates that BGES's share of this relevant market has declined to 60% in June 2008 from 81% in December 2005. This percentage is expected to decline further in the near future as competitors increase their capture of the FVT market.

Notwithstanding this decline, the Commission is mindful that an analysis of a market should not rely exclusively on prevailing market share statistics. Market share statistics alone can give imperfect information on the realities of a market and its dynamics, particularly if they ignore barriers to entry. The structures that are currently in place in the relevant market, such as existing competition and a real threat of further potential competition, may prevent BGES from operating independently without consideration for its competitors and consumers.

The Commission has been and remains cautious in setting rigid market share cap rules as part of its review of the RTF. Although intuitively it provides a transparent signal to the market, it has a number of practical difficulties, including gaming by competing market participants. In assessing the relevant market and the level of competition in the relevant market, the Commission will consider the intangible elements of market power, such as competing suppliers, the characteristics of customers in the relevant market, barriers to entry and exit to the relevant market and ultimately and the benefits accrued to customers.

[4] 'LIEU', refers to 'Large Industrial Energy Users' who consume in excess of 264GWh of gas per annum.

[5] CER/04/306 provides for an exemption from the RTF regime for CHP customers between the RTF threshold of 5.5GWh and 264GWh. This essentially allows such sites to enter contracts with BGES on either a regulated or unregulated basis.

3.2 Assessment Criteria

In 2004, the Commission focused on three criteria that would be used in the assessment of the RTF and in future decisions with respect to the adjustment or removal of the RTF regime;

- The levels of customer switching suppliers in both the RTF and the non-price regulated market sectors
- The sustainability of competition within the RTF market sector; and,
- The elimination (through market structures) of any benefit that BGES may enjoy by virtue of its market position

Given the changes that have since occurred in the gas market, it is reasonable to ask whether the criteria are still legitimate in the current market environment. For instance, the second criterion refers to sustainable competition in the RTF market sector only. Is sustainability in this market sector alone a sufficient demonstration of effective competition? It is likely that an independent supplier would be more at risk to the impact of BGES regaining its market share in the RTF if it did not have a foothold in another market segment.

The Commission therefore, believes that each of the criteria should be clarified and extended to address the current environment facing customers and competing gas suppliers.

3.2.1 Levels of Customer Switching Suppliers in both the RTF and the non-price regulated market sectors

The first criterion, regarding the levels of customer switching in the “non-price regulated” market sectors refers to unregulated I&C gas users. In light of changes that have incurred in the gas retail market since this initial criteria was set[6] and as discussed in section 3.1, the Commission considers that the relevant market sector for the purpose of assessing customer switching should be seen as those consumers in the range of the RTF and FVT market sectors. In this framework the FVT can be regarded as an extension of the RTF regime to encompass the larger NDM sites.

Evidence from the Gas Point Registration Operator suggests that the level of customer switching in the relevant market has increased year on year, and substantially so during the 2007/08 gas year. This is particularly the case within the RTF sector, such that BGES currently holds a 29% share by volume of the specific sector (excluding CHP sites that have opted-out of the regime). Although not to the same extent as the RTF sector, competition is developing slowly in the FVT sector following the first year of its implementation. Switching levels within

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[6] This refers to the establishment of price regulation in the FVT customer sector anda implementation of rules to inhibit the ‘portfolio benefits’ enjoyed by BGES as the incumbent.

the RTF eligible CHP sector has been significantly less than those in the RTF sector. The reasons appear to be related to price discounts afforded to BGES customers relative to non-BGES customers. This issue will be addressed further as part of the third criteria "elimination of any benefit that BGES may enjoy by virtue of its market position".

3.2.2 The Sustainability of Competition within the RTF Market Sector

The sustainability of competition in the RTF sector is partly a function of barriers to entry for new entrant suppliers and partly a function of the perceived risk/return relationship for market participants. As stated earlier, the Commission believes that the sustainability criteria should be extended to sustainability in the relevant market defined for the purpose of this review. This will provide competitors with a wider customer base, such that they are not overly reliant on their market share in one sector and therefore more susceptible to a regaining of market share by the incumbent should regulation be removed.

Borrowing from a report analysing the impact of maintaining price regulation in Australia, which refers to 'established competition'[7], the Commission believes that a suitable assessment for sustainable competition is where 'competitive constraints are sufficiently strong as to afford a significant degree of protection to customers with respect to the level and range of prices and services offered. Sustainability is also apparent when innovative offers feature more prominently in the marketplace and where the activities of incumbents and challengers in responding to one another through offers and new tariffs tend to promote a much higher level of consumer awareness of the alternatives on offer. In other words, sustainable competition is evident when customers have a real choice between competing suppliers and competing products.

The Commission considers that this criterion is currently being partly met. Barriers to entry in the RTF market sector are low such that two market entrants have accrued a large share of the market (one of the competitors now has a larger share, in terms of volumes shipped, than the incumbent). Furthermore, competition and the threat of further competition in the Irish market should be sufficient to afford a significant degree of protection and purchasing power to customers. These factors demonstrate a level of sustainability in the RTF sector, but as stated previously the Commission is not minded to remove all regulation in the RTF market sector until such time as competition in the FVT market sector is suitably sustainable. To be clear, although there is evidence of sustainable competition in the RTF market sector, the Commission does not believe that the level of competition in the FVT market sector is adequately sustainable to rationalize the termination of regulation in the RTF regime at this time. Further progress in competition in the FVT market sector would greatly facilitate the removal of any remaining regulations in the RTF regime.

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[7] 'Report on the Impact of Maintaining Price Regulation', Yarrow, George, Regulatory Policy Institute, Oxford, January 2008.

3.2.3 The Elimination (through market structures) of Any Benefits that BGES may Enjoy by Virtue of its Market Position

When the RTF was established, BGES, as the market incumbent, inherited a number of competitive advantages over new market entrants. These were related to its economy of scale, its usage of secondary capacity discounts and its portfolio of gas.

In terms of economies of scale, although it can be considered advantageous, it is (as discussed in recent competition law decisions and analysis) not considered as an "unfair" barrier to entry, such that it does not prevent effective competition from being established.

As referred to earlier, the Commission has worked with BGES since the introduction of the RTF regime to reduce the benefits accruing as a result of secondary capacity discounts and its larger gas portfolio.

Firstly, BGES has been directed to offer secondary transmission capacity products from its NDM portfolio on a transparent, non-discriminatory basis and at a regulated price. BGES submits a quarterly report of all secondary capacity product transactions to the Commission as part of the monitoring process. Although it appears that BGES make more use of the secondary capacity products than its competitors, the Commission does not believe that this is due to its position as the incumbent supplier to the revenue-regulated NDM sector.

Secondly, legacy contracts, which pre-dated the establishment of the RTF, have terminated such that BGES purchase gas on the same markets as other suppliers. Finally, BGES is ring-fenced to the extent that gas purchases cannot be shared or cross-subsidised amongst customer sectors. Access to the gas networks used to transport gas is based on transparent and regulated terms and prices, including interruptible secondary capacity offered by BGES and the Interconnector inventory product.

The Commission is satisfied that the third criterion has been met and that BGES is competing, to an extent that is possible given its incumbent status, on a level playing field with other suppliers in the market.

3.3 BGES RTF Contract

The Commission feels that given the level of competition that has emerged and in the interest of the customer, and taking account of the comments received from two large RTF customers, it is appropriate to relax certain restrictions of the

RTF and introduce certain flexibilities to the RTF contract. This involves changes to BGES' standard RTF Contract and changes to the Code of Practice for Customer Contact.

Fixed term contracts will continue to be offered for terms of 3, 6, 9, or 12 months. For each month of any contract period, a sterling gas commodity price will be set by one or more of the following mechanisms:

a) The customer may elect to fix some or all of the monthly prices at the time of acceptance. Where this mechanism applies, the monthly fixed prices will be based on the previous day's ICE settlement prices, although the offer from BGES will only be held open until 5pm on the same business day. This is a change from the current contract, whereby the offer can be held open for a further two days;

b) Any prices which are not fixed at the outset may subsequently be fixed at any time during the relevant booking window for each month M. In the case of a futures price, the booking window expires at 5pm on the second last business day in month M-1. Where this mechanism applies, the monthly fixed prices will be determined by reference to ICE monthly futures prices prevailing immediately prior to the time of the offer, and the offer must be accepted on the same business day. BGES must retain a time-stamped copy of the offer and of the relevant ICE screen data for audit purposes. In the case of an ICE-index price, the booking window expires at 5pm on the second last business day in M-2.

c) Any monthly prices which have not been fixed prior to expiry of the relevant booking window will be fixed by default. Where this mechanism applies, the monthly fixed price for month M will be based on the closing settlement price on the second last business day of M-1

In addition, BGES RTF customers will be permitted to purchase gas in non-consecutive months quarter and/or seasons within the given contract period. This allows customers to lock in prices within the contract period, but does not allow BGES to offer customers contracts for periods greater than one year. This will enhance the flexibility offered to customers, who in their responses to the Commission's consultation criticised their ability to manage their energy portfolios in the current volatile environment under the RTF regime.

To summarise and for the avoidance of doubt:

- The RTF pricing mechanism will remain in place;
- BGES will not offer the option of 'prompt' (day-ahead or within day) pricing to its RTF customers;

- BGES will not offer fixed prices for less than a site's entire monthly requirement;
- BGES will not amend a customer's price fixing decisions once they have been made;
- The price of a BGES offer will only be held open for one business day.

It was suggested by one respondent that the Commission should extend the practice of price regulation to all other segments of the retail gas market. In its dealings with customers in the various market sectors, the Commission has not received any indication that customers wish the RTF price regulation model to be extended to other market sectors. The Commission, in its attempt to provide value to the customer, has endeavoured to establish a market which is transparent and where barriers to entry are low. The Commission has maintained regulation in areas where customers may not have sufficient bargaining powers or information to influence the behaviour of suppliers. In those areas where there is no regulation, the Commission believes that customers have an incentive to actively manage their energy portfolios and are large enough that they can exert a high degree of purchasing power over their suppliers. Keeping the interest of customers in mind, it would therefore, not appear appropriate or necessary to introduce regulation to the retail market areas that are currently un-regulated.

3.4 BGES RTF Customer Code of Contact

In its review of the RTF regime, the Commission also considered the Code of Practice for Customer Contact ('the code") that is currently in place to reguate communications between BGES and all customers in the RTF customer segment.

The code outlines when, how and why BGES may contact any RTF eligible customers and is auditable by the Commission. The Commission does not believe that it would be appropriate to remove the code at this time. However, it does feel that certain aspects of the code can be relaxed and/or removed. The compliance, training, auditing and comments on competing offers aspects of the code will remain, but the Commission does not believe that it is approriate for such a code to dictate under what circumstances a customer may contact BGES, it should only address how BGES may appropriately respond to requests from customers or address customers.

As the code is in practice a BGES document, the Commission will liaise with BGES following the publication of this decision to amend the code as deemed appropriate and this code will be published on the BGES website. The Commission will also consider the merits for the implementation of a Customer Code of Contact in the FVT market as part of its larger review of the FVT market in Quarter 4 of this year.

3.5 Future of the RTF Regime

The RTF was established in 2003 in response to the creation of a new “eligible market” created under the Gas (Interim) Regulation Act, 2002. As highlighted previously, it was designed as an incentive mechanism and benchmark for independent suppliers to enter the Irish retail market – not as a permanent substitute to competition. It was always intended that the RTF would be a transitionary measure until such time as competitive constraints could over-ride regulatory constraints.

In its May 2008 (CER/08/068) consultation paper, the Commission emphasised that its primary objective is to protect the long term interests of industrial and commercial gas customers, including those in the RTF consumption category. Promotion of competition within this category is a very important tool in this regard. That said, it is important to bear in mind that, as the Supreme Court has recently observed[8], at least in a competition law case, the objective should be to promote competition which need not always equate to the interests of competitors, or at least of existing competitors. The structural and dynamic aspects of markets have to be taken into account, including ease or barriers to entry by new suppliers.

The Commission recognizes that regulation, and in this case price regulation, limits the flexibility and adaptability offered to market participants. This can be particularly frustrating for customers under the current volatile market conditions. In the long-term interest of the market, however, removal of regulation should not occur before ‘effective’ or ‘established’ competition is in-place. Defining and recognizing when this has occurred can admittedly, be difficult and probably requires some degree of judgment as well as empirical evidence.

There is also the more general point that a regime such as the RTF, which has been expressly recognized as a transition measure by the Commission over the years, should not be envisaged to continue indefinitely in the market. Otherwise it is not a transitional measure in any credible sense, and it amounts effectively to acknowledging that there is no prospect of real competition emerging in the relevant market.

As the Commission has previously outlined, outright removal of the RTF regime could be triggered by credible evidence of established competition for customers in the ‘relevant market’. This stems from the Commission’s view that competition may be more robust and viable if at least some of the independent suppliers were actively marketing to more than one of the customer segments. A supplier focusing exclusively on the RTF sector would be more likely to exit the market if it could not maintain a substantial market share of that particular sector.

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[8] This reference relates to the Supreme Court judgment in the Competition Authority v Irish League of Credit Unions, delivered on 8th May 2007 but as yet not published.

As stated previously, making the removal of regulation conditional on the attainment of published market share targets by suppliers in the relevant market is inappropriate. The Commission has considered this approach and believes that it potentially presents a risk in creating perverse incentives for market participants to impede competition. For example, independent suppliers might find it more profitable to delay competing outside the RTF, thereby prolonging the restrictions on BGES.

Given the changing market environment and to avoid potential gaming between market participants, the Commission does not feel that it is in a position at this time to give a specific date as to when it will remove or amend the RTF regime further. However, it does wish to note that barriers to entry in this market sector are now relatively low, that successful entry has occurred and is continuing to win market share from the incumbent, and thus that the conditions for full relaxation of remaining regulations are now close to being met. The Commission will continuously keep developments in the market, and particularly in the current RTF and FVT sectors, under close review so that it can give the industry reasonable advance notice of any intention to remove or limit the application of the RTF regime when the evidence so warrants.

3.6 Summary

This section outlines the Commission's view with respect to the RTF regime and its future review. Of most importance to interested parties, it approves interim changes to the RTF contract offered by BGES to enhance the purchasing flexibility of customers.

Summary of Decisions

- The RTF regulated pricing mechanism will remain in place.
- From 1st October 2008 onwards, a BGES RTF customer may lock in a contract price for non-consecutive months within the period of the contract.
- From 1st October 2008 onwards BGES contract quotations will be valid until 5pm on the same business day.
- The BGES Code of Practice for Customer Contact will be amended, but the compliance, training, auditing and comments on competing offers aspects of the code will remain.
- The Commission will keep the case for retaining, or removing, the RTF regime under continuous review.

4.0 Conclusions and Next Steps

4.1 Summary

This decision paper outlines the Commission's position with respect to the RTF regulated pricing regime. Following extensive consultation with industry, which involved the publication of a consultation paper in May 2008 and also subsequent meetings with respondents, the Commission has decided, in the short-term, to retain the current RTF regulated pricing mechanism but to approve certain amendments to the RTF contract offered by BGES such that it improves the flexibility offered to customers. Following consideration of the different options to remove the RTF regime, the Commission has also decided to retain regulation in the RTF market sector but to keep it under continuous review.

4.2 Next Steps

This decision will take effect as of 1st October 2008. The Commission will keep developments in the 'relevant market' defined in section 3.1 under review, and will reserve the right to amend or reverse this decision should it become apparent that there is gaming or anti-competitive practices emerging in the 'relevant market'.

The Commission will also liaise with BGES, following publication of this decision paper, to amend the Code of Practice for Customer Contact. This ameded code will subsequently be published on the BGES website.

Appendix A – Responses to Consultation

Summary of issues raised and responses received in respect of consultation paper CER/08/068

CER consultation paper CER/08/068 sought responses from interested parties in respect of several specific key questions. These questions are summarised below, along with a summary of responses received and (where appropriate) the Commission's views on these responses.

Question A1.

"With respect to changes in the RTF, should criteria other than those previously established by the Commission be considered? If so, please justify why these are relevant."

Responses included:

- that the criteria previously specified by CER are sufficient (and have arguably been met in full)
- that the CER's stated criterion regarding sustainability of competition within the RTF sector should be broadened to include sustainability of competition in CHP and other I&C customer segments
- that the criterion regarding rates of customer switching should be between all suppliers, not just from BGES
- that sustainability of competition depends on independent suppliers having similar abilities to BGES in respect of capacity trading and hence in the discounting of capacity costs
- that any relaxation of RTF controls should be contingent on BGES having less than 40% share in each segment of the retail market (including NDM customers)
- that the removal (through market structures) of any benefit that BGES enjoys through its market position could include measures such as:
    - the removal of K-factors from NDM tariffs;
    - elimination of capacity transfers between RTF and NDM customers;
    - transparency of cost allocation between BGES customer segments; and
    - managerial separation; and/or re-branding of BGE's gas supply arm
    - preventing cross-subsidy between its regulated and unregulated customer segments (including any dual fuel offering)
    - stronger auditing of compliance to the RTF with the possibility of sanctions for non-compliance

Commission's view:

As outlined in Section 2, the Commission considers that the structural barriers to competition in the RTF sector have been removed. There is no logical justification for preventing the efficient use of secondary NDM capacity. Nor is there any justification for the Commission to make reform of the RTF contingent on the future progress of competition in the domestic sector. Moreover, BGES has adequately met its regulatory requirements in terms of organisational unbundling from BGÉ's networks business. Nevertheless, the conditions to justify an outright removal of the RTF regime have not yet been achieved. In considering any such decision in future it will take due account of competitor activity and customer switching away from BGES in customer segments other than the RTF.

<u>Question A2.</u>

"Is there evidence of emerging competition and customer choice for Unregulated or CHP customers and the largest NDM customers? If so, is it appropriate for BGES to share with its RTF customers some of the portfolio efficiency benefits it enjoys?"

Responses included:

- that from the market share data presented in the consultation paper, evidence of competition in these segments is extremely limited
- that winter-peaking RTF customers already benefit to some extent via the application of 5-day averaging of peak day transmission capacity
- that summer peaking RTF customers already benefit from the use of secondary capacity by BGES
- that no FVT sites had switched supplier during the first three months of its operation
- that the reason why no LIEU sites have switched to date is because transmission capacity discounts are offered by BGES
- that if similar discounts/subsidies were to be made available to RTF-eligible sites, there would be a rapid transfer of customers back to BGES
- that for consistency, any analysis of emerging competition should include the entire powergen sector including self-shippers
- that it is inappropriate for the CER to include sectors that are not price regulated in its analysis of RTF competition; to include such end-users may lead to a perverse outcome where potential new entrants do not seek customers in those sectors
- that competition is nevertheless beginning to emerge in the FVT sector
- that the portfolio efficiency benefits referred to in the consultation paper are available in principle to all suppliers; RTF customers should be able to share in these

Commission's view:

The Commission understands that circa 15 FVT sites had switched away from BGES at the end of April 2008. This represents less than 1% of the relevant customer population, suggesting a low switching rate to date. However, the independent suppliers were not marketing very actively during the first six months of the FVT scheme, possibly because of implementation delays in the BGE Networks GasMAP project. It is not yet clear whether the 'hit rate' on offers seeking to switch FVT sites away from BGES is comparable to that previously observed for RTF sites.

<u>Question A3.</u>

"Which if any aspects of the RTF regime should be amended, removed or preserved? Please explain why."

Responses included:

- that, due to a lack of sustainable competition to date, the current RTF Direction should not be amended at this stage, although this would not preclude a future re-examination of the issue
- that amendment of the RTF Contract and/or the Code of Practice would only be justified if necessary to give effect to an amended RTF Direction
- that if BGES were allowed to offer additional flexibility on price hedging, it would engage in predatory behaviour, would offer products not available in the (wholesale) market, and would offer prices that could not be matched
- that any fixed price offers by BGES should in any case reflect ICE forward prices at the time of acceptance, rather than prior-day settlement prices
- that the treatment of capacity over-runs and daily contract quantities should be more explicit
- that the contractual provision for CER-approved special conditions should be discontinued
- that RTF-type rules should also be applied to CHP sites and LIEUs
- that the RTF audits should be commissioned by CER rather than BGES and the results of such audits should be more widely available
- that RTF customers of BGES should be allowed to negotiate all aspects of their charges for gas supply, particularly those relating to efficiency benefits and pricing flexibilities

Commission's view:

From its outset, the current review of flexibility arrangements was contingent on NDM tariff structures, rather than the achievement of specific market outcomes. As previously noted, the Commission will need to be alert to the possibility of gaming behaviour by independent suppliers. It will also be alert to the possibility of predatory behaviour by BGES in respect of the RTF sector.

The Commission can confirm that no requests for special conditions have been requested to date under the RTF contract. The issue of whether any might be requested in future is not relevant to the current decision.

The Commission regards the suggestion of extending RTF-type rules to the entire NDM sector as being impractical due to constraints on data quality. The vast majority of NDM customers have only three meter reads per annum, whereas the FVT sites have 12 reads per annum.

Question A4.

"Does Table 1 of the consultation paper provide an accurate assessment of BGS market share trends?"

Responses included:

- that the market share data presented by CER is broadly consistent with what would have been expected by other observers
- that although BGES may currently hold less than 100% of the LIEU segment, this is due to the recent reclassification of a large RTF site rather than to any LIEU sites actually having switched away from BGES
- that BGES's current share of the CHP segment is actually circa 80% (rather than 93% as stated in Table 1)
- that the powergen retail sector (if relevant to the analysis) should include all sites including self-shippers
- that, in any case, the registered shipper to a powergen site does not necessarily have an exclusive gas supply contract with the end user

Commission's view:

The Commission has so far been unable to reconcile conflicting claims of different suppliers as to the number of daily metered CHP sites which are not served by BGES. The difficulty in maintaining a definitive list of eligible sites reflects an apparent absence of generation licence registration by many of these sites. The Commission considers this uncertainty over site eligibility status to be unhelpful and will continue to press for greater clarity.

The Commission agrees with respondents comments that the position of BGES as a gas supplier and/or shipper to the Powergen sector is of little relevance to the current consultation.

Question A5.

“What is the most appropriate combination of the larger I&C market segments when considering BGS’ market share?”

Responses included:

- that the retail gas market can usefully be segmented into business and domestic segments, but that further subdivision within the I&C segment is not helpful in assessing whether sustainable competition is emerging
- that the most appropriate combination would be (Powergen Retail plus LIEU), (CHP plus RTF) and FVT
- that FVT customers are part of the NDM market sector and should not be considered as part of the RTF competitive review
- that RTF and CHP sites should be considered as a whole (because opted-out CHP sites could in principle choose to go back into the RTF)

Commission’s view:

Section 2.2 of this paper outlines why the FVT segment needs to be taken into account, and why it is helpful to consider market shares in the CHP segment.

Question A6.

“To what extent do the higher BGES market shares of LIEU and CHP segments reflect price discounts, product flexibility, service quality and/or credit issues?”

Responses included:

- that other suppliers struggle to compete with the products and services to LIEU and CHP at the rates offered by BGES
- that this may be due in part to BGES’ branding and superior credit rating
- that the main reason why there is limited penetration by independent suppliers in these sectors is that BGES offers commodity based deals with capacity discounts, the cost advantage being derived from a dominant market position
- that if BGES were constrained to offer RTF-type products in these sectors, independent suppliers would be able to offer superior product flexibility and service quality
- realistically, only customers can answer such a question, and in any case it is not relevant to the RTF sector

Commission's view:

There is no logical justification for penalising BGES in respect of its brand name or credit rating, particularly given the similar status of some of the existing and potential new entrant suppliers.

The Commission's research suggests that BGES may well enjoys a relative cost advantage in the RTF, CHP and LIEU segments but that in all cases this is due to an apparent greater willingness to use secondary transmission capacity at the regulated transfer price. As such, it represents a different appetite (or ability) to manage the associated commercial risks. There is no evidence to support the allegation of cross-subsidy from the NDM sector, either in terms of capacity costs or gas commodity costs.

<u>Question A7.</u>

"Is competition in gas supply to larger I&C customers currently effective and/or sustainable? If not, under what circumstances would it be so?"

Responses included:

- that the market share data [for LIEU and CHP segments] is evidence for a lack of effective competition in these sectors
- that the departure of RWE from the unregulated I&C segment provides further evidence of that the I&C market remains relatively non-competitive
- that evidence of sustainable competition should take account of the business sector as a whole including the RTF and FVT
- that the gas commodity element of the floating-price FVT should be based on monthly ICE Index (rather than on the average of the last five days of M-1)
- that the CER should consider re-including CHP sites within the RTF
- that the RTF in its current format is effective
- that the inability of BGES RTF customers to avail of naturally occurring scale efficiencies and opportunities for flexible pricing arrangements means that competition is ineffective

Commission's view:

The Commission notes that RWE, prior its departure from the Irish gas market, successfully supplied gas to two customers in the Powergen sector, and had developed a substantial RTF portfolio. The company's departure was arguably attributable to factors unrelated to the status of supply competition in the wider I&C sector.

The Commission sees no justification for imposing RTF-type controls on BGES customers in the LIEU or CHP segment. However, it has identified a need for better verification of the CHP-status of RTF-eligible sites. The operation of the FVT may be reviewed as a separate exercise later in 2008.

Question A8.

"What would be the likely competitive impact of changes to the RTF regime?"

Responses included:

- that any such changes at this stage could have significant adverse effects, including the withdrawal of independent suppliers from the business sector and the discouragement of potential new entrants
- that BGES would utilise its portfolio of commodity and capacity bookings to offer discounts which other suppliers could not match
- that BGES's RTF market share would revert towards 100%
- that the competitive impact would be detrimental to the development of the retail gas market
- that all suppliers would reassess their competitive offerings to the benefit of customers

Commission's view:

The Commission expects that the proposed changes to RTF flexibility rules will enable BGES to halt, and possibly to reverse its declining share of the sector. However, in the absence of price discounts, the effect is unlikely to be sufficient to deter new or existing competitors.

Question A9.

"What permutations of RTF regime changes (if any) would improve the effectiveness of competition?"

Responses included:

- that direct action by CER would be required in respect of BGES market dominance, the accuracy of commodity cost pass-through and the distorting effect of K-factors
- that none of the changes suggested should be adopted
- that BGES should be allowed to offer group/flexible pricing and should be able to pass on capacity efficiency savings

Commission's view:

The reference to K-factors is primarily of relevance to NDM revenue regulated tariffs, which apply to sites below the FVT threshold. Although the elimination of such competition-distorting factors is an objective of the Commission, it lies out outside the scope of the RTF consultation.

Question A10.

“Over what timescale ought any changes be phased, and why?”

Responses included:

- that no changes should be envisaged at present, but that a periodic review of the scheme would ensure that it remains aligned to market conditions
- that the existing RTF principles should be applied in other sectors of the I&C market within 12 months, and they should ultimately be extended to the total gas market
- that in the current market environment, there is justification for making the changes immediately

Commission’s view:

The Commission has previously outlined why the RTF model (a forward-looking monthly pricing regime with no provision for recovery of unexpected trading losses) is not suitable for the majority of NDM customers.

Question A11.

“Would an amendment of the RTF regime promote greater innovation and better customer service by BGES and/or other suppliers? Why?”

Responses included:

- that the removal of the RTF regime before effective supply competition has fully developed would ultimately reduce rather than enhance the level of innovation and service being offered by BGES
- that an amendment of the RTF that allowed BGES to offer ‘one-off’ deals would lead to independents being squeezed out rather than to greater innovation or customer service
- that the effective re-introduction of a third competitive supplier (i.e. BGES) would be likely to increase innovation by all suppliers

Commission’s view:

The Commission notes that the gas commodity prices offered to all BGES’s monthly-billed I&C sites are very similar, being derived from the same ICE wholesale products. It is only the Transmission capacity charges (which constitute about 10% of the total bill) that are routinely discounted for CHP/LIEU sites. The Commission understands that some of these sites are offered flat gas with exposure to daily balancing charges, rather than a swing product. It may be that a withdrawal of the RTF would result in more widespread use of such offerings. Further research would be required to ascertain whether this would prevent other suppliers from offering innovative, flexible swing products, to the eventual detriment of customers. (This scenario was described by one respondent as a 'race to the bottom', claiming that that non-RTF sites currently experience no product innovation, a limited choice of products, and curtailed flexibility.)

<u>Question A12.</u>

"Please provide any additional comments related to competition in the larger I&C supply segment and/or the terms and conditions of the RTF."

Responses included:

- that BGES still enjoys significant advantages from its legacy position which are particularly relevant to the market risks inherent in serving smaller customers
- that such advantages include substitutability of hedging arrangements across customer classes (RTF, NDM I&C, NDM retail) allowing it to take greater risks in the knowledge that it will recoup any shortfall
- that some of the incumbent advantages could be addressed by providing better access to customer profiling data, and/or by the development of tailored network tariff products and imbalance arrangements geared to the independent supplier
- that the primary objective of the CER should be to promote competition and open up the entire gas market
- that the flexibility restrictions on BGES mean that it is effectively not a player in the RTF sector, and that customer prices are unnecessarily high as a consequence
- that the RTF rules do not allow customers to exercise their judgement in hedging of gas purchases, thereby resulting in inefficiency
- that real competition would result if the RTF regime were discontinued altogether; failing this, BGES should be allowed to offer much greater flexibility in both fixed and floating price contracts
- that international precedent supports the removal of all RTF restrictions at this stage

Commission's view:

BGES is not allowed to pass commercial risk from its unregulated customer portfolio to its regulated portfolio. Nor is it allowed to pass such risk between its regulated customer groups. Separate gas purchase books are maintained for each customer group, and any inter-book transactions must take place at prevailing spot market prices.

The promotion of *effective* competition is one of the Commission's statutory duties; however it is not an over-riding one and in any case it does not necessarily equate to the indefinite protection of competitors.

The Commission has taken note of various studies of gas market deregulation including the UK, New Zealand and Australia. In some cases, the model of deregulation is different. Nevertheless the Commission does agree in principle with some of the 'guidelines' for removal of energy price restraints as recently suggested by the UK Regulatory Policy Institute[9] in a study commissioned by the Australian Energy Markets Commission.

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[9] http://www.rpieurope.org/