

THE COMPETITION AUTHORITY



**Draft European Communities (Internal
Market in Electricity) Regulations, 2004**

**Submission to the Department of
Communications, Marine and
Natural Resources**

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PART A

1 INTRODUCTION

This is The Competition Authority's response to a Public Consultation by the Department of Communications, Marine and Natural Resources. The Consultation concerns the draft *European Communities (Internal Market in Electricity) Regulations, 2004* (the 'Draft'), intended to implement an EU Directive further liberalising electricity markets¹. The Authority welcomes this opportunity to comment on the Draft.

While the primary objective of the EU liberalisation programme is to integrate national energy markets, the value of liberalisation to consumers and businesses alike is the attendant increase in competition. Increased competition, in any market, is valuable because it incentivises firms to provide a better quality of service for their customers, to keep costs down and to innovate.

The Authority nonetheless recognises that, as with other sectors, policy needs to take account of non-economic factors. Electricity liberalisation is influenced not only by issues of competition, but also by legitimate concerns about security and continuity of supply, environmental considerations and questions of socio-economic equity. However, any necessary regulation should be proportionate, and have the least distortionary effect possible on the market.

A number of recent developments in the electricity market are to be welcomed as positive steps on the road to liberalisation and effective competition –

- The two planned 500MW Ireland-Wales interconnectors, constructed on a PPP basis, will bring a number of benefits.²
- The reduction of the eligibility threshold for customers to 0.1GWh last February, and full market opening in February 2005.
- The signing by the Minister for Communications, Marine and Natural Resources of a Memorandum of Understanding with his Northern Ireland counterpart. The Authority has consistently advocated the establishment of an all-Ireland energy market and applauds this initiative, which will facilitate further cross-border trade in electricity, and looks forward to the publication in October of the final All-Island Energy Market Development Framework

However, the Authority is concerned that a number of other issues are hindering the implementation of a fully-liberalised market. It is particularly concerned that the unsatisfactory separation of ESB and ESB National Grid (as well as the status of the Infrastructure Agreement), neither provides proper incentives in the market, nor addresses the issue of ESB dominance. Such a state of affairs is discouraging investment in the Irish electricity market.

¹ Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC.

² See, for instance, the Authority's paper presentation to the SMi Energy Conference of November 2003, available at www.tca.ie.

2 THE AUTHORITY'S POSITION

The Authority has identified a number of obstacles and issues which need to be addressed before an effective, fully-functioning, competitive electricity market can develop on the island of Ireland.³ The Authority's views on these issues have been mirrored by external independent bodies such as the OECD.

Vertical Separation

The Authority advocates the full vertical separation of the ESB into its component parts (generation, transmission, distribution and supply) in a legal, operational and commercial sense. In particular, the Authority argues that the separation of ownership of generation from transmission is the only form of separation that effectively eliminates the incentives and the ability to discriminate. Vertical integration has a chilling effect on the market as it acts as a disincentive to generation market entry and investment, due to concerns about the ability of the incumbent to discriminate in favour of its own generation and supply functions.

Structural Solution

The Authority reiterates its support for a structural, rather than a regulatory, approach to ESB dominance. A regulatory approach necessarily imposes a second-best solution on the market. Because regulation seeks only to mimic the best aspects of competition, mitigating the unwanted effects of market dominance by means of price control, direction or other compulsion, it can never be as effective as competition in ensuring efficiency. Market forces are the best means of aligning producer and consumer incentives.

The current regulatory system should be viewed as an interim step on the way to the phasing out of economic regulation. This system should be explicitly designated as temporary, and SMART⁴ goals should be set to move to a structural approach which would reduce significantly the need for regulation, while imposing market disciplines on the incumbent and introducing efficiencies to the market. Regulation undoubtedly has a role to play but, over the long term, this should be in non-economic areas such as quality and environmental regulation.

Interconnection

The Authority welcomes moves towards greater interconnection, and the attendant benefits which this will have for the Irish consumer, particularly in terms of increased security of supply. The Authority also welcomes the expanded role of the Commission for Energy Regulation ("CER") in the areas of interconnection, and urges that the highest priority be given to ensuring meaningful interconnection with Northern Ireland as a major step towards ensuring the viability of an all-Ireland market, as envisaged in the Ministerial Memorandum of Understanding.

Nevertheless, interconnection on its own will be insufficient to fully address the issue of ESB dominance. Unless the Irish market were to become fully integrated with the

³ See, for instance, the following Competition Authority submissions, available at www.tca.ie/submissions.html: "CA Response to CER/01/59: Transmission Infrastructure Agreement Principles Paper"; "CA response to CER's Draft Direction on the Infrastructure Agreement between ESB & Eirgrid"; "Submission to the Commission for Energy Regulation - A Regulatory Approach to ESB Dominance" and "Submission to the Commission for Energy Regulation - Strategy for the Management of ESB Dominance under the MAE".

⁴ SMART goals are **S**pecific, **M**easurable, **A**ttainable, **R**ealistic and **T**ime-bound.

UK market, the issue of ESB dominance in the market will not be fully mitigated by interconnection. Other structural remedies also need to be put in place, including horizontal separation of generating plant, divestment of mid-merit price-setting plant, vertical separation of the ESB, and strengthening the position of ESB National Grid.

Progress of liberalisation to date

So far, liberalisation of the electricity market has not delivered effective competition. Despite the best efforts of the CER and the Department, market entry has not occurred at a satisfactory level. Due to a combination of low incentives for market entry and concern about the ability of the incumbent to discriminate, only two large scale Independent Power Producers have entered the market, one of which is part-owned by ESB. The ESB therefore retains the overwhelming bulk of generating plant.

Investment in generation must be better incentivised for two key reasons: firstly, to increase the level of choice in the market, and secondly to increase the overall amount of generating stock, given the demand increases of 3-4% predicted in the ESB National Grid's most recent Generation Adequacy Report. Measures such as enhanced demand-side management and installation of ESB Power Generation Peaking Capacity Plant fail to adequately address this problem. The Authority has nonetheless welcomed the CER's Capacity 2005 competition and the plans for Ireland/Wales interconnection, which should partly alleviate the problem.

Liberalisation has also failed in the eligible supply market, specifically because one of the main avenues of access to power is the Virtual Independent Power Producer auctions. These auctions provide a second-best solution to real competition at generation level, and their usefulness is further clouded by the short-term nature of the contracts involved, and the participation of ESB IE in them.

Opportunity for the Department

The Department is now in the fortunate position of having the ability to meaningfully influence the way in which competition in the electricity market is fostered. The Authority would encourage the Department to implement regulations which encourage market entry, provide a greater choice to consumers, and create a level playing field on which everyone, including the incumbent, can compete aggressively and fairly.

3 INDEPENDENCE OF ESB NATIONAL GRID

3.1 Independence of ESB National Grid – why is it important?

The role of ESB National Grid in the electricity network is fundamental, being responsible for the coordination of delivery of electricity to the end user. Specifically, its role in coordinating the generation and dispatching of plant gives it great power in the electricity market. It is therefore necessary to ensure that true non-discriminatory access to the grid develops, as this is vital to the development of effective competition.

Only a truly independent Transmission System Operator will send the correct signals to potential market entrants that all generating plant will be treated equally, as the motivation for discriminating in favour of incumbent generators is removed by structural measures. Investment is therefore incentivised. Where the system operator remains linked to the incumbent power provider, this maintains a chilling effect on the market. Furthermore, the maintenance of the link will signal to the market and, more importantly, to potential market entrants, that the Government's commitment to full and fair competition is open to question.

Ensuring the independence of ESB National Grid, on the other hand, will increase the receptivity of the market to competition, leading to increased efficiency and consumer welfare, and stronger national competitiveness.⁵

3.2 Inadequacy of the current arrangement

The experience in Ireland to date indicates that the arrangements set out in current legislation⁶ do not work. Significant market entry has not occurred and prices to industrial customers remain higher than in other EU Member States. One of the principal reasons for the failure of the current approach is the way in which the relationship between the ESB and ESB National Grid was legislated for. Because responsibilities for design, construction and maintenance of the transmission network are divided between ESB National Grid and the ESB, the possibility exists for the latter to frustrate ESB National Grid in developing the network, in order to benefit itself, for instance by delaying preliminary work for procurement, detailed project design and specification, project construction or project review. Shared responsibility also allows the ESB to continue to heavily influence the availability of transmission circuits. This sends strongly negative signals to the investment community, whose enthusiasm for funding construction of generating plant may be curbed by potential discriminatory behaviour influencing their possibilities of access to the network.

The Infrastructure Agreement approach taken in SI 445 has not been effective in clearly delineating and apportioning responsibilities between ESB National Grid and the ESB. Indeed, the Agreement itself is flawed, as it does not unambiguously place responsibility for the transmission network on ESB National Grid. Even if the current Agreement were to be fully implemented, the ESB would still have a role to play in planning and construction of the network, giving a less than optimal solution.

So long as the current unsatisfactory arrangements persist, such that transmission asset ownership, operation and management are concentrated within a dominant incumbent with monopoly powers in key market sectors, the incentive for market entry is inhibited. Additionally, the ability of ESB National Grid to discharge its functions in an independent manner, so that non-discriminatory third-party access to the grid is ensured, is called into question.

In this regard, the Authority agrees fully with the CER that *"the mere presence of a dominant market participant may be enough to undermine the market, even if that*

⁵ A recent Eurostat survey showed that Ireland was the 3rd most expensive country of nine surveyed for industrial electricity prices - see NCC "Annual Competitiveness Report 2003" p.54, available at http://www.forfas.ie/ncc/reports/ncc_annual_03/webopt/ncc_annual_competitiveness_report_03.pdf.

⁶ Set out in the *Electricity Regulation Act, 1999* and the *European Communities (Internal Market in Electricity) Regulations, 2000*, S.I. 445 of 2000.

*dominant participant does not exercise its market power*⁷. Accordingly, on the grounds that even the perception of market power or its exercise can act as a barrier to entry, it would be prudent to ensure the complete and unfettered separation of ESB National Grid from ESB. Only when this has occurred can investors, consumers, regulators, government, potential entrants and other interested parties be assured that market mechanisms will operate freely, fairly and without prejudice to any market participants.

3.3 The EU Directive

The independence of ESB National Grid is currently provided for under regulation 9 of SI 445, while the Infrastructure Agreement is governed by regulation 8. The new EU Directive does not envisage the exact type of structure described in SI 445, but Article 10.2(c) of the Directive specifically demands the removal from integrated electricity undertakings of the type of powers granted to the ESB by Irish legislation:

"2. In order to ensure the independence of the transmission system operator referred to in paragraph 1, the following minimum criteria shall apply:.....

(c) the transmission system operator shall have effective decision-making rights, independent from the integrated electricity undertaking, with respect to assets necessary to operate, maintain or develop the network. It shall not permit the parent company to give instructions regarding day-to-day operations, nor with respect to individual decisions concerning the construction or upgrading of transmission lines, that do not exceed the terms of the approved financial plan, or any equivalent instrument"

At the very least, the new Regulations should ensure that the provisions stated here are enshrined in Irish law, such that *effective* decision-making rights rest with ESB National Grid. This is not the case at the moment, where decision-making rights are partial and encumbered.

The best means of complying with the independence principles of the Directive, however, is total, complete, unencumbered separation of the ESB and ESB National Grid, that is, going beyond the decision-making independence specified by the Directive, to full legal separation. Any other solution will be sub-optimal, not only because it will act as a disincentive to investment, due to concerns about discrimination and uncertainty in future, but also because it will require the imposition of an expensive, cumbersome and complex regulatory framework to enforce compliance, especially on the part of the ESB. Full separation of each party is a more efficient, streamlined solution which will incentivise investment, decrease the regulatory burden, and allow each party to concentrate wholeheartedly on its core competencies.

⁷ CER, "Strategy for the Management of ESB Dominance under the MAE", p.7. <http://www.cer.ie/cerdocs/cer04189.pdf>

4 CONCLUDING COMMENT

The Authority welcomes the publication of the draft Regulations, and trusts that its recommendations will be given due consideration by the Department. The new legislation represents a unique opportunity for the Department to resolve the Gordian knot of ESB National Grid/ESB entanglement, as well as the persistent problem of incumbent dominance. The regulatory and legislative regime has, to date, failed to address the structural problems which inhibit the development of real competition in the Irish electricity market. Therefore, structural change continues to be the best solution, and should be instituted by means of legislation.

The Authority would welcome the opportunity to discuss these recommendations with the Department in greater detail.

PART B

Detailed comments on the Draft

Functions of CER

1. Draft **regulation 3(a)(iii)** provides for a much enhanced role for the CER in terms of monitoring market activities, such as ensuring a high standard of protection for final customers. While this may be appropriate in the current climate of market dominance by the ESB, it should be recognised that this comes at an extra cost. Assuming that it is not envisaged that the State will have to bear the burden of this cost indefinitely, it may be prudent to include in this regulation a provision relating to the sunseting of regulatory provisions, in order to legislate for the effective time-bound removal of the regulatory burden as its usefulness and necessity diminishes.

In particular, draft **regulation 3(b) and (c), clauses 1B(c) and 1B(g)** provide that it shall be a function of the Commission to monitor "*the time taken by the transmission system operator and the distribution system operator to make connections and repairs*" and "*the extent to which the transmission system operator and the distribution system operator fulfil their functions in accordance with statutory requirements*". While this is wholly appropriate in light of the need to ensure non-discriminatory access to the grid, it must be borne in mind that the extent to which ESB National Grid will be able to effect speedy connections to the grid or generally fulfil its statutory obligations will be highly dependent on the ESB.

Draft **regulation 3(c)** refers to monitoring the "*level of transparency and competition*". This provision is vague and open to interpretation; provision should be made for the appropriate standards to use and their independent verification. The word "transparency" needs to be defined, and a provision included obliging the CER to consult formally with The Competition Authority on the method of monitoring competition.

The need to refer to "*reasonable*" prices in draft **regulation 3(d)(iii)** appears questionable, in view of the vagueness of the term. Price regulation may be justified where firms have excessive market power and in such circumstances prices should reflect costs of production and allow for a specified rate of return on assets. The word "*reasonable*" should therefore be deleted, or clarified in order to specify more exactly the parameters under which price regulation would be implemented.

The Transmission System Operator

2. Draft **regulation 7(2)(b)** provides that

"The requirements considered necessary by the transmission system operator in subparagraph (a) may relate to minimum standards for the maintenance and development of the transmission system, including interconnection capacity."

This provision should be reworded to remove any possible misconception that the powers granted to ESB National Grid in regulation 7(2)(a) are being circumscribed or restricted in scope here. Otherwise, there is a danger that the provision could be read as restricting further the independence of ESB National Grid.

3. Draft **regulation 8** provides for the establishment of a compliance programme by ESB National Grid, and reporting procedures to the CER. In particular, the programme is required to set out:

"(i) the measures taken to ensure that discriminatory conduct by it or its employees is prevented;

(ii) the specific obligations imposed on employees to ensure that discriminatory conduct is prevented"

The Department should considering requiring the ESB to abide by a Compliance Programme along with ESB National Grid, particularly given that it is the ESB which has the potential ability to frustrate the work of ESB National Grid under the current scenario where responsibilities are divided. The Authority notes, nonetheless, that this may be a double-edged sword, and that opportunities for obfuscation also arise on the part of ESB National Grid, if it can simply blame the ESB for any malfeasance. Even so, if the ESB is subject to a less stringent compliance regime than ESB National Grid, a lacuna in regulatory oversight will be created.

Authorisations for generating stations

4. In draft **regulation 13**, there may be a benefit in specifying that authorisations should be retrospectively given to each existing generation unit, such that they were authorised simply as a stand-alone generation station, and not as part of ESB Power Generation's generating plant portfolio. This would have the effect of reducing the possible administrative burdens involved in re-licensing generation plant in future, upon horizontal separation of ESB generating plant.

The drafting in draft **regulation 14(c)** should be more narrowly focused and defined, for the purposes of increasing clarity and avoiding doubt.

In the interests of promoting competition, it would be useful in draft **regulation 15(a)** to add a further criterion after criterion (i) relating to the promotion of competition. Other criteria refer to security of supply and efficiency, but there is nothing to indicate that new generating plant should be constructed in the interests of fostering competition.

Licences

5. With respect to the proposed amendment in draft **regulation 16(e)**, the Authority suggests that generating stations be licensed in their own name, and not as constituent parts of ESB Power Generation's generating portfolio, in order to reduce the possible administrative burdens involved in re-licensing generation plant in future, upon vertical separation of ESB generating plant (see comment above re draft regulation 13).

Public Service Obligations and consumer protection

6. The need to refer to "*reasonable*" prices in draft **regulation 25(3)(a)** is questionable, for the same reasons noted above with respect to draft regulation 3(d)(iii).

In a similar vein, in draft **regulation 25(3)(g)**, the words "*unfair*" and "*or predatory*" should be deleted. Given that "*unfair*" and "*predatory*" are such nebulous terms, there are legitimate concerns that this provision could, despite best intentions, be used by incumbent suppliers to frustrate or delay the switching process by alleging such practices by incoming suppliers. In particular, given the difficulty of proving predatory pricing, switching could be delayed interminably pending investigation of complaints.

The provision in draft **regulation 25(3)(h)** for free customer switching is welcome, but it could be expanded to include a Switching Code, perhaps as a part of the Customer Charter, outlining the responsibilities of relevant parties, timescales, and avenues of redress, should the code be breached. While switching might not be such a significant competitive issue for large users of electricity, customer inertia among small consumers is likely to be more pronounced. When the supply market is fully opened in February 2005, this will be an important factor, and everything possible should be done to facilitate effortless switching and market transparency.

Security of supply

7. Competitive tenders should be asymmetrically regulated, such that the ESB is excluded from such tenders until such time as its market power has been addressed, in order to encourage new generating plant providers.

The reasoning behind draft **regulation 30(6)(b)** is unclear and needs elaboration.

The import of draft **regulation 30(7)** may be to bias any competitive tender in favour of incumbents, noting in particular the inclusion of the word "*existing*". Given the benefits of incentivising new generation from diverse sources, the Authority would question whether this apparent bias in the legislation is advisable.

The Infrastructure Agreement

8. With respect to the provisions concerning the Infrastructure Agreement detailed in draft **regulation 38(10)(a) and (b)**, the proposed wording is, in all substantive respects, identical to the wording in SI 445 of 2000.

Two points arise. Firstly, the Agreement may need rewording to strengthen the position of ESB National Grid vis-à-vis the ESB, and secondly, a date should be specified in the legislation as the effective implementation date for the coming into being of the Agreement.

The Authority has in the past set out in detail its view that the Agreement does not resolve the issues relating to ESB National Grid independence;⁸ it reiterates here that regulation of the ESB National Grid/ESB relationship via an Infrastructure Agreement has been ineffective. Despite the assembled evidence, the new Regulations seek to impose the self-same “solution” on the market, where it is clear that a new, structural solution is required, i.e. the full separation of ESB National Grid and ESB.

⁸ CA response to CER's Draft Direction on the Infrastructure Agreement between ESB & Eirgrid at www.tca.ie