

COMPETITION AUTHORITY



Submission to the Commission for Energy Regulation – Irish Electricity Trading Arrangements Second Options Paper

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1 INTRODUCTION

The Commission for Energy Regulation (the ‘CER’) is currently undertaking a review of the electricity trading arrangements in Ireland. The review will result in a set of trading arrangements that will apply to a fully opened electricity market. At this stage, the CER has expressed a preference for a set of high-level principles which are presented in a second CER consultation document on the issue – *Irish Electricity Trading Arrangements Second Options Paper*. This submission is the Competition Authority’s (the ‘Authority’) response to the CER consultation paper.

We acknowledge that the CER has broadened the scope of the current review and have invited comments on preferred options for dealing with the ESB’s dominance, including options for structural reform. The Authority welcomes this development and strongly supports the CER in its efforts in this regard.

The remainder of this submission briefly outlines the Authority’s position regarding the reform of electricity trading arrangements, but particularly with regard to meaningful structural reform of the sector.

2 THE CER’S PREFERRED MODEL

The Authority generally concurs with the CER’s preferred model for the new trading arrangements, i.e. the centralised or integrated market design. From a competition perspective, the proposed model has a number of distinct advantages over other potential models. These are:

- **Market Liquidity** – Since trades are done through the spot market, independent generators can find an outlet for their power without having to find specific customers. In past reviews and studies of barriers to entry in generation, this market liquidity issue was identified as extremely important.
- **Market Transparency and Price Signals** – Under a system of bilateral contracts no price information is created. The effect is two-fold. First, since generators in this model only supplied volume information to the system operator, the acceptance of contracts is not based on order of merit. The second effect is that price signals are

not created with the effect that the market can not respond appropriately. An additional advantage afforded by the transparent nature of spot markets is that it should make any problems associated with the exercise of market power apparent.

- **Locational Marginal Pricing (LMP)** – LMP is recognised as a core feature of the integrated market model preferred by the CER. Locational marginal pricing can provide good signals to potential entrants on where best to locate new generation plant. It also gives good signals to large energy consumers (e.g. web farms and other industrial consumers) on where best to locate and withdraw energy from the transmission system. LMP would also provide signals to the system operator on where transmission system upgrades are required and for congestion management.
- **Transmission Usage Charges (TUCs) and Financial Transmission Rights (FTRs)** – In a recent Forfás report on Energy issues in Ireland¹, the preferred electricity model is the Standard Market Design model, which appears to be similar in some respects to the CER's preferred option. However, according to the Forfás report, the three core concepts of the SMD Model are LMP, TUC and FTR. These tools may merit consideration for use in the Irish context.

3 STRUCTURAL REFORM

3.1 The Authority's View of a First Best Solution

As stated in previous submissions², the Authority's opinion of the current electricity trading arrangements review is that it is a step in the right direction, but that unless the dominance of the ESB is addressed in a meaningful way, then the result of the review can only be a second best solution. Entry on its own cannot be relied upon to deliver competition within an acceptable time frame, nor can contracting or other market mechanisms be expected to fully control the ESB's dominance. In the Authority's view, a first best solution can only be attained if the ESB is both horizontally and vertically restructured, specifically:

¹ A Review of the Energy Market in Ireland, Forfás 2003.

² See Competition Authority Document S/02/005 – Competition Authority submission to the Department of Communications, Marine and Natural Resources re draft Electricity Bill 2002.

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- Vertical separation of the ESB into its component parts, i.e. full legal and operational unbundling of generation, transmission, distribution and supply;
 - Horizontal separation of ESB's generating capacity into a number of competing units ('baby ESBs'); and
 - Transfer of ownership of the transmission assets to Eirgrid along with a strengthening of its position.

It would be incorrect to assume that the Authority regards the implementation of structural reform as either a simple or straightforward matter. We fully appreciate that the details of the process, both practical and theoretical, are important. In this regard, we suggest that the CER undertake, or at least advocate, an in-depth study of the feasibility of this option.

3.2 Privatisation -v- Retained Public Ownership

The Authority has stated in the past that it has no opinion on the issue of private versus public ownership.

However, economic theory indicates that the more concentrated ownership is within a sector, the less rivalry there will be, other things being equal. Should the Minister for Communications, Marine and Natural Resources, along with the Minister for Finance, remain the sole shareholders of the 'baby' ESBs, ownership would indeed remain concentrated and the theory therefore indicates that rivalry would be weak.

However, in New Zealand, which has a similar population and market size to Ireland, the incumbent generator was split in three and the new State-owned 'baby' firms compete quite vigorously. A change in New Zealand competition law was required so that the baby generators could be treated as separate undertakings even though they were under common ownership. In Ireland, this measure would not be required; the same effect could be achieved by requiring the baby ESBs to give an undertaking to the Courts that they would abide by competition law as if they had diverse ownership.

3.3 Efficient Exit

When structural reform is undertaken, it is important the exit conditions are appropriate. The following extract from Hunt (2002)³ makes this point:

“New competitive markets, wherever they have been set up, often have some existing plants that are uneconomic – too costly to run even if the sunk costs are disregarded – because they burn fuel inefficiently or are constantly breaking down. These plants should be closed, but sometimes regulators step in and keep them open to ensure reliability. This prevents new entrants offering cheaper power and increasing diversity of ownership.”

Given the high average age of ESB generating plant, this issue is likely to arise in the short-term. The Authority’s view is that efficient exit should be allowed to occur.

4 CENTRAL TRADER OPTION -V- REGULATORY OPTION – SECOND BEST SOLUTIONS

The Authority’s view on the choice of Central Trader or Regulatory Option is based on the principle that such a choice would be an interim solution only. As such, the choice of solution would be based on whichever model is most suitable for the transition period only.

Briefly, under the Central Trader model, a new entity would be created, called the ‘Central Trader’, that would act as a counterpart to hedge contracts with generators on the one hand and supply companies on the other. The idea is that by imposing contracts on the ESB, its market power would be controlled.⁴ Under the regulatory model, the ESB’s behaviour would be controlled via the licensing regime.

On the basis of the detail provided in the CER consultation document, we make the following points:

³ Hunt, Sally, *Making Competition Work in Electricity*, John Wiley and Son, Inc. 2002.

⁴ It is worth bearing in mind the experience of the Northern Ireland electricity sector in this regard. In particular, the lesson learned there is that it is important that not too great a proportion of contracts are long-term. The conventional wisdom on the issue puts the correct proportion of long-term contracts between 75-80%.

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- Under the Central Trader model, the economic link between ESB Power Generation (ESB PG) and ESB Public Electricity Supply (ESB PES) would be broken. Though this is not a full legal separation, it is one step closer to a meaningful vertical separation. The regulatory option would not break the economic link between ESB PG and ESB PES (they would still have hedge contracts) and would rely instead on a requirement to deal with supply companies on a non-discriminatory basis. However, since the economic links between ESB PG and ESB PES would remain intact, the ESB would retain both the incentive and ability to engage in affiliate exploitation of PES.
 - Under both models regulatory intervention is heavy. With the Central Trader option, the CER would impose contracts (all terms, including prices, set by the CER) on ESB PG's generating units and ESB PES for the bulk of capacity (thus limiting market power). Any remaining capacity would be traded through the spot market – thus, meaningful price information and therefore good signals would be produced.
 - Under the Regulatory Option, ESB PG's generating units would keep separate accounts and incentive regulation would be employed to induce efficiency. A spot market would still operate and price information and signals produced. It is not clear from the CER consultation document whether the price information produced under this option would be superior or inferior to the information produced under the Central Trader option.
 - Under both models, the CER must rely, to some extent, on information provided by the dominant incumbent. Based on the details provided in the consultation paper, it is difficult to determine how incentives to supply misleading information are affected.

Finally, the ease with which the regulator can extract itself from market operations is another dimension that should be considered when assessing which of the options to choose. Moreover, whichever option is chosen, it is important that *sunsetting* provisions are allowed for. From the details presented in the consultation document it appears that it might be easier to *sunset* the Central Trader arrangement.

5 INSTITUTIONAL ARRANGEMENTS – INDUSTRY PARTICIPATION

Section 4.8.5 of the CER consultation paper deals with industry and consumer participation in the regulatory process. The Authority has some concerns in this regard and has commented publicly on similar matters in different contexts. The following quote from the Authority's submission to the Department of Finance Working Group on the Strategic Review of the Future of Irish Banking is prescient in this regard:⁵

“Regulation should minimise, rather than create, opportunities for anti-competitive behaviour. For example, regulatory rules should not require or encourage the sharing of information between competitors, or give blanket approval to arrangements jointly proposed by competitors.”

In general, the Authority's main concern in relation to industry participation in the regulatory process is that:

- A mechanism may be provided whereby competitors will be encouraged to form a common view in cases where consumer welfare is better served if each responds individually; and
- A mechanism may be provided whereby the industry might capture the regulatory process.

We would like to make a number of recommendations relating primarily to transparency of procedure and function. As a principle, industry participation in the regulatory process, in whatever context, should be kept to a minimum. However, good regulatory practice necessarily involves a degree of industry participation, usually in the form of regular, open consultation where interested parties, including industry players, may make a contribution to the regulatory process. The Authority's view is that any additional structures that enable the regulated industry to have formal input into the regulatory process need to be justified. The Authority accepts however, that such circumstances sometimes exist.

⁵ See Competition Authority Document S/02/004 – Competition Authority submission to the Department of Finance re legislation relating to *Irish Financial Services Regulatory Authority*.

In the event that additional formal structures for industry participation in the regulatory process are deemed appropriate, the Authority recommends:

- Narrow prescription of functions – the functions of any industry board should be defined clearly and narrowly. It is not appropriate to allow competitors latitude in relation to the matters they may discuss.
- Transparent procedures – the procedures of an industry board should be as open as possible. For instance, the minutes of board meetings, all documents produced by, or for, the board, as well as any proposals being made by the board to the CER should be published (possibly on the CER website).
- Composition – the composition of any industry board should also be clearly prescribed.
- Competition Act 2002 – board members should be required to give a special undertaking that, in the course carrying out their duties on the board, they will not breach the Competition Act, 2002.

Finally, formal consumer participation in regulatory process is appropriate, if only to act as a countervailing force to industry interests. However, it may be difficult to ensure effective consumer representation. Industry players are generally a focussed and well-resourced group, skilled in representing their own needs and interests. In contrast, consumers are generally a diffuse and amorphous group lacking the necessary information and expertise to represent themselves effectively. Accordingly, to ensure meaningful consumer representation in the regulatory process, sufficient financial resources should be made available.

6 GENERATION ADEQUACY

It is now well accepted that the current interim trading arrangements and market structure have not been conducive to entry into the market for generation. The implication has been that the CER has had to become pro-active in encouraging entry and investment in the sector.

Section 5.2 of the CER consultation paper raises some generation adequacy issues for discussion and presents a number of ‘safety net’ options. The Authority’s view is that

once the new trading arrangements are in operation and the dominance of the ESB has been addressed, the need for a safety net will be much diminished, if not completely removed.

The Authority would however, make the following point with regard to moral hazard. The principal danger when providing a safety net facility is that the market may come to rely upon it. Specifically, it may prove profitable for a potential entrant to wait until safety net mechanisms have been triggered so that they may gain entry to market without having to assume the *usual* risks. Should a safety net prove necessary, it is important that it allow for this. For example, it may be appropriate to adjust the rate of return accruing the owners of a 'safety net plant' to compensate for the reduced risk they have assumed.

The CER present three safety net options:

- The Default buyer;
- Development Incentive Option; and
- The SMO builds generation plant option.

The Authority favours the third option on the grounds that the SMO would be far better placed to react quickly, most likely in less than half the time of anyone else.

7 CONCLUDING COMMENTS

The Authority welcomes the increased willingness of the CER to consider, in a formal manner, structural reform of the electricity sector, including horizontal and vertical separation of the super dominant incumbent. In this regard, the Authority encourages the CER to further investigate this line of action and undertake a comprehensive feasibility study.

The Authority views the current review of the electricity trading arrangements as a necessary step toward the development of competition and broadly concurs with the CER's preferred model for new trading arrangements.

The Authority remains available for further discussion of the issues raised in this submission, or any other competition related issues.