

COMPETITION AUTHORITY



**Submission to the Commission for Energy
Regulation –
A Regulatory Approach to ESB Dominance**

Submission No.: S/04/001

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1 INTRODUCTION

The Commission for Energy Regulation ('the CER') has published a consultation paper on the issue of ESB dominance in the Irish electricity market and the measures that could be taken to mitigate the effects. It has also published for comment a paper it requested from the ESB on the subject.

The CER accepts that the generally recognised approach to market dominance is structural disaggregation of the dominant entity. It also accepts that such a comprehensive structural approach would, if applied in Ireland, largely (but not completely) address ESB's market dominance. However, it then puts forward a number of reasons why such an approach would not be optimal for Ireland.

This short response is limited in scope to comments on the CER's decision not to pursue a structural solution at this time. It does not comment on the specifics of any regulatory regime.

2 STRUCTURAL SOLUTION WIDELY ADVOCATED

In the Competition Authority's view, a comprehensive structural solution involving vertical and horizontal elements is required if the benefits of market liberalisation are to be realised.

Vertical separation of the ESB

A variety of reports have identified the dominance of the ESB, and the potential for discrimination as a result of its vertically integrated position, as significant obstacles to the development of effective competition in the electricity sector.¹ The Authority supports these conclusions and has advocated the full vertical separation of the ESB into its component parts (generation, transmission & distribution and supply) in a legal,

¹ See for example, "Final Report on North/South Energy Studies to the Northern Ireland Department of Enterprise, Trade and Investment and the Republic of Ireland Department of Public Enterprise", IPA Consulting, PB Power Ltd., Energy Links Consultancy, 2001. See also "Issues Facing those Considering Investing in the Irish Electricity Market", NCB Corporate Finance for the CER, 2002 and "Regulatory Reform in Ireland", OECD, 2000.

operational and commercial sense.² In particular, the Authority has advocated the separation of ownership of generation from transmission as the only form of separation that effectively eliminates the incentives – and ability – to discriminate. This aspect of structural reform is of no less importance in light of the proposed East/West interconnection.

Horizontal separation of generation

The Authority has suggested a number of options for addressing the dominance of the ESB in generation. First, the costs and benefits of splitting up the ESB's generation concern should be investigated. Second, a requirement on the ESB to divest some of its mid-merit price-setting plant should be considered. Third, the Authority has indicated support, as a second best solution, for the ESRI suggestion that tendered plant management might be appropriate.³ This approach would involve the tendering of plant management on a competitive basis.

3 WHY NOT PURSUE THE STRUCTURAL SOLUTION?

The CER notes several factors that, in its view, make a structural solution less than optimal in Ireland.

First, the CER does not *itself* have the authority to order structural changes. What is important, however, is the efficacy of a structural solution were such a solution implemented. Legislation would be required to enable the implementation of a comprehensive structural solution. This should not however be regarded as an insurmountable obstacle, or mean that the option should not be thoroughly explored.

The CER also notes that a structural solution would take extensive time to implement and would not be completed by the time of market opening. In the Authority's view, this is not a valid reason for not pursuing or recommending such an option. It would be preferable to begin implementing a structural solution as soon as possible and have a

² See for example Competition Authority Submission S/03/002, "Submission to the Commission for Energy Regulation - Irish Electricity Trading Arrangements Second Options Paper" and Competition Authority Submission S/02/005, "Submission to Department of Communications, Marine and Natural Resources on the Draft Electricity Bill 2002".

³ Fitzgerald, J. (2002), "The Irish Energy market – Putting the Consumer First", ESRI Working Paper No. 145, Dublin.

regulatory regime as an interim solution only. The later this reform commences, the longer before consumers and business will benefit from fuller competition and the longer that expensive and sub optimal behavioral regulation will be required.

The third reason cited by the CER for not pursuing a structural solution is that because the size of ESB generation plant relative to the size of the Irish market is large, even a horizontal break-up of ESB would still leave some plants with market power. While this may be true, such mitigated market power would be much less of a concern than the extensive market power that ESB currently has and, importantly, would require much less burdensome and costly regulatory oversight. In addition, a comprehensive structural solution, as outlined above, would involve more than a horizontal break-up of the ESB's generating plant – it should also include a vertical split of generation, transmission & distribution and supply.

The CER does note that a regulatory approach would necessarily be a less than perfect substitute for a comprehensive structural approach. However if, as the CER argues, a structural solution would be less than optimal for Ireland, it follows that a regulatory solution would be even *less* optimal.

4 REGULATORY V. STRUCTURAL APPROACH

The CER consultation paper sets out the advantages and disadvantages of a regulatory approach to addressing the dominance of the ESB. As already mentioned, the advantages and disadvantages of a structural approach are not outlined.

While the task of regulating a vertically integrated firm with market power at every stage of production should not be underestimated, one advantage of the purely regulatory approach is that it would be certainly faster and easier to implement, not least because it may be seen as a more palatable option to industry vested interests. The latter is given weight by the ESB's willingness to produce a paper for the CER about how it thinks it should be regulated, particularly as the ESB's claims (in its own paper) about its future predicted market share are not tested or challenged. As a matter of public policy, it seems inappropriate that this kind of consideration should sway the direction of policy, particularly in a sector as important in the long term as the electricity sector is to both consumers and business alike.

While a purely regulatory approach would of course allow the CER mechanisms to control the ESB, the need for this would clearly be less if a comprehensive structural solution were pursued – in the latter case, the market would impose the requisite discipline over the ESB.

The CER notes that one of the disadvantages of the regulatory approach is that it would create additional long-term demands for the CER that would require additional resources and impose increased costs. Conversely, however, a structural approach, while being initially costly, would not require additional long term resources to be allocated to the CER and would ultimately result in efficiency gains within the industry. Importantly, a comprehensive structural solution, resulting in increased competition in the sector, would ensure that efficiency gains are passed on to consumers.

5 CONCLUSION

The Authority recommends that an investigation should be undertaken (if necessary by external consultants) of the costs and benefits associated with each potential aspect of structural reform, including (but not necessarily limited to) those outlined above, with a view to advising policy-makers on the fullest possible range of options for the future development of the electricity market in Ireland. Furthermore, such an analysis should include a Regulatory Impact Assessment of a regulatory solution under different market outcomes.

Finally, while the ESB's contribution to the appropriate way that it should be regulated is undoubtedly valuable and indeed necessary, it is nevertheless the Authority's view that the CER should be leading the way forward with its own independent set of proposals.