

THE COMPETITION AUTHORITY



Submission to the Commission for Energy Regulation – Strategy for the Management of ESB Dominance under the MAE

Submission No: S/04/002

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1. Introduction

The Competition Authority is grateful for the opportunity to comment on the CER's proposals for the management of ESB dominance. The Authority is mindful of the importance of this issue not just for the energy sector, but, *a fortiori*, for the economy and Irish competitiveness as a whole.

The Authority's comments follow on from those originally submitted to the CER last February in its consultation on *A Regulatory Approach to ESB Dominance*.

This short response is limited in scope and addresses itself to the overall regulatory approach taken to ESB dominance, rather than to each of the specific points enumerated in the consultation paper.

2. The CER Approach to Dominance

The CER is rightly mindful of the detrimental effects of ESB dominance, and this consultation represents a worthwhile and valuable addition to the policy debate in this field. The Authority welcomes, in particular, the focus on the ramifications of dominance for market entry and new entrants. The Authority also notes the recent statement of the Minister for Communications, Marine and Natural Resources to the Joint Oireachtas Committee on Communications, Marine and Natural Resources that "*ESB's presence in the market as a fully-integrated utility is seen by some stakeholders as an inhibitor to the development of a fully-liberalised market*".¹

However, the Authority considers that the set of solutions advanced by the CER to grapple with this problem represents a second-best, or even third-

¹ Joint Committee on Communications, the Marine and Natural Resources, March 10th, 2004, <http://www.oireachtas.ie/documents/committees29thdail/jcmnr/jcmnr100304.rtf>.



best, scenario.² Regulation, by definition, can only mimic the best attributes of competition, and in so doing, can only partially realise the benefits which accrue from competition, in this case at the power generation and supply stages.

The consultation paper frequently speaks of initiatives designed to “mimic the likely behaviour” of an entity in a competitive market. The Authority believes that this is the crux of the matter, and that, where feasible, non-regulatory mechanisms should be introduced, in this case by the complete vertical and horizontal separation of the ESB. Excluding consideration of structural measures runs the risk of ignoring a pro-competitive and relatively straightforward solution to the problems of dominance.

This entails:

- Vertical separation of the generation, transmission and distribution, and supply components into separately owned, managed and operated entities; this would involve complete legal, managerial and operational independence of EirGrid from the ESB, and
- Horizontal separation of ESB generation assets to encourage competitive outcomes in power generation.

3. Separation of EirGrid from the ESB

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 EirGrid to discharge its functions in an independent manner, so that non-discriminatory third-party access to the grid is ensured, is called into question.

² See, for instance, The Competition Authority’s *Submission to the CER – A Regulatory Approach to ESB Dominance* at www.tca.ie



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 dominant participant does not exercise its market power"*. 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 EirGrid 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. It is noteworthy that a number of Members of the Joint Oireachtas Committee on Communications, Marine and Natural Resources recently called for further separation of EirGrid and the ESB.³

Separation also means ending the current tenuous division of ownership and operational responsibilities between two entities with ostensibly differing business objectives and strategies. At present, new legislation is being prepared to implement Directive 2003/54/EC concerning common rules for the internal market in electricity. A number of parties have raised with the CER their concern that the ESB, by virtue of its monopoly over construction and maintenance of the grid, has the potential to influence prices under the proposed new market trading arrangements to the benefit of its own generating units. In addition to this avenue of potential influence, the ESB also has an incentive to influence entry to the market in a more direct manner, for instance by delaying the construction of grid connections.

Article 10 (2) (c) of Directive 2003/54/EC states that *'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.'* Furthermore, the parent company must approve an annual financial plan of the transmission system operator and may set global limits on the level of indebtedness of the subsidiary TSO. This *'shall not permit the parent company to give instructions regarding the day-to-day operations, nor with respect to*

³ See footnote 1.



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.'

The Authority's preferred solution has been that ESB and EirGrid should be separated in every sense and that transmission system assets should be transferred to EirGrid. In the interim, the Authority recommends that the infrastructure agreement should be drafted such that EirGrid has maximum control over the grid. The Authority's view of the proposed infrastructure agreement, however, is that the proposed contractual terms are weighted heavily toward the ESB rather than EirGrid. The result of this would be to inhibit entry into the generation market by creating an unnecessarily high level of transaction costs.

The Authority shares the view of the Minister for Communications, Marine and Natural Resources that reintegrating EirGrid back into the ESB would send a negative signal to the market.⁴

4. A Structural Approach

The Authority reiterates its support for a structural, rather than a regulatory, approach to ESB dominance. In the interim, a regulatory system may need to be implemented, but this system should be explicitly designated as temporary, and specific, achievable goals should be set to move to a structural approach which would reduce significantly the need for regulation. This approach also removes regulatory risk, over-regulation and the perceptions of regulatory capture, while imposing market disciplines on the incumbent and introducing efficiencies to the market.

The Authority agrees with the CER that a centralised offer submission agency and management function operated by the dominant generator could constitute a barrier to entry. Although ostensibly, efficiency gains could

⁴ *ibid.*



accrue from the ESB operating a central offer management function, those gains would be far outweighed by the disadvantages engendered, specifically the possibility of gaming or discriminatory behaviour by ESB PG in those areas in which it has discretion, and also the perception of market power created, whereby potential entrants would be disinclined to enter the market.

5. Horizontal separation of generation

The Authority welcomes the statement that the *"general objective of the Commission's overall strategy is to ensure that each ESB PG station is incentivised to act commercially in the market place"*; however it reiterates its suggestions for addressing the ESB's dominance in generation, viz:

- a. Assess the costs and benefits of splitting up ESB generation
- b. Require the ESB to divest some of its mid-merit price-setting plant
- c. The Authority has already indicated its support, as a second-best solution, for the ESRI's proposal on tendered plant management.

Competition in power generation can only be adequately ensured by a horizontal restructuring of ESB's generation concern. Competition will help to engender the cost and operational efficiencies which lead to better, market-led, outcomes. Second-best solutions which seek to imitate these effects can only be partially successful. Where a first best solution is available, such a solution should be advocated.

6. Conclusion

The Authority welcomes the Minister's conclusion that other initiatives, aside from regulation, need to be considered in order to address concerns about dominance. The Authority again recommends that an investigation be undertaken of the costs and benefits of each aspect of structural reform in order to provide a wide range of policy options for the development of the electricity market in Ireland. Following the precepts established in the Government White Paper: *Regulating Better*, a series of regulatory impact analyses should also be carried out under different market outcomes.