A SUBMISSION TO THE COMMISSION FOR ENERGY REGULATION CONSULTATION PAPER, *REVIEW OF NON DAILY METERED RETAIL GAS MARKET*, CER 12/164

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Introduction

The Commission of Energy Regulation (CER or Commission) is seeking comments on its review of the state of competition in the domestic retail or residential gas market to determine if the *ex ante* retail price regulation that applies to BG Energy can be removed (CER, 2012). There are good reasons why, where possible, market forces should set prices rather regulators. In our response to the CER's earlier proposals for the removal of *ex ante* retail price controls in electricity we set out these reasons, which need not be rehearsed here.[1]

The CER review draws on previously developed Commission (2010, 2011) methodology for designing a roadmap for deregulation of *ex ante* retail price controls on BG Energy, while updating the findings based on that methodology. While the roadmap set out the conditions that the CER considered had to be satisfied in order for deregulation to take place, the Commission decided in 2011 that was "prudent to await future developments … before making any final decision" concerning deregulation (CER, 2011, p. 4). In the current review subsequent developments are outlined, but the CER concludes, notwithstanding these developments, that "some form of *ex ante* price control remains necessary" (*ibid*, p. 4).

We are pleased to comment on the consultation questions that are posed in the Commission's review relating to issues such as market definition, switching, bundling (i.e. dual fuel offerings), barriers to entry and branding. In our response we follow the question order suggested by the CER. This follows a standard competition assessment procedure starting with market definition, before moving onto barriers to entry. There is a presumption by the CER that once four conditions, which are largely structural, are met that the market is competitive. However, the CER in its review does pay attention to some measures of performance such as the extent of price competition.

Market Definition

The purpose of market definition is set out in the European Commission's (EC) Commission *Notice on the Definition of the Relevant Market of the Purposes of Community Competition*[2] *Law*,

> 2. Market definition is a tool to identify and define the boundaries of competition between firms. It serves to establish the framework within which competition policy is applied by the Commission. The main purpose of market definition is to identify in a systematic way the competitive constraints that the undertakings involved face. The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure. It is from this perspective that the market definition makes it possible inter alia to calculate market shares that would convey meaningful information regarding market power for the purposes of assessing dominance … .

Thus the correct market definition underlies the subsequent competition assessment in terms of estimating market shares, barriers to entry and so on.

[1] See Gorecki *et al* (2010, pp. 1-2).
[2] EC (1997).

The CER considers that the appropriate product market is the retail supply of natural gas to non daily metered residential customers (retail or residential supply of natural gas), while the relevant geographic market is Ireland. In reaching this conclusion the CER applies the standard competition assessment approach to market definition: the Small but Significant Non-transitory Increase in Price (SSNIP). Under this test if a hypothetical monopolist of a product or service can profitably raise price by 5 to 10 per cent above the competitive level then the product or service is a separate market. Typically the smallest subset of products is selected and then added to if the SSNIP test is not met.

The CER applies the SNNIP test noting on the demand side the non-trivial costs and difficulties of consumers switching to substitutes such as electricity from gas and on the supply side the investment and other costs of a supplier of electricity also supplying gas to residential customers. What the CER fails to consider is the degree to which there is a wider gas market. More specifically the degree to which suppliers of gas to fuel variation tariff customers and to non daily metered industrial and commercial customers could switch to supply non daily metered residential customers. In the earlier CER (2010, p. 22) consultation paper reference is made to these different gas market sectors, but the issue of this aspect of supply side substitutability does not seem to have been addressed in the CER review.

The CER also raises the issue of whether or not there is a separate market for gas and electricity, bundled together, at the retail level. Consideration of this dual fuel market reflects the fact that "just under 50% of customers now purchase gas and electricity from the same supplier" (CER, 2012, p. 14). To address whether or not there is a separate dual fuel market the SNNIP test has to be applied. Recall that the test is applied to the smallest subset of products and only gradually expanded if the smallest subset does not form a separate market. However, if one has already concluded that the supply of gas to residential customers is a separate market, there are no grounds for expanding the market definition. Nevertheless, abstracting from this, the CER rightly point out if a hypothetical monopolist of the dual fuel product raised the price by 5 to 10 per cent then consumers could unpick the bundle by sourcing each from separate suppliers, thus implying that the hypothetical monopolist would not be able to profitably raise the price of the dual fuel product.

Competition Assessment

Competition assessment usually starts with discussion of the size distribution of firms before moving onto barriers to entry and expansion. The latter may reinforce or soften any conclusions drawn concerning market power from the presence of a firm with a large market share.

Market Share: Is BG Energy Dominant?

The CER (2012, p. 21) considers that the BG Energy's share of the residential gas market at 70 per cent in 2012 is presumptive of dominance, pending the examination of other factors. Dominance means that a firm has market power and so is able to profitably raise price above the competitive level. European competition law has established various market share thresholds in relation to dominance. A market share of 50 per cent or more establishes a legal presumption of dominance (Whish, 2009, p. 46). Hence the CER's conditional conclusion is sensible.

Attention also, however, needs to be paid to the evolution of market shares in the supply of residential gas. Conclusions concerning BG Energy's dominance would be strengthened if it had consistently held a market share of 70 per cent despite much entry and exit as compared to a situation where entry had rapidly eroded its incumbent status. The CER (2012, Figure 2, p. 19; Figure 3, p. 20) in its review presents the evolution of market shares over time. Although BG Energy has a market share of 70 per cent in Q2 2012, in Q4 2009 it had close to a 100 per cent of the market. The loss of market share has come from Airtricity which entered the residential gas market in 2010 and has 18 per cent of the market, while Electric Ireland which entered in 2011 accounts for 8 per cent of the market in 2012. In contrast, Flogas which entered in 2004 only has a market share of 4 per cent almost a decade later. Whether the entry of two strong competitors and the rapid erosion of BG Energy's market share suggest that the incumbent is not dominant can only be assessed by examining other market facts.

Barrier to Entry, Expansion and Exit

The CER review considers five barriers to entry: wholesale market liquidity; economies of scale and scope; customer switching; dual fuel offers; and branding. Barriers to entry are important because they enable incumbents to charge prices in excess of the competitive level without attracting entry of new firms sufficient to make the price increase unprofitable. We consider each in turn.

<u>Wholesale Market Liquidity</u>

To enter the market for the supply of residential gas requires access to supplies of gas. Access can be secured either via backward integration into upstream exploration, production and distribution of gas or via purchasing (through a combination of contracts of varying durations) gas from the wholesale market. Absent a wholesale gas market, entry costs would be substantial since the entrant would have to enter at not only the residential level but also adjacent upstream markets as well. It is not clear, however, that these latter costs can be characterised as necessarily sunk, since the entrant may discover gas and hence have recoverable assets to sell on exit. In contrast, if there is a competitive and efficient wholesale market, then entry costs will be much lower, since the entrant can purchase gas on this market. If the CER's view that entrants do indeed have access to a very large and highly liquid wholesale gas supplies through the National Balancing Point (NBP) in the UK, then access to wholesale gas supplies would not appear to be a barrier to entry.

<u>Economies of Scale and Scope</u>

The CER (2012, p. 23) conclude that the "residential gas is relatively small and is limited to the gas network footprint could potentially constitute a barrier to entry and expansion associated with economies of scale." This is a somewhat tentative conclusion. It is based in part at least on the fact that there is no evidence on scale economies in the supply gas to residential customers. Perhaps the CER should consider examining the major elements of the cost of supplying gas to residential customers and then examining the evidence as to whether there are economies of scale, paying attention to a *de novo* entrant and an already established firm. All the entrants to date in Ireland have been already established firms in a related or adjacent market, for whom the costs of entry are likely to be lower than for a *de novo* entrant.

<u>Consumer Switching</u>

In order for competition to take place in a market the consumer needs to be able to switch easily and seamlessly between suppliers, particularly for an essential product such as the supply of gas for heating and cooking. In other words, the transaction costs need to be low to encourage competition. The CER (2012, p. 24) is thus undoubtedly correct when it states that "[L]ow barriers to switching would indicate that even when market share may still be high, market power *may* be reduced." (emphasis added)

The CER in its review does not consider the mechanics of switching, but rather looks at evidence concerning the rate of switching. It notes that one of the triggers set out in its roadmap for the removal of price regulation of BG Energy is an annual switching rate of at least 10 per cent. The CER (2012, Figure 6, p. 25) documents how switching rates have increased since the entry of Airtricity and Electric Ireland such that since 2010 switching rates – measured quarterly on an annualised basis – have exceed 15 per cent. Survey evidence cited suggests the primary reason for switching was to save money. In terms of the ease of switching only 5 per cent of customers said switching was 'difficult' or 'very difficult.' Hence the CER (2012, p. 26) concludes from this evidence that "switching does not constitute a barrier to entry or expansion."

A number of caveats or qualifications need to be taken into account in interpreting switching rates. First, the CER should take into account recent findings relating to consumer behaviour. These findings were presented in our previous submission concerning the roadmap for deregulation of residential price controls for electricity.[3] UK research suggests that consumers in switching electricity supplier do not always make good decisions. In fact, a significant percentage of consumers end up on higher tariffs. There is some evidence that such results might be replicated in Ireland. In a CER sponsored 2012 survey of residential users of natural gas, 24 per cent of respondents had a small degree or no understanding of gas suppliers' offers, while 34 per cent said they had some understanding. Only 8 per cent they fully understood such offers.[4] This might imply that potential switchers are less sensitive to price than they might otherwise be, and thus that their presence exerts a weaker competitive constraint than their share would suggest.

Second, the annual rate of switching soon after liberalisation may be a misleading indicator of the degree to which switching is a barrier to entry, if a significant share of switching is accounted for by a group of "active" consumers switching repeatedly and most customers remaining "inactive" rather than an increasing share of consumers switching from the incumbent. There is some evidence to support this, in that 64 per cent of gas consumers in Ireland have never switched, 10 per cent have switched more than twice, and 25 per cent switched once (Research Perspectives, 2012, p. 28). If all the switching reported was away from BG Energy to other suppliers, BG Energy market share should be around 50 per cent.[5] Switching is also much less likely to occur in some groups – e.g. older persons and social class DE (*ibid*, p. 19). The competitive effect of switching depends upon the share of customers accessible to entrants, not on the switching rate *per se*.

Third, current rates of switching may not necessarily be indicative of future rates. As we pointed out in our response to the roadmap for deregulation of electricity, consumers are more likely to switch to recognised brands since they have confidence that they will be able to supply. For those consumers who did not switch gas supplier, the leading reason given was that "I am concerned

[3] Gorecki *et al* (2010) where further discussion and references are cited.
[4] For details see Research Perspectives (2012, p. 19).
[5] CER (2012, Figure 6, p. 25) which report quarterly switching rates from Q1 2010 to Q2 2012. After Q2 2010 these never fall below 15 per cent reaching close to 25 per cent in QQ4 2010.

about whether the alternative supplier will provide a reliable supplier of gas (op cit, p. 36). Electric Ireland and Airtricity, the two leading entrants are two well known brands and hence consumers are likely to trust such suppliers. Future entrants may not command such confidence. If, for whatever reason, the share of new switchers were to fall once the potentially active segment of the population had switched at least once, this would imply that the effect of switching as a competitive constraint on the incumbent would decline.

Given the objective of regulation is to promote competition so as to increase consumer welfare the CER might consider the adoption of indicators that try to capture these aspects of switching so that it is in a better position to evaluate the meaning of switching rates and perhaps introduce policies or information campaigns to facilitate consumers making better more well informed decision. The consumer gas survey sponsored by the CER is an obvious vehicle for exploring these aspects of switching. To some degree, of course, this survey already meets some of these some questions relating to finding out what might stimulate more switching (*op cit*, p. 40).

<u>Dual Fuel Offers: Bundling</u>

The CER review devotes considerable space to the discussion of the bundling of the supply of gas and electricity. The bundling of these two products has increased substantially, but stabilised from late 2011, with "just under 50% of all domestic gas customers" purchasing the bundled product from the same supplier (CER, 2012, p. 27). The review makes a number of observations concerning the relevance of the bundled product to the competition assessment. These include: that the residential electricity has been deregulated since April 2011, which has resulted in some decline in BG Energy's market share in this market; BG Energy's prices are competitive; somewhat surprisingly the review finds that the bundled product is priced higher than purchasing each separately (*ibid,* p. 29).[6] The usual rationale for bundling is that there are certain economies such as lower transaction costs or complementarities that offer consumers a better price; that price competition in supplies of residential gas is muted; and that BG Energy retains 70 per cent of the residential gas market, which may of course be related to the muted nature of competition in that market. The CER "tend towards the view that BG Energy remains dominant in the gas market (*ibid*, p. 31)."

The CER (2012, p. 31) then comments that if the link between the electricity and gas markets were further strengthened by the bundled offering increasing in importance then,

> … it could be considered possible that BG Energy having a high market share in gas would not be harmful to consumers, as any attempt to increase the price of gas (where it was dominant) would be unlikely to be successful given its relatively small market share in electricity. Whether this constraint is sufficient to allow some relaxation of the current price control, either now or in the future, is an issue we turn to in Section 4.

If BG Energy is dominant then it, by definition, can raise prices profitably above the competitive level. That is the definition of market power. It is not clear how relevant is the fact that it has a small share of the electricity market via offering a bundled product. This does not mean that bundling is irrelevant in the competition assessment of the residential gas market. There is a line of thought

[6] This does not mean that (say) BG Energy's gas and electricity prices are lower when bought separately than together, only that it is possible to buy gas and electricity separately than together, given the current offers available on the market.

that sees a dominant firm in one market leveraging that dominance into an adjacent market with the result that a potential entrant into one market has to enter both markets and this raises entry barriers substantially. However, since under the terms of BG Energy's license it is prohibited from tying (*ibid*, p. 26) it is difficult to see how that leverage can be exercised through bundling.

Branding

Firms strive to differentiate their products from competitors. While the most visible manifestation of differentiation is the product brand (e.g. BG Energy), it nevertheless represents a bundle of characteristics such as reliability, price, competence, innovation and so on that mark successful differentiation. The firm makes an investment in differentiation which, if successful, leads to increased consumer loyalty. If the firm is successful in such differentiation then its products are likely to command a price premium over less successful firms. However, whether that constitutes a barrier to entry is somewhat of a moot point on several grounds.

First, firms in adjacent markets may have successfully differentiated their products or services and able to transfer that reputation/brand image into the gas market and so be able to compete with BG Energy. Electric Ireland and Airtricity, successful entrants into the residential gas market, are two examples of this phenomenon. Second, one definition of a barrier to entry is that it costs more for a *de novo* entrant to successfully establish a brand as compared to the incumbent BG Energy. On this no evidence is presented. Hence more would be required in order to come to the conclusion that the BG Energy brand is a barrier to entry. Nevertheless, the evidence presented in the CER (2012, pp. 31-32) is very mixed as to whether or not the BG Energy is a barrier to entry. The CER (2012, p. 32) conclude that branding is not a strong barrier to entry, an issue which is explored further in 'Branding and BG Energy's Market Threshold' below.

Preliminary Conclusion on Competition Assessment

The CER (2012, p. 33), concludes the wholesale market liquidity, economies of scale and scope, customer switching and branding "are not sufficient strong to counter BG Energy's position of dominance in the retail NDM gas market." Furthermore, "BG Energy remains in a position of market power where is has the ability and incentive to exert that market power to the detriment of consumers and competition." Bundling is considered as a way that BG Energy's market power could be mitigated.

The critical question is whether or not BG Energy is dominant in the market for the supply of residential gas. A 70 per cent market share suggests a strong presumption of dominance. However, set against that has been substantial entry with the combined market share of Airtricity and Electric Ireland reaching 26 per cent in 2012 after entering in 2010 and 2011, respectively. There is large and liquid wholesale gas market. Branding does not appear to be an important barrier to entry, especially for already established firms in adjacent markets, although this may not be the case for *de novo* entrants. Switching rates have been reasonably high in the short time since liberalisation, but more work is needed to establish whether they are likely to be sustained into the future and how much competitive constraint the prevailing pattern of switching imposes upon BGE. There is no evidence concerning scale and scope economies, while the issue of bundling seems to be largely a red herring. Finally, price competition appears to be muted.

The key issue then is whether BG Energy could raise price above the competitive level for a relatively homogenous product, natural gas, if price regulation were removed. Frequently firms with market power will employ some exclusionary tactics such as exclusive contracts, typing, margin squeeze, and predatory pricing to prevent competitors being able to enter and compete away any economic rent.[7] However, several if not all of these are or could be prohibited by BG Energy's license conditions, while they are also likely to breach competition law if practiced by a dominant firm. Absent the ability to employ these tactics BG Energy could still raise prices unilaterally. However, would it be profitable? There are two sizeable competitors and one smaller competitor. If one assumes they face no capacity constraints,[8] they may well be able to capture sufficient of BG Energy's market to make it unprofitable for BG Energy to raise prices above the competitive level. This would raise questions about BG Energy's dominance. However, it is not clear that capacity is as flexible as assumed or that it will remain so, as discussed earlier. Also, even if capacity is flexible, the best response of BG Energy's competitor might not be to leave their prices unchanged in response to a unilateral price rise by BG Energy, but rather increase their prices, but not as much as BG Energy. Hence although there may be doubts as to whether or not BG Energy is dominant, any unilateral price increase would almost certainly be partially accommodated by its competitors. Finally BG Energy may decide not to raise its price for all consumers, but only those that are unlikely to switch, a pattern that could be followed by its competitors, so that competition would largely be confined to particularly price sensitive consumers, an issue we return to in 'Roadmap for Deregulation of Price Controls on Residential Gas: Reprise' below. Under this scenario the consumers who are unlikely to switch, what Ofgem (2012) refers to as 'sticky' consumers, would pay higher prices.

Roadmap to Deregulation of Ex Ante Price Regulation of the Supply of Gas to Residential Consumers

The CER (2012, pp. 34-39) review raises a number of issues in relation to the conditions it set out for deregulation of ex ante regulation of residential gas prices. We consider each in turn.

Roadmap for Deregulation of Price Controls on Residential Gas

The CER (2012, p. 34) has set out a set of four conditions that need to be met in order for price deregulation would be removed:

- Three suppliers should be active in the market
- There should be at least two independent suppliers, each with a market share of at least 10%
- There should be an annual customer switching rate of at least 10%
- Deregulation would not be considered until BG's market share fell below a certain level. An indicative level of 60% was suggested, but no conclusive decision was taken on the level of market share, as CER's view was that this was contingent on a decision on branding.

The past tense in the last bullet point reflects the fact that these conditions were drawn from the previously developed CER (2010, 2011) consultation exercise. The CER (2012, p. 35) a year on still

[7] These are analysed in EC (2008).

[8] It is true that while Flogas was initially confined to a limited geographical area (CER, 2012, p.10) an examination of its website reveals it sells natural gas to consumers wherever the natural gas pipeline grid extends. See http://www.flogasnaturalgas.ie/whyswitch.php for details. Accessed 8 November 2012.

take the view that these are a "reasonable minimum." The 60 per cent threshold is justified by the fact that 64 per cent of residential customers have not switched in the past couple of years.

Underpinning these quantitative thresholds is the assumption of a lack of capacity constraints on expansion of competitors to the incumbent. These can be either on the supply side – e.g. access to gas supplies – or on the demand side – the incumbent is not able to directly or indirectly prevent customers switching. If these conditions do not hold then it is possible that due to capacity constraints on the entrants, that the incumbent BG Energy could profitably raise prices. Even though switching rates is one of the four criteria for reasons set out above its interpretation needs to be supplemented by consideration of a number of factors. This confirmed by the CER's reference to the fact that 64 per cent of residential gas customers have never switched. There is a danger, as noted or implied above, that there will be a contestable portion of the market of say 40 per cent and the remainder with remain attached to BG Energy that in a deregulated market may be able to raise prices for these infra marginal consumers. However, that is too pessimistic, since competition by Electric Ireland and Airtricity is relatively recent. Furthermore the consumer survey's sponsored by CER can be used to identify possible strategies that the CER could employ in order to facilitate switching and at least observe renegotiation without switching, a point we made in our earlier submission (Gorecki *et al*, 2010, p. 7). Ofgem (2012) proposals to equip consumers to get the best deal could also be drawn upon.

The criteria put forward by the CER are reasonable, subject to the caveats mentioned above, with the exception of the 60 per cent market share threshold for the incumbent. This is not only substantially above the dominance threshold adopted by European competition policy, but also ignores the possibility of substantial share of infra marginal consumers who might be exploited.

Branding and BG Energy's Market Threshold

The CER (2012, p.p. 36-38) considers that there are three main reasons to consider the issue of BG Energy rebranding in relation to market share. First, it may remove any confusion in the minds of consumers between the wholesale and retail operations of Bord Gais.[9] Of course, this does not mean that BG Energy should rebrand, it could equally be the upstream operation, BG Networks. There may be less drastic ways of removing the confusing such an information campaign. Finally, and perhaps more importantly, it is not clear that the confusion bestows any competitive advantage on BG Energy as the CER (2012, p. 36) notes. This issue could be further clarified in the consumer survey sponsored by the CER, a sensible step in advance of the rebranding suggested by the CER (2012, p. 38) to remove the confusion.

Second, the brand may confirm an unfair competitive advantage on BG Energy. However, the evidence cited by the CER (2012, p. 37) suggests that the brand confers little competitive advantage on BG Energy. As noted above the brand is only part of the package of characteristics that constitute the BG Energy product. If it has to rebrand all these other characteristics may be retained but simply migrated to a new brand name that through extensive advertising will be associated with BG Energy. In other words, it is not clear how effective rebranding would be in any event. There is little empirical evidence of rebranding significantly improving the vulnerability of Irish utilities to competition (e.g. in the cases of Eircom or ESB).

[9] See Research Perspectives (2012, pp. 22-23).

Third, rebranding could be a mechanism for reducing the market share threshold for BG Energy. The argument is that since the BG brand may give the incumbent an advantage over new entrants, if it were to rebrand and hence remove this advantage the market share threshold set out above of 60 per cent could be reduced depending on the perceived value of the brand in terms of market share. However, as the CER (2012, p. 38) acknowledges the BG brand does not seem to confer a competitive advantage on BG Energy and hence rebranding for this purpose is not proposed. Even if this mechanism were expected to be effective, it is not obvious why it could not be tested by requiring rebranding before deregulation, rather than doing it simultaneously. That would allow the hypothesised pro-competitive effect of rebranding to be tested empirically before withdrawing conduct regulation.

Roadmap for Deregulation of Price Controls on Residential Gas: Reprise

The CER (2012, pp. 38-39) revisit the roadmap conditions set out above and propose that the market share threshold for BG Energy should be lowered to 50-55 per cent. The 50 per cent threshold is consistent with the presumption of dominance in competition law as noted above. However, suppose that the threshold for BG Energy were lowered to 50-55 per cent and the other conditions were satisfied in the roadmap should deregulation of BG Energy's retail gas price take place. We consider that before that step is taken that the CER investigate two important issues.

First, why have a large proportion of consumers never switched? The survey suggest that they are older and in the lower socio economic groups. What can be done to encourage switching? What can be learnt from the behavioural economics literature that was referred to earlier? What can be learnt from the current Ofgem (2012) experience in this regard, which suggests that these sticky consumers will form a part of the customer base of all gas suppliers, although at the moment they are likely to be heavily skewed towards BG Energy? This is an important issue since if these consumers remain BG Energy's customers primarily through inertia then there is a distinct possibility that it will develop tariff structures that are able to effectively charge these consumers higher prices while offering better deals to price sensitive customers. However, as Waddam's (2012) points out trying to design pricing rules to resolve this problem can do more harm than good.

Second, why has no entry occurred from firms that are not already established in the energy market? In telecommunications and health insurance we have seen firms entering with little prior experience, such as Tesco which has a whole suite of offerings in these are related areas such as pharmacy. Why have such firms not entered the energy sector? Are there some barriers to entry to which insufficient attention has been paid and that regulatory intervention could assist in removing?

After these issues have been investigated the CER would in a better position to come to a view as to what criteria should be introduced to remove the price of retail gas.

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