CONSULTATION ON MARKET ARRANGEMENT PRINCIPLES

SUBMISSION

TO THE

COMMISSION FOR ENERGY REGULATION

27 September 2002

1. INTRODUCTION

1.1 The Commission for Energy Regulation (The Commission) has issued a consultation document "Consultation Document on Market Arrangement Principles" – 28 August 2002 requesting responses by the 27th September 2002.

1.2 This document is the combined response of Bord Gáis Corporate Centre and the Transmission Business Unit of Bord Gáis Éireann (BGE Transmission) to the Commission document. For ease of reading all subsequent reference will be to Bord Gáis.

1.3 Bord Gáis welcomes the opportunity to contribute to this important consultation and is happy that its response is made public on the Commission's website.

1.4 In section 2 we highlight some general points that should be given consideration in reviewing the current regime and deciding on the future direction for the gas industry in Ireland. Below in section 3 we provide our initial responses to the questions raised in the Commission's consultation. In order to facilitate cross-referencing with the Commission document we have addressed each question and issue in turn in the same order as that document.

2. GENERAL OBSERVATIONS AND QUESTIONS

2.1 Bord Gáis welcomes the opportunity to take a leading role in pushing forward further development of the gas transportation regime in Ireland.

2.2 However, before setting out on this fundamental review of the Code of Operations and associated arrangements, it is important to note that:

- the Code of Operations came into existence following a long, wide and extensive public consultation with all interested parties; and
- the existing gas transportation arrangements are working well and have facilitated an extensive opening of a competitive gas market. The Irish gas market is arguably second, within Europe to the UK, in the successful introduction of choice for gas consumers with some 80% of gas demand open to competitive supply. Suppliers other than BGE Energy Supply now supply a significant amount of gas.

2.3 We note that section 2 of the Commission consultation document lists some very general objectives. However, the Commission does not fully specify the aims and objectives of this fundamental review. The Code of Operations is an evolving document, as witnessed by the modifications that have already been agreed or are under discussion with shippers. We do believe it is essential for all market players to understand the aims and objectives of any wide ranging review and how these aims fit within the Commission's plans for the Irish energy market over the medium term i.e. the next 3 to 5 years.

Other significant changes in the Irish Market

2.4 This is a time of considerable change and uncertainty for the Irish gas industry including;

- the lowering of the eligibility threshold with Full Market Opening in 2005;
- the fundamental review of transportation tariffs proposed by the Commission to take place next year;
- the addition of a new entry point for indigenous Irish gas from the Corrib discovery; and
- the addition of new indigenous gas from Ramco at Inch.

2.5 The above and other factors have a bearing on the optimum gas transportation regime to be aimed for and on the timing of introducing changes to existing gas transportation arrangements. As far as possible we need to develop a shared industry view of priorities for development – what are the imperatives as opposed to the desirable? Well-intentioned improvements may prove counter-productive if they deflect from more important goals. The focus for the next two years must be first and foremost on meeting legislative requirements in terms of further market opening. The scale and scope of changes to be undertaken within this near term time frame must match the availability of key resources both within the industry and within Bord Gáis. Priorities must be set within this context.

Impact of possible changes on the BGE's revenue and rate of return

2.6 Bord Gáis notes that the Commission raises issues that would have a direct impact on Bord Gáis revenue recovery. These include the proposal to introduce incentives on the transporter and a qualification of the concept of revenue neutrality.

2.7 The existing tariff and associated allowed rate of return were agreed assuming that the current treatment of revenue would continue. If financial incentives are introduced which could result in a risk to full revenue recovery, BGE's cost of capital could increase and the rate of return may need to be adjusted accordingly. This area obviously requires further detailed consideration. We would also welcome some further clarification of the way in which the Commission sees such incentives operating in practice.

A holistic approach is essential

2.8 Turning to the review itself we wish to make the following observations:

- Many of the issues addressed in the Commission's document are highly interdependent, and are also critically related to the wider context of the Irish energy market and specific matters such as security of supply, investment and the treatment of revenues.
- Bord Gáis is mindful of the fact that changes to the current transportation regime, which was itself the result of extensive discussions, will be required as a result of other changes in the Irish gas market such as the extension of TPA to lower levels.
- We believe that the Commission and the industry must prioritise the objectives of any review and rank desired outcomes into at least two categories, for example – "essential" and "desirable but postponable to a later date". We would emphasise the need to fully consider all the issues and their interdependence in the wider context, in order to achieve the optimum way forward.
- We are making our initial comments on each of the individual issues listed in the Commission document with this important caveat.

Summary

2.9 In our view the most important driver of any reform must be to ensure that any changes offer real advantages to market players in the Irish Energy Market. It is also necessary to manage any transition of the transportation regime to avoid unnecessary disruption. Hence, any changes proposed must be subject to a robust cost-benefit analysis. This is particularly important in light of the fact that the Irish market is relatively small at between 5 and 6 Bcm/annum demand compared with over 100 Bcm/annum in the UK. In such a small market it is easy for the actual cost of 'theoretical improvements' to significantly outweigh the anticipated benefits.

2.10 In summary, Bord Gáis believes that the existing Code of Operations and associated concepts form a good foundation from which to further develop a fully transparent and competitive gas market in Ireland. Bord Gáis suggests that the process following on from the Commission consultation should be one of evolution, building on the strengths of the existing arrangements, but recognising that some change is essential in order to further open the market. We would welcome further information about how the Commission sees the issues raised in their consultation documents being taken forward. We are also keen to ensure that the review of the Code of Operations and the work of proposed Gas Market Advisory Group complement each other efficiently.

3. OUR INITIAL COMMENTS ON QUESTIONS LISTED IN THE CONSULTATION DOCUMENT

Gas Capacity: investment and trading

3.1 The Commission invited comments on:

- Whether the current point-to-point system is the most suitable option for Ireland or whether another system, such as a pure entry/exit system would be a more appropriate option.
- The role of the transporter in, and methods of, facilitating capacity rights trading.
- The duration for which capacity rights may be traded.

3.2 Bord Gáis believes that the existing Code of Operations and associated concepts can form a base from which to further develop a fully transparent and competitive gas market in Ireland. Bord Gáis suggests that the process following on from the Commission consultation should be one of evolution, building on the strengths of the existing arrangements, but recognising that some changes are necessary in order to improve the procedures.

The appropriate approach - point-to-point basis or entry/exit basis

3.3 As the Commission points out, entry/exit systems "generally abstract from physical capacity limits" and the separate trade of entry and exit capacity will impose additional scheduling responsibilities on the Transporter. We believe that abstracting from the physical reality of the network in whatever way makes it very difficult to define capacity rights in a manner that will allow them to be traded. Indeed, not having a link between capacity reservations and the physical capacity available may remove any incentive to transfer or trade capacity.

3.4 A mechanism for the transfer of transmission capacity on the Irish transmission system is already in place under the Code of Operations. It is being used effectively by system users. Bord Gáis does not see the merits of the introduction of an entry/exit capacity definition. In Britain the application of an entry/exit capacity definition with common carriage has required a move to contractualisation using an auction-based allocation of capacity before an effective basis for secondary market in transmission capacity could be established.

3.5 Bord Gáis concurs with the Commissions views as to the viability of a spot market in the near term. The implicit corollary in the short to medium term, is that gas and capacity trading will take place on a bilateral basis. Bord Gáis recognises that systems users may contend that the point-to-point system will impose greater constraints on the bilateral trading of gas and capacity that would not arise under an entry/exit regime. In response to this it is Bord Gáis's view that a point-to-point system will impose very few additional constraints on the bilateral trading of capacity compared with a contractualised entry/exit system. In addition, Bord Gáis is considering the establishment of exit zones from the Transmission system that will aggregate lower level meter points. This will contribute to further flexibility in delivery.

3.6 In a market where trades are bilateral, a point-to-point system is likely to impose few, if any, additional constraints on gas trading relative to an entry/exit system. System users at the principal entry point will have access to a liquid spot market in Britain. If gas exchanges are mutually beneficial, traders will develop arrangements to deal with any restrictions that might emerge in relation to gas inputs from Corrib or at Inch (or at any other entry points that might be established in the future). Physical trades in gas must be accompanied by access to the necessary capacity to ensure completion of the transaction. A point-to-point system ensures that this relationship holds. It confronts users with the physical realities of the system and maintains the necessary relationship between gas trades and the capacity required to effect these trades. Any restrictions it imposes on opportunities to trade gas or transfer capacity reflect the location of the transmission system in relation to the nearest liquid spot gas market.

3.7 In summary, we believe that while an entry/exit system (based on a common carriage regime) may provide shippers with some increased flexibility, it does not provide an adequate basis for capacity trading.

3.8 We look forward to contributing to further discussions before any decisions are made.

The role of the Transporter in facilitating capacity trading

3.9 Bord Gáis supports the concept of secondary capacity trading. However, we believe that it is best for developments in this area to be market led. It would be inappropriate to impose any mandatory requirement for the Transporter to introduce a particular mechanism to facilitate trading at this stage.

3.10 We believe that the development of capacity trading must be market led because it is difficult to anticipate both the form and level of demand for capacity trading. Experience in GB has shown that traded volumes were much lower than anticipated in the early years of operation and indeed liquidity is still a major concern.

3.11 The mandatory role of the transporter should therefore be confined to the development of the primary capacity regime in a way which creates the conditions in which secondary trading might develop, always mindful of the other objectives of the primary regime such as efficiency and cost reflectivity. However, Bord Gáis is willing to investigate the cost and practicality of putting in place and operating a "Bulletin Board" system to allow shippers to post capacity bids and offers to encourage the development of a secondary market. The completion of trades and their settlement would be a matter for shippers, and would presumably be conducted on an "over the counter" basis at this stage.

3.12 We note that the Commission believes that there is no reason why the transporter should have access to the prices at which secondary capacity is traded. Other regulators have argued that price information derived in the secondary market can provide useful investment signals for the transporter. Perhaps this information could be collected by other parties e.g. the Commission and presented in a non-confidential format to Bord Gáis for planning purposes?

The duration for which capacity rights may be traded

3.13 The Commission suggests a minimum capacity trading interval equal to the balancing period of one gas day. Capacity transfers are currently permitted within day (for balance of day transfers). Any reduction in capacity rights should be considered carefully within the context of the new framework to be adopted.

Transportation services

3.14 The Commission invited comments on:

- The desirability of the Transporter offering short-term firm service.
- The duration of short-term firm service and pricing arrangements.
- At what level of capacity utilisation the Transporter should offer interruptible services and pricing arrangements for this service.
- The desirability of the Transporter offering an authorised overrun service.
- The duration of an authorised overrun service and pricing arrangements.
- The desirability of allowing overrun trading.

Short term and interruptible services

3.15 BGÉ Transmission does not support the introduction of primary short-term services at this stage. Bord Gáis provides a primary firm transportation service and levies regulated tariffs for the provision of these services. It is not in its interests nor should it be compelled to offer interruptible, overrun or other services that will inevitably undermine reservations for its primary firm transportation service.

3.16 Any obligation to provide these services will result in under-recovery of revenue which will be rolled forward into the cost base for the next year and this will increase and add to the volatility of the average capacity charge. If any attempt is made to modify the extent of the roll-forward the cost of capital will increase. This would occur primarily through an increase in financial risk to the business and possibly a reduction in Bord Gáis's credit-rating. Any increase in the cost of capital will be passed on to shippers who will, most likely, attempt to recover it from gas consumers.

3.17 Selling primary capacity in minimum 12-month tranches has the advantages of simplicity and mitigates against seasonal gaming opportunities by encouraging shippers to book their true peak capacity requirements. Furthermore, the cash flow to the transporter is likely to be more predictable, avoiding the need for retrospective recovery from (or rebates to) shippers. Shippers can currently update their primary capacity holdings every quarter, and can trade in the secondary market more frequently to adjust positions.

3.18 The secondary capacity market can evolve to provide a range of shorter-term capacity services as required, for example, daily or monthly. We look forward to discussing how the transporter can facilitate the further development of secondary capacity trading within the review of the Code of Operations.

3.19 We agree with the Commission's comments about the need to guard against capacity hoarding. However, given that sufficient capacity is availability, we can see no motive or benefit for shippers to hoard capacity. Furthermore, we see every incentive for primary capacity holders to reduce costs through selling any unutilised capacity on a bi-lateral basis to other shippers through the capacity transfer arrangement.

3.20 The existing transportation arrangements also have a form of use-it-or-lose-it provision within them. To date these provisions have never been invoked but this area could be developed further if the Commission decided that a major problem or potential problem existed which could not be addressed by other means such as recourse to licence enforcement or general competition law.

3.21 We agree with the Commission that the transporter should only be obliged to offer interruptible capacity when all firm capacity has been sold, as a protection against the risk of shippers choosing an interruptible tariff yet effectively receiving a firm service.

3.22 The fundamental issues to take account of in the review of capacity services are:

- the implications for efficient use of the system;
- the implications for planning, investment and security of supply;
- fairness of capacity costs for shippers; and
- the longer-term implications on the emerging market for secondary capacity trading.

3.23 One must also consider the impact of the introduction of complexity in capacity services and trading on shipper systems and operating costs.

Authorised overrun service and overrun trading

3.24 Bord Gáis does not support the introduction of an authorised overrun service and believes that overrun trading would also be inappropriate.

3.25 Overrun charges are an incentive to ensure that a shipper has obtained capacity ***prior*** to using it – the "ticket to ride" principle. It is more important that shippers have access to the right combination of services and incentives to avoid overruns than to provide mechanisms to trade them away. Shippers can avoid overrun charges by booking (or trading) adequate capacity to meet their peak requirements in advance.

3.26 Authorised overruns would appear to be simply a different way of paying for a firm daily capacity product. The Commission elsewhere suggests that a monthly firm product is preferred. As explained above, BGE would prefer to see shorter term services evolve through the secondary market, and is concerned that authorised overruns appear to be a "back door" primary alternative to a secondary daily capacity product, and may undermine both the primary market and the development of the secondary market.

3.27 Authorised overruns and ex-post overrun trading create unnecessary complexity and run the risk of shippers understating their true peak requirements, with potential implications for investment planning and even (in the longer term) security of supply.

3.28 We would also argue that the existing capacity booking arrangements, supplemented by the capacity transfers facilitated by Bord Gáis, provide efficient means for shippers to book the correct amount of capacity and so avoid any overruns in the first instance. This could be complemented by some of the possible initiatives already raised above, such as a bulletin board to encourage the secondary market's development.

Nominations and Balancing

3.29 The Commission invited comments on:

- The scope for increasing the flexibility of the nominations process, the potential costs involved and the likely interaction with upstream nominations procedures.
- The adoption of an entry/exit balancing regime.
- The setting of imbalance tolerances by the Transporter.
- The role of the Transporter in, and methods of, facilitating imbalance trading.
- Allowing ex-post trading of imbalances.
- Imbalance charging.
- An arrangement whereby shippers in Ireland provide balancing gas under a bid-based mechanism, when this yields a better price than the OCM in Britain.

- Whether the Transporter should be given a financial incentive to minimise balancing costs and if so, the form such an incentive may take.
- Arrangements for settling residual imbalances.
- Charges for divergences from nominations and nomination divergence tolerance levels.

The scope for increasing the flexibility of the nominations process, the potential costs involved and the likely interaction with upstream nominations procedures.

3.30 Bord Gáis has ensured that the nomination process is compatible with the upstream nomination procedures particularly at Moffat. The integration of the nomination and allocation procedures between BGE and Transco at Moffat has been seen as a model for use elsewhere in Europe, including at the Bacton-Zeebrugge interconnector flange. We believe that the Moffat Agency arrangements are an efficient and cost effective way of handling nominations between the two systems. Shippers accept this and have supported the introduction of similar matching nominations and allocation mechanisms at new entry points, for example, Corrib entry.

3.31 The arrangements ensure that shippers are given the maximum level of flexibility whilst avoiding the considerable risk that arises as a result of mismatches in the regime.

3.32 Bord Gáis will continue to work with parties involved in any upstream regime to maintain this best industry practice. Bord Gáis is committed to meeting the requirements of the EU Gas Directive, which requires interoperability between systems. We have actively participated in the work of GTE, the association of European transmission companies, to this end. Indeed much of the GTE's well received Interoperability Report was drafted based on our direct experience, and we have contributed significantly in other areas such as the Gas Balancing workgroup.

3.33 The proof that the system has worked so well to date is illustrated by the fact that shippers are generally satisfied with the nomination/allocation procedures and also that the considerable problems encountered at GB entry points have not been a problem in Ireland. Irish shippers, unlike most GB shippers, know how their gas entry and exit allocations on day D+1(i.e. next day). GB shippers must wait sometimes until day M+15 (i.e. the middle of the following month) before they know their entry allocation. This is an area where our existing arrangements are clearly superior to those of the GB gas industry.

3.34 Bord Gáis has in the past discussed other flexible arrangements with Transco including the possibility of putting in place an Operational Balancing Agreement (OBA) between the two operators. These discussions were not successful but illustrate the commitment of BGE to increasing any flexibility that might be obtained. The Connected Systems Agreement (CSA) negotiated with Transco did capture some flexibility to vary the offtake profile which is of benefit to the Irish shippers.

The adoption of an entry/exit balancing regime.

3.35 As stated above, there are a number of perceived advantages of an entry/exit regime that should be considered. One important issue for the balancing regime, which may not necessarily require the adoption of entry/exit capacity arrangements, is the facilitation of the shippers' ability to combine his portfolio to minimise any imbalance and be cashed out for a single aggregate imbalance.

3.36 One of the major advantages claimed for a pure entry/exit regime is the generation of a single notional point – an Irish NBP - at which gas trades can occur on a like for like basis (whilst still allowing the flexibility for parties to trade elsewhere if they prefer). However, the certainty over volumes of gas at entry system in Ireland means that trading could more easily be facilitated at entry points than was the case in GB. This may reduce the benefit of developing an Irish 'NBP' trading point.

3.37 It could, of course, be argued that overall liquidity might be greater if all trading took place at a single point, i.e., an NBP, but it would be inappropriate to prohibit trading elsewhere. Given the size and number of potential players in the Irish market we believe that, whatever approach is finally adopted, it is unlikely that an Irish NBP could develop sufficient liquidity anyway to justify any significant costs in setting one up.

3.38 We recognise this as an important area for debate and look forward to making a significant contribution to further discussion in this area.

The setting of imbalance tolerances by the Transporter.

3.39 Tolerances must be considered together with the cash-out price(s) which in combination need to provide efficient incentives on shippers to balance. Bord Gáis believes that individual shippers should be encouraged to manage their own portfolio in such a way that the system operator is only required to perform a residual balancing role. This is more likely to produce an efficient and equitable outcome than a regime in which shippers' incentives are diluted by generous tolerances and/or weak cash out price signals.

3.40 Imbalance tolerances as described within Commission's paper cover two issues. The first is at what level should a tolerance be set outside which shippers will incur higher balancing charges. The second is, should a tolerance be available below which shippers can carry over the imbalance into the next day without any cashing out.

3.41 With regard to the first issue, we believe that the size of the imbalance charge should fully incentivise shippers to stay within any tolerance but not be so large as to distort shipper behaviour or impose unnecessary costs. The cash out price outside of the tolerance has recently been discussed in the Code of Operations Forum and there are plans to amend the multipliers (Mod 9/12 multipliers) to reduce the impact on shippers of straying outside their tolerance. We have facilitated and supported the recent discussions leading to the proposed reduction in the multiplier to be applied to out of tolerance imbalances.

3.42 With regard to the second issue, we would not support the proposal of carrying over imbalances between balancing periods as this could increase the level of untargeted costs and create unnecessary complexity in the settlement arrangements. Such carry over arrangements would effectively confer on shippers the free use of linepack, an important topic discussed further in section 3.76 below. Depending on the tolerances introduced, this could equate more to a form of monthly rather than daily balancing and may dampen shipper discipline. This in turn could give rise to an increase in the number of compensatory balancing actions required by the transporter, and hence to a rise in untargeted costs which need to be borne by shippers generally regardless of individual behaviour.

3.43 Rather than increasing or introducing new types of tolerances, it is for debate whether Ireland may in future wish to move towards the reduction or complete removal of tolerances, as has occurred in GB. It is accepted in GB that the removal of tolerances has improved shipper balancing performance and so reduced the role of Transco in taking residual balancing actions. This in turn has reduced overall system balancing costs to shippers generally.

The role of the Transporter in, and methods of, facilitating imbalance trading.

3.44 In our view the proposals in this section of the document have not been fully thought through. We believe that there may be some confusion about the difference between before the day[1] (ex-ante) gas trading and imbalance trading.

3.45 Bord Gáis agrees with an earlier statement by the Commission that the Commission's role should be limited to ensuring that there are no unnecessary obstacles preventing the establishment of an effective spot market. However, we believe that the prospects for the development of a competitive wholesale Irish spot market may be limited in the short to medium-term. There would seem to be little justification for a market of this size generating significant costs to facilitate imbalance trading as a further separate activity from gas trading.

3.46 The transporter obviously has an essential role to play in recording after the day title trades in order to ensure accurate gas allocations are used in the final imbalance calculations. Before the day gas transactions, however, can and should be outside the transporter's control and knowledge.

Allowing after the day (ex-post) trading of imbalances.

3.47 One of the advantages of the Irish regime when compared to GB is that both shippers and transporter have much greater certainty over gas flows at entry points to the system. This means that it is possible for individual shippers to balance with greater certainty and also after the day or ex-post trading can be prevented or at least limited if required. The current Code of Operations does allow after the day trading of gas by allowing shippers to submit a revised allocation.

3.48 In GB, after the day (ex-post) trading was not encouraged or indeed welcomed, but it was simply not possible to prevent it given the protracted upstream allocation processes. Concerns in GB included a possible dampening of individual balancing disciplines and the prospect of some shippers with less access to the upstream arrangements being disadvantaged by ex-post trading.

3.49 We would welcome an open debate about whether ex-post trading is considered to be a legitimate activity for the Irish market. We recognise that ex-post gas trading is currently permitted within the Code of Operations, but this does not necessarily mean it should continue as other changes to the Irish gas market are introduced.

3.50 Any advantages that shippers would gain through after the day (ex-post) trading of imbalances would be better achieved by ensuring appropriate cash out prices and encouraging better before and within day (ex ante) balancing discipline. The ideal world is one where the incentives on shippers result in individual shipper balancing to a close tolerance throughout the gas day which then results in aggregate system balancing. In this world the transporter's residual role is minimised, as are balancing

[1] More accurately known as before gate closure or the time when the cash out is calculated. The opposite ex-post is often called after the day meaning after gate closure or when cash out is calculated.

costs. Facilitating after the day trading does not necessary mean lower system balancing costs since the transporter may still need to take balancing actions within day

Imbalance charging.

3.51 BGE believes in the principal of targeting the costs arising from balancing actions on the shipper(s) causing the problem. The current imbalance charging principals were established after long debate and discussion. Shippers are cashed out within tolerance at the so-called “neutral” price derived from the balancing gas contracts. Outside of the tolerance the shipper faces higher charges in part based on the need to prevent shippers arbitraging the Irish and UK gas markets. A recent Code Modification 9/12 is amending the higher charges.

3.52 We look forward to a full debate on this issue during the review.

An arrangement whereby shippers in Ireland provide balancing gas under a bid-based mechanism, when this yields a better price than the OCM in Britain.

3.53 Balancing gas is currently obtained via a contract entered into prior to the start of the gas year. The contract is let following a fully transparent and open tender process which is advertised in the European Journal and followed up with invitations to tender to a number of Irish and GB shippers.

3.54 The main advantages of the current arrangements are simplicity of operation and predictability of cash out prices for shippers. The Transporter simply decides the timing and size of a balancing action as necessary, whilst the price is fixed by the contract. Hence the current arrangements require no further trading activity by the Transporter. However, there may inevitably be some days when the UK OCM price will be materially higher or lower than the balancing gas contract prices.

3.55 A spot market has a number of advantages in terms of cost reflectivity over a predetermined contract price. However, we consider it would be unwise to rely solely on spot gas for system balancing purposes. We would be concerned that any emergent Irish spot market would not have sufficient liquidity to be sufficiently reliable as the only source of balancing gas.

3.56 We do not understand the Commission’s implications about the linkage with the GB OCM. This is because:

- We do not believe Irish shippers would offer a discount to the prices on the OCM – this would be a market inefficiency in which shippers were knowingly losing money.
- Bord Gáis does not and cannot purchase gas directly from the GB OCM. In order to do so in the future Bord Gáis Transmission would have to become a GB licensed shipper and sign on to Transco’s network code. Furthermore, this would be a purely trading function which is counter to Commission’s stated aim of restricting the trading activity of the transporter.

3.57 It may be worth considering a hybrid approach in which one or more balancing contracts are put in place but the transporter may access Irish spot gas where this could give rise to cost savings. Consideration would have to be given to the fact that such a hybrid model may have significant implications for the prices and conditions in the balancing contracts.

3.58 The Commission appears to be proposing a similar model to that previously operated in GB by Transco using a Flexibility Mechanism to allow shippers to post bids to buy or sell gas within day. This system was criticised for its lack of liquidity and dominance by large players that resulted in unnecessarily high balancing costs. At the time of its introduction and up until its replacement in 1999, by the OCM, the GB gas market had markedly more shippers and access to significant and diverse quantities of gas. In a much smaller Irish gas market with fewer shippers, it is difficult to see how such a mechanism could operate successfully without increasing balancing costs.

3.59 We recommend that careful consideration be given to the costs which will arise from setting up the processes, putting in or amending systems for both transporter and shippers and any additional operating and audit costs. We believe that the total costs may be significant and possibly out weigh any benefits compared with the simple, efficient and pragmatic mechanism currently in place.

3.60 This area requires further detailed discussion and consideration before decisions are made and these must be tested against a requirement to offer a measurable improvement over the existing arrangements.

Whether the Transporter should be given a financial incentive to minimise balancing costs and if so, the form such an incentive may take.

3.61 As stated above, balancing gas is purchased through a tender process in order to minimise the cost to shippers. The introduction of incentives implies the transporter having to take a greater interest in the daily gas prices and carrying out a more direct trading function. Any such change should only be considered if it can be shown that some real advantage will result.

3.62 Bord Gáis has some doubt about how such a clear advantage would arise. We note the extensive debate in GB concerning the introduction of financial incentives on Transco and how incentive design is complex and can often result in unexpected outcomes. We would be happy to discuss the possible form that incentives may take but believe that initial incentives should be simple. One example may be for the transporter to be allowed to keep a proportion of any savings arising from running a spot regime in parallel with the balancing contract(s).

Arrangements for settling residual imbalances.

3.63 We believe that if the incentives on shippers are working well through a combination of efficient tolerances and cash out prices – residual imbalances will be small. An efficient system should be able to target most balancing costs at those shippers causing the problem. Residual imbalance settlement is not then a significant issue. The transporter remains cash neutral via the Disbursements Account under the Code of Operations since any residual imbalances are charged pro rata to annual volumes transported across all shippers. We believe that these arrangements should continue.

Charges for divergences from nominations and nomination divergence tolerance levels.

3.64 Scheduling charges are provided for in the Code of Operations because of the importance of the shippers' nominations. A transporter must be able to anticipate likely flows on the system in order to manage operations efficiently. Accurate shipper nominations allow the transporter to make more efficient balancing decisions and avoid unnecessary interventions, so reducing balancing costs for all shippers.

3.65 We note the Commission's preference both for a fixed scheduling charge and recommendation that such charges be cost reflective.

3.66 The costs associated with poor nominations are often difficult to quantify, however we do not understand how a fixed charge could be cost reflective in all circumstances. If scheduling charges are to continue and perhaps be strengthened in the future, cost reflectivity is probably best achieved by continuing with something like the current formulation of using a multiplier of the balancing gas price for that day, even if the precise level of that multiplier needs to be reviewed.

3.67 The Commission appears to be suggesting that scheduling charges should be applied now – is this interpretation correct? Or should we review, as part of this overall review of the Code, shippers' nomination performance to date and the implications for overall system balancing?

Shrinkage gas and linepack

3.68 The Commission invited comments on:

- Arrangements for (i) determining the amount of shrinkage on the transportation system, (ii) procuring shrinkage gas, and (iii) incentivising the Transporter to minimise the amount of shrinkage on the system.
- Allocating all line-pack to the Transporter initially.

Shrinkage.

3.69 Bord Gáis still holds the same view on the provision of shrinkage gas as indicated in our earlier responses to the Commission.

3.70 At that time the Commission presented two options for future arrangements for dealing with shrinkage gas. Both of these options involve the incentivisation of BGE Transmission, either by minimising the cost of shrinkage gas provision or by minimising the level of shrinkage. The Commission suggested that there may be confusion over the roles of gas transporter and gas trader/supplier. BGE believes that there is no confusion at the moment but BGE Transmission, as any gas transporter, must acquire some gas for own use since the operation of compressors is a responsibility of the transporter. BGE Transmission does not "trade" gas or take a position in gas but we agree that any confusion over roles must continue to be avoided if the shrinkage gas arrangements are changed in the future.

3.71 To date, BGE Transmission has issued a competitive tender every year for the provision of shrinkage gas. BGE believes that this ensures that the lowest price is discovered and all shippers benefit from this market based process.

3.72 Requiring shippers to take responsibility for shrinkage gas also raises issues, not least of which is how can the correct level of deliveries be made by shippers? It is only the transporter that can accurately determine the level of shrinkage gas that is required both before and during the gas day. If shippers were to include an assumed level of shrinkage in their deliveries of gas to the system then this would rarely be the correct quantity leading to an inefficient outcome.

3.73 Whilst we understand the Commission's concerns with regard to the transporter carrying out a trading function, we believe that the current arrangements represent a reasonable approach as a pre-set operational function which limits any trading activity.

3.74 Requiring shippers to take responsibility for shrinkage gas according to factors determined by the transporter also raises issues. Any mismatch between the shrinkage factor or the actual delivery of shrinkage gas and the real shrinkage quantity would have to be dealt with via the balancing arrangements. This could lead to a distortion in cost recovery. This problem could be further exacerbated if incentives are in place on use of balancing gas.

3.75 We believe that BGE Transmission operates efficiently to minimise shrinkage on the system and that our levels of shrinkage compare well with other high pressure gas transportation systems. We would be happy to discuss this further with the Commission.

Allocating all linepack to the transporter

3.76 Linepack represents the network's flexibility to manage diurnal variations and other imbalances between input and offtake on the system. As such it is a critical and relatively scarce component in the safe and efficient operation of the network, and can also be thought of as the key tool by which the Transporter can reconcile the differences between the theoretical commercial transportation model and the underlying physical system. It is not a separate entity from pipeline capacity but rather is an intrinsic part of it.

3.77 In the interests of minimising balancing costs, maintaining a reasonably simple commercial model and facilitating greater flexibility in the capacity regime, BGE Transmission agrees with the Commission's proposal that all linepack be allocated to the transporter initially. Any possible future departure from this principle needs to be made only after the most careful consideration in view of the fundamental role of linepack to the transportation system. Indeed it is difficult to envisage when shippers could be expected to make a more efficient decision regarding appropriate linepack levels than the Transporter.