Common Arrangements for Gas (CAG)

Transmission Tariff Methodology and Regulation in Ireland and Northern Ireland

Utility Regulator Office Belfast

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Introduction: Objective

**Objective:**

“...to establish All-Island Common Arrangements for Gas whereby all stakeholders can buy, sell, transport, operate, develop and plan the natural gas market north and south of the border effectively on an all-island basis. This means that variations in the price and conditions on which gas is bought and sold will be determined by market conditions and economics, not by variations in regulatory arrangements.”

*Taken from MoU*
Introduction: Drivers

**Main drivers:**

- common incentives within an integrated network – with the gas system becoming more integrated, through the South-North pipeline, it is important to consider the implications of different tariff methodologies in each of the jurisdictions (eg. the distortional effect they may have on the SEM);

- reliance on flows from Ireland – linked to the above point is the fact that Northern Ireland is likely to become increasingly dependent on flows of gas from Ireland through the South-North pipeline as SNIP becomes fully utilised;

- competition – create a larger market which is able to attract more players and which has the critical mass for competition to extend to more consumers; and

- attract investment to enhance security and diversity of supply – as with the above point, a larger market should be more attractive to investors and this should allow greater security and diversity of supply to be achieved.
Existing Position: the Network

Source: Bord Gais Networks
## Existing Position – the Tariff Framework

<table>
<thead>
<tr>
<th></th>
<th>Ireland</th>
<th>Northern Ireland</th>
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</thead>
<tbody>
<tr>
<td>Capacity/Commodity Split</td>
<td>90/10</td>
<td>50/50 (75/25 from Oct 08)</td>
</tr>
<tr>
<td>Entry</td>
<td>Separate</td>
<td>Postalised</td>
</tr>
<tr>
<td>Exit</td>
<td>Postalised</td>
<td>Postalised</td>
</tr>
<tr>
<td>Rate of Return</td>
<td>5.2%</td>
<td>SNIP (2.461%) and BGTP (2.387%) mutualised – WACC based on fixed bond payment BGE UK 6.19%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>Straight Line</td>
<td>Cash Flow Methodology</td>
</tr>
<tr>
<td>Tariffs</td>
<td>Smoothed over 5 years</td>
<td>Set each year independently</td>
</tr>
<tr>
<td>Capacity Trading</td>
<td>Available</td>
<td>Available</td>
</tr>
<tr>
<td>Short Term Product</td>
<td>Available</td>
<td>Not Available</td>
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<tr>
<td>Interruptible Product</td>
<td>Not Available</td>
<td>Available</td>
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<tr>
<td>Inventory Product</td>
<td>Available</td>
<td>Not Available</td>
</tr>
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Assessment Criteria

Criteria arise from:

1) the primary legislation establishing the respective Regulatory Authorities;

2) Government and wider (such as EU) principles of good regulation – often incorporated into better regulation principles; and

3) practical issues relating to the sector and future development.

Overall, needs to reflect the underlying premise of the CAG as set out in the MoU

1. We are committed to working together to establish All-Island Common Arrangements for Gas whereby all stakeholders can buy, sell, transport, operate, develop and plan the natural gas market north and south of the border effectively on an all-island basis. This means that variations in the price and conditions on which gas is bought and sold will be determined by market conditions and economics, not by variations in regulatory arrangements.
Assessment Criteria

**Key considerations are:**

1) Developing the industry – this incorporates a range of issues including cost orientation, a degree of cost averaging and ensuring financial viability;

2) Protecting consumers – this entails ensuring sustainable efficient tariffs and minimum volatility in prices (including the IBP);

3) Security of supply – which involves ensuring sufficient diversity of supply as well as security of supply; and

4) Promotion of competition – at both the wholesale and retail level.
Assessment Criteria

**Protecting consumers includes consideration of:**

1) Impact on the Irish Balancing Point (BP);
2) Interaction with the wider energy market;
3) Ease of implementation
Reform Options: Overall tariff methodology

Options to consider for mixture of entry and exit points include:

1) Postalisation

2) Entry points:
   - Combined IC and others separate
   - Combined IC and combined others
   - Single entry point
   - Separate entry points

3) Exit points:
   - Two Exit points
   - Combined onshore system
   - Multiple (more than two) exit points
Declining interconnector utilisation

Reducing the annual revenue requirement of the ICs by:

- Establishing a Public Service Obligation (PSO) levy to defray some of the costs
- Buying down some of the costs through changing the Regulatory Asset Base (RAB) by moving or suspending some of the asset value during the trough in consumption
- Cutting the allowed rate of return

Reducing the effect of the decline in utilisation by:

- Reprofiling (averaging out the trough in consumption)
- Setting a minimum booking level (filling in the trough)
- Reducing the depreciation level during the trough in consumption
Reform Options: Tariff Structure

Capacity / commodity split:

- Should there be common allocations to capacity and commodity charges in Ireland and Northern Ireland?
- If there were to be common allocations at what level would they be set?

Tariff smoothing

- Again, issue of commonality across jurisdictions
- Possibility of smoothing out beyond the normal five year period

Non annual gas capacity products:

- Short-term Products
- Inventory Products
- Interruptible Products
Modelling

An indicative financial/tariff model has been built that allows different options to be considered

Key features of the model include:

• looks out to 2020
• considers various scenarios and combinations of reform options outlined earlier
• data and assumptions have been provided by transporters
• Larne data arrived very close to Consultation Paper publication
• updated public version of model will be made available
Modelling: Capacity baseline

- **Multiple entry / exit options**
- **No SLNG or Larne**
- **No tariff smoothing**
Initial Assessment: Postalisation

Postalisation leads to:

• a simplified tariff structure
• assured revenue recovery and the Northern Ireland annual approach
• lower and less volatile prices for consumers

Against this:

• impact on investment/consumption signals and overall security of supply need to be assessed
• concerns over establishing a postalised tariff, eg with two jurisdictions it is possible that the tariff be higher than status quo in Northern Ireland requiring some form of revenue transfer.
• potential currency risk issues between the two jurisdictions (although similar issues have been addressed within the SEM)
Modelling: Postalisation

- Single entry and exit option
- Corrib only (ie, no SLNG or Larne)
- Tariffs smoothed for years 3-4 and 5-12
Initial Assessment: Entry options

Viable options include:

• a single entry point
• a single Moffat entry point with all other entry points combined
• a single Moffat entry point with all other entry points treated separately
• multiple separate entry points

Compared to the existing forecast tariffs:

• the Moffat and single entry options lead to an increasingly stable tariff. Some remaining variability could be removed through price smoothing
• combining the other entry points into a single entry point leads to a stable and low cost entry point. The gradually reducing capacity of Corrib and the consequent increasing price (if so priced) is mitigated through the addition of Shannon and Inch
Modelling: Single entry / multiple exits

- Single entry and dual exit options
- Corrib only (ie, no SLNG or Larne)
- Tariffs smoothed for years 3-4 and 5-12

- Block 1 = single entry
- Block 2 = RoI onshore
- Block 3 = NI onshore
Modelling: Multiple entry options

- Moffat and combined other entry points
- Corrib only (ie, no SLNG or Larne)
- Tariffs smoothed for years 3-4 and 5-12
Initial Assessment: Exit options

**Three main exit options:**

- a single exit point for the two jurisdictions
- two exit points, one in RoI and one in NI
- multiple exit points – based on some form of local distribution zone or point to point exit

**Key features:**

- Two exit points allows differences in cost to be reflected and also provides a route by which revenues could be transferred between jurisdictions
- A single exit point provides for smooth and stable prices whilst giving up a degree of cost reflectivity
- Multiple exit points would allow a more cost reflective system, although how meaningful that is for the market the size of Ireland is not clear
Initial Assessment: Declining interconnector utilisation

**Key factors to consider:**

- administrative burden: eg, mutualisation involves significant upfront cost
- transmission investment signals: low guaranteed costs of capital for existing assets may encourage inefficient investment
- impact on indigenous producers: reducing the cost of the marginal entry point lowers the IBP and consequently revenues received by producers
- concerns about revenue recovery: some of the options, eg long reprofiling or asset suspension, could create concerns about investment being remunerated and consequently actually increase the cost of capital for new investment
Modelling: Impact on ICs of SLNG and Larne

- **Multiple entry / exit options**
- **Tariffs smoothed years 3-4 and 5-12**
Initial Assessment: Capacity and commodity charges

- We have only considered the range between the regulators’ current positions, ie NI’s 75:25 split and RoI’s 90:10 split)
- Overall impact of any change in the split is likely to be minimal
- The distributional impact is of primary interest with different users being affected depending on their load profile
- Consequently, there is a trade-off between cost reflectivity and distributional impact that needs to be considered
- best practice amongst European regulators has been to reflect the division between fixed and variable costs in the capacity – commodity split
- This enables fixed costs, such as capex, to be recovered through the capacity charge and variable costs, such as opex, to be recovered through the commodity charge
Initial Assessment: Tariff smoothing

- Options for within period tariff smoothing (smoothing) and across period tariff smoothing (reprofiling)
- Need to consider effect of smoothing / reprofiling in NI in on the requirements of bond holders of the mutualised assets
- Both smoothing and reprofiling have an impact on the ability of indigenous producers to benefit from peaky prices. The longer the period of the smoothing the fewer the peaks and the less a producer is able to gain
- Impact on competition unclear and depends on whether peaks encourage competition in supply (in which case smoothing would dampen incentive) or result from reduced demand (in which case smoothing would limit this effect and maintain a larger market where competition amongst shippers/suppliers may flourish)
Modelling: Tariff smoothing

- **Multiple entry / exit options**
- **Corrib only (ie, no SLNG or Larne)**
- **Tariffs smoothed years 3-4 and 5-12**
Initial Assessment: Auctions

**Key points to consider:**

- Are auctions likely to raise sufficient revenue to cover costs for each transmission line and what mechanisms are in place if they do not?

- The interaction of the level of competition for gas customers in NI and Ireland with the likely level of competition for the auctions for entry capacity. Currently, little competition and with increased excess capacity it is not clear that auctions would raise sufficient revenue, or provide meaningful signals, about consumption or investment.

- If NI operates a separate gas tariff methodology auctions could be used for allocating access to the SNIP. Prices could be bid-up towards the IC tariff cost raising additional revenue.
Next Steps

The role of this consultation paper has been to provide:

- A framework for analysing reform options
- A first view of the range of possible reforms
- An initial assessment of the reforms