Commission for Energy Regulation
An Coimisiún um Rialáil Fuinnimh

Proposed Reductions in Gas Tariffs 2009

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Abstract:

The purpose of this paper is to consult on the scope for bringing forward anticipated reductions in BGE regulated retail gas tariffs.

Target Audience:

Gas Customers, Suppliers, Shippers and Producers.

Related Documents:

- Bord Gáis Tariff Decision Paper 2009: CER/08/247
- Final Decision on the Associated Tariffs for Bord Gáis Energy Supply Residential and Smaller Commercial and Industrial Customers January 2009 – 30 September 2009 http://www.cer.ie/en/documents-by-year.aspx?year=2008

Responses to this consultation should be returned by email, post or fax and marked for the attention of Stuart Coleman (scoleman@cer.ie) at the Commission**.**

The Commission intends to publish all submissions received. Respondents who do not wish part of their submission to be published should mark this area clearly and separately or enclose it in an Appendix, stating the rationale for not publishing this part of their comments.

Executive Summary

Following a request from Minister for Communications, Energy and Natural Resources, Eamon Ryan T.D., the Commission sets out in this consultation a review of current gas retail tariffs and the scope for bringing forward tariff reductions which would normally be expected to arise in October 2009.

On 8th August 2008 the Commission approved a two-phase approach to tariffs and an interim 20% increase in tariffs for residential and small Industrial and Commercial customer segment. It was anticipated at the time that there would be a further increase in the second phase likely to come into effect on 1st December 2008. In the intervening period, however, international gas prices reduced significantly. This, combined with a voluntary rebate by BGE of €8.5m to all gas customers, allowed the Commission announce on 1st December that there would be no further increase in existing tariffs.

Since then, emerging trends in international gas prices as well as a higher than anticipated gas consumption in Ireland during the winter months have resulted in the prospect of a significant reduction in BGE's regulated tariffs to residential and small industrial and commercial customers. In the normal course this reduction would come into effect on 1 October next, the beginning of the gas year. In view of the exceptional difficulties currently facing the economy, the Commission now proposes to bring forward the benefits of these reduced tariffs to 1 May 2009. From that date, the Commission proposes a 12% decrease in BGE's tariffs. A further reduction is anticipated next October for the 2009/10 gas year if current international market projections are borne out. This reduction will obviously be less – of the order of 10% rather than 23% - than would be the case without the present 1 May reduction proposal.

The Commission invites comments regarding the options set out in this paper or indeed variations on them if parties feel there are better options available.

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1.0 Introduction

On the 3rd Feb 2009 the Minister for Communications, Energy and Natural Resources, Eamon Ryan, T.D. announced to the Dáil that he had asked the Commission for Energy Regulation (CER) to undertake an immediate review of options for bringing forward anticipated reductions in electricity and gas prices for householders and business.

1.1 Background Information

2008/09 Approved tariffs:

On 8th August 2008 the Commission approved a two-phase approach to tariffs and an interim 20% increase in tariffs for residential and small Industrial and Commercial customer segment. It was anticipated at the time that there would be a further increase in the second phase. However, wholesale gas prices reduced significantly in the intervening period. This, combined with a voluntary €8.5m rebate offered by BGE to all residential and small I&C customers - i.e. regardless of their supplier - resulted in the CER decision on 1st December that there would be no further change to existing tariffs.

2.0 Gas Market

2.1 Introduction

Currently, over 90% of Ireland's gas is imported through our interconnectors with Scotland with the remainder from indigenous sources, including the Kinsale and Seven Heads gas fields. Corrib will add to Ireland's indigenous supplies but the nature of the Corrib field is such that its production profile is expected to decline quite sharply after the early years of flow. Clearly, then, the Irish price for gas is set by the GB price for gas i.e. Ireland is effectively a price taker for gas commodity purposes. The speed with which changes in international energy commodity prices – upwards or downwards – feeds through to gas retail tariffs to end customers is affected by, among other things, the hedging policies of suppliers and how BGES in particular is regulated in this regard. This is dealt with in more detail in section 3 below.

By international standards, the Irish gas market is small. The national transmission network currently comprises two entry points (Inch & Moffat). The Moffat entry point is connected to the National Grid in Great Britain (GB) and allows for the importation of gas from GB to Ireland via two sub-sea interconnectors (IC's). IC1 and IC2 connect the GB network in Scotland to Loughshinny and Gormanston in Dublin & Meath respectively. These ICs provide a secure link to European gas sources.

An additional entry point is planned in Mayo to allow connection of the Corrib gas field to the national transmission system. This is due to commence commercial operations by October 2010. There is a natural gas storage[1] facility at the Kinsale gas field, connected to the transmission system via the Inch entry point in Co. Cork. A new entry point will be required for the proposed Shannon LNG terminal.

Natural gas currently makes up c. 27% of Ireland's Total Primary Energy Requirement (TPER) a share that is in line with the EU average[2]. The TPER includes all sources of energy including oil, gas, coal, peat, renewable electricity and electricity imports. It includes all consumption of energy including transport and gross fuel input into power stations. With Ireland's TPER 96% reliant on fossil fuels and 89% reliant on imports, Ireland is highly susceptible to market fluctuations which affect end user prices.

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[1] Production on Kinsale & Seven Head field due to cease 2013. Continued storage may only be viable if increased revenue makes the operation of the assets profitable: GCS2008, pg:38. This facility is operated on a commercial basis rather than a strategic storage basis.

[2] BGN Transmission Development Statement 2006/7 to 2012/13 Sec 2 & 3.1.1 ref 2006

Other EU counties like France have a much lower dependence on fossil fuels primarily due to their use of nuclear power. Ireland also has a relatively immature network infrastructure, with large investment undertaken in the relatively recent past and therefore still to be paid off. There is also a relatively dispersed population structure. Both these factors cumulate to put upward pressure on unit network costs to customers.

The cost of gas in Ireland depends on the wholesale price of gas at the National Balancing Point (NBP) in the UK, and will do for as long as it remains the marginal source of gas. Being at the end of the pipeline network means the Irish consumers pay the price at NBP plus a transportation charge which automatically puts the Irish consumer at a disadvantage relative to its EU counterparts. Indigenous supplies will not necessarily reduce the price for wholesale gas. While Corrib may provide a significant portion of demand (for a relatively short period), the marginal source will still be the UK gas coming across the ICs. The Irish market is therefore highly susceptible to changes in wholesale gas prices worldwide.

With respect to the actual price of gas delivered to consumers, the cost of purchasing wholesale gas accounts for approximately 60% of the total delivered cost to NDM customers. Accordingly, a large increase in the wholesale unit cost will have a significant impact on gas tariffs[3]. It should be borne in mind here, however, that large users of gas i.e. FVT, RTF and those consuming above 264 GWh, are not locked in to regulated tariffs and have thus been benefitting from the falling fuel prices which have emerged in recent months.

2.2 Wholesale Gas Market

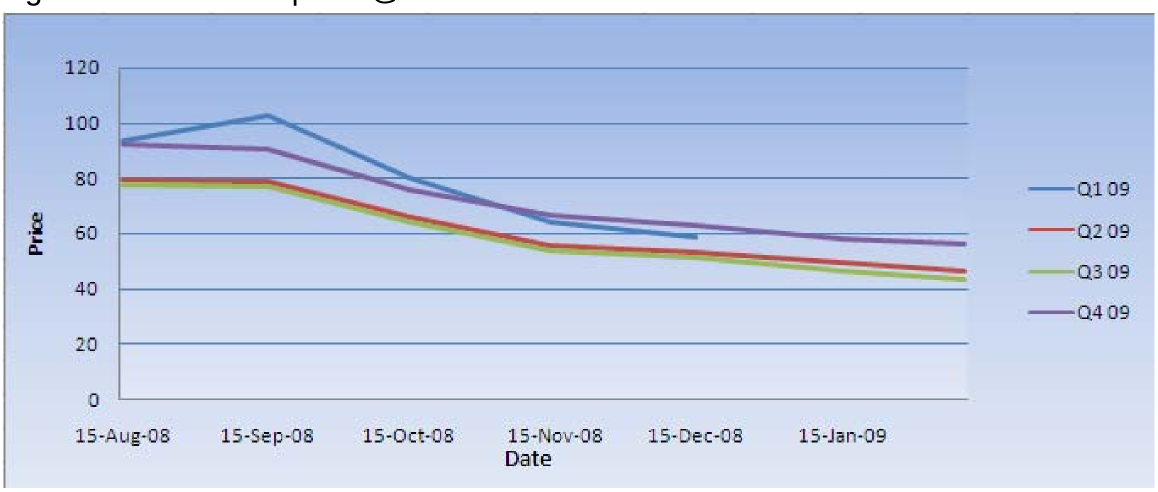
In the past wholesale gas prices in Ireland and the UK were not heavily linked to global fuel prices. In recent times, however, the UK's domestic production of gas has declined and it has become increasingly dependent on imports to meet demand. With this direct link the UK price has been greatly influenced by the global wholesale oil and gas markets.

[3] Less than 264 Gwh

The rise in the NBP price has come about due to a combination of regional and global factors[4]. Supply disruptions and the steep rise in both crude oil and coal prices had a direct impact on the NBP price. Prices peaked in July 2008 and began to fall back steadily. Prices are still relatively high in historical terms, however. The monthly price for February ‘09 at €0.6586/therm[5] compares to the equivalent price for February 2008 of €0.6789/therm[6]. Thus prices have fallen back to close to where they were prior to the 20% rise announced on 8th August 2008. As gas was purchased partly at the higher prices in the intervening period, on an ongoing basis (in the laddered approach), the scale of any decrease now warranted is less than 20% (as some of the gas was bought at the higher prices in the intervening period).

Although prices appear to be stabilising in the short term, in a global fuel market where prices are influenced by a number of political, geographical and economic factors, it is difficult to predict how or the scale on which they will change in the coming months.

Figure 1: Wholesale price @ NBP



[4] Wholesale gas prices across Europe are primarily driven by the oil market. This occurs through the influence of long term contracts from suppliers e.g. Algeria, Norway, Russia where the price is linked to the oil market on a lagged basis.
[5] Using exchange rate of Euro/Sterling on 11th Feb 2009 at 0.89999 pence.
[6] Using average Euro/Sterling exchange rate for 2008 of 0.7988 pence, source AIB FX centre.

3.0 Tariff Review Process

Under normal tariff review procedures the Commission receives a revenue and tariff submission from BGES. This submission is then extensively examined and published for consultation. Following consultation and review of responses a decision is published.

The process by which the Commission carries out the tariff revue is well documented[7]. In October 2007, the Commission approved a Revenue Control Formula (RCF) to calculate revenue regulated gas tariffs for the gas years 2008/09 – 2011/12.

There are six main features of the RCF:

1. Gas Commodity Purchases
2. Network Charges
3. Supply Costs
4. Margin
5. Correction Factors
6. Capital Expenditure

As part of the RCF the Commission approved the use of a benchmark mechanism to approve the allowed **gas commodity cost**. This benchmark applies a laddered approach to the purchasing of gas for each month throughout the whole year.

Two key elements underpin the benchmark:

1. A certain percentage of the total anticipated gas volume demanded for each delivery month will be procured in a gradual manner as the delivery month approaches (i.e. the "laddered approach", see Table 1). The percentage of total anticipated monthly gas volume demanded procured prior to the delivery month differs by delivery month.
2. The procurement pattern of gas contract for delivery in any given gas month is fixed for the period the benchmark is applicable.

[7] CER/07/158: Final Decision on BGES NDM 5 Year Regulatory Review 2007/08 – 2011/12
CER/07/110: Transmission Decision Paper, BGN Revenue Review
CER/07/111: Distribution Decision Paper, BGN Revenue Review

This acts as a hedge on changes on the gas price and offers transparency in the tariff formulation process and provides a target for other suppliers to compete against.

Table 1: Gas purchasing benchmark

For delivery in:	Q4 2008	Q1 2009	Q2 2009	Q3 2009
Purchases starting in:				
Q4 2007	20.9%	16.1%	0.0%	0.0%
Q1 2008	20.9%	16.1%	0.0%	0.0%
Q2 2008	20.6%	21.4%	7.6%	22.1%
Q3 2008	18.0%	19.3%	12.5%	22.1%
Q4 2008	4.5%	11.1%	16.1%	0.0%
Q1 2009	0.0%	3.0%	19.5%	3.7%
Q2 2009	0.0%	0.0%	4.3%	13.7%
Q3 2009	0.0%	0.0%	0.0%	8.5%
Total	**85.0%**	**87.0%**	**60.0%**	**70.0%**

Total = average % of total volume purchased prior to delivery months

BGES acquires its gas portfolio requirements for the residential and small I&C customer segment using the laddered approach. This strategy is in keeping with general industry practice, and in itself is a hedging type strategy, which ensures that gas costs are not heavily impacted by random market spikes. Instead, the cost of gas is smoothed out to reflect changes that occur in the market throughout the year.

Network charges are the CER approved costs that suppliers are required to pay the operator of the natural gas network for the transportation of gas to the consumer. Network charges are largely pass through costs and are outside the control of BGES.

The Commission approves a **baseline supply cost** for BGES as part of its five year review[8]. The supply cost element of the RCF comprises allowed operating expenditure and other costs that are deemed to be efficient and recoverable over the period. This figure is adjusted year on year to account for changes in customer numbers and inflation. It also includes an efficiency factor of a certain percentage, which accounts for annual improvements in productivity within BGES.

[8] CER/07/158 – Final Decision on BGES NDM 5-year regulatory review 2007/8 – 2011/12

The Commission also approves **BGES's allowable margin**. The regulated margin was introduced to allow BGES take on a portion of the risk associated with gas volumes in exchange for a higher allowable margin. The Commission approved a margin of 2% for the residential and small I&C customers segment for the 2008/09 gas year. The decision was premised on the removal of the volume risk element of the gas benchmark.

The **correction factor (K factor)** is a key feature in a tariff review process which sets on an ex-ante basis for the period of the year. A gas year's total correction (or, K) factor is defined as: the difference between the gas year's ex post allowed revenue and the revenue BGES has actually collected during the gas year.

As the BGES revenue requirement and the associated tariffs for any one year are set in advance of the year to which they relate, they are based on a combination of actual and forecast data. These forecasts include assumptions on various elements of the RCF such as customer numbers, gas sales, weather and gas procurement costs.

In addition to the K factor, the Commission introduced a **Z factor** (incentive-sharing) whereby BGES shares with the customer the difference between allowed gas and supply costs and the actual gas and supply costs. The intention of this factor is to incentivise BGES to beat the benchmark and to share any resulting gains with the customer.

Finally, **capital expenditure** allowance is also approved by the Commission on an annual basis, with all expenditure being broken down into the costing of each expenditure and how those costings should be apportioned. The Commission approved a capital expenditure cost of €2.747 million for the 2008/09 gas year. This included two systems projects - the Customer Information and Billing System (CIBS) approved by the Commission in 2006 and a new Energy Trading system.

All the above elements make up the gas tariffs. With gas commodity costs comprising over 60% of the tariff, this figure can cause the biggest increase or decrease to the NDM market.

4.0 Proposed Interim Review of Current Tariffs

In principle, the Commission could consider a number of different approaches to bringing forward anticipated reductions in gas retail tariffs, each with its own advantages and disadvantages. For example, the Commission could direct BGE to move, say, to an 18 month approved fixed tariff regime or to reduce the network components of tariffs with immediate effect with the commitment to correcting for this in later network tariff adjustments.

A better approach, in the Commission's view, is the more straightforward one of an early reduction commodity component of current approved tariffs which can be objectively justified by the clearly evident trends in gas wholesale prices and in recent consumption trends in Ireland.

This approach is elaborated below.

The key cost driver for the NDM tariff is largely determined by the cost of energy, which accounts for the largest portion of the end user tariff. In its December '08 decision paper CER/08/247 the Commission committed to further monitoring the developments in wholesale gas markets and stated the approved tariffs would remain in place for the remainder of the 2008/09 gas year, unless significant changes in the wholesale market occurs such that another review by the Commission was deemed appropriate.

Under normal circumstances the tariff decision made in December would remain in place until the end of the gas year (i.e. to 1 October next). This year, however, the Commission has undertaken to keep the intra year developments under close review not least because of the current very adverse economic climate faced by consumers.

Following a very recent examination of BGES revenue requirements and other factors for the gas year 2008/09 there is a projection of a €20 million over recovery on its required revenue for the gas year '08/09. The reasons for this emerging over-recovery are a combination of lower gas costs for the gas year '08/09 than originally forecast, exchange rate developments, and increased sales in the months between October 2008 and January 2009 due to the particularly cold weather. On latest trends and forecasts, therefore, BGES forecasts that a 12% decrease in NDM tariffs could be 'brought forward' to commence 1st May 2009.

A decision to take a 12% decrease in May rather than allowing the over- recovery into next year's K factor would mean there would be a smaller than expected decrease in NDM tariffs from 1st October 2008. Looking at current projections and making the assumption that wholesale prices adhere to current predictions – which may or may not turn out to be the case - a 23% decrease in the NDM tariffs could be expected. A 12% decrease on 1st May would reduce this 1st October anticipated decrease to 10%.

The Commission is anxious to ensure that exercising this particular option is not seen by any existing or potential competing supplier to BGES in the NDM market sector as changing the market rules within the gas year and putting that supplier at an unfair disadvantage. It is true that the Commission alerted the industry on 1 December that it reserved the right to intervene in setting BGES' tariffs during the current gas year in the event of "significant developments in wholesale gas markets." To be fair, however, the scale and timing of this particular intervention was hardly anticipated at the time. The gas purchasing strategy adopted by an individual supplier could also have a bearing on this question. Should a competing supplier to BGES be able to demonstrate that, by virtue of the Commission exercising this particular option with effect from 1st May this would put the supplier at an unfair competitive disadvantage – and the Commission is not assuming that this is necessarily the case - BGE has agreed to do whatever is necessary to remedy this situation subject to approval by the Commission.

5.0 Request for feedback

The Commission invites comments regarding the proposal set out in this paper or indeed variations on it if parties feel there are better options for bringing forward anticipated tariff reductions without undermining the current regulatory framework or giving rise to market distortions.

6.0 Responding to this paper

The Commission invites comments on this paper from interested parties to be submitted no later than 5.00pm on Friday 20th March 2009. Comments should be sent, preferably in electronic format to;

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The Commission intends to publish all comments received – those respondents wishing for certain sections of their submission to remain confidential should submit the relevant sections in an appendix marked confidential.