Airtricity Response to

Consultation on Proposed Reductions in Gas Tariffs 2009

CER/09/039

20 March 2009

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Introduction

As a recent market entrant, Airtricity is particularly interested in the Commission's approach to the current price adjustment process. Our primary concern is that the market should have a stable regulatory framework that does not deliver surprises having the effect of ex-post regulation. Although the Consultation highlights recent significant changes in gas commodity prices, it also highlights exchange rate and weather influences but without quantifying their impact. The data provided on BGÉ's hedging process is also somewhat limited and no comparison with the benchmark is provided.

Given the emphasis on competition underpinning the Commission's parallel Consultation on electricity prices (CER/09/038), we believe that a greater focus on this issue would have been appropriate when considering gas price adjustments. It would certainly have been relevant given the Commission's duty to promote competition in the supply of natural gas.

Overall we were disappointed with the level of background explanation provided and are left with the impression that, although "the Commission is anxious to ensure that exercising this particular option is not seen by any existing or potential competing supplier to BGÉS in the NDM market sector as changing the market rules within the gas year"[1], this is exactly what has happened. The "better approach" recommended "is the more straightforward one"[2], but no reference is made to any potential impact on competition. What potential solutions, other than adjustment of transport or commodity charges were considered? Taken together with the voluntary rebate of €8.5m offered by BGÉ <u>Supply</u> in November 2008, we believe the current proposal creates an environment of regulatory uncertainty surrounding gas supply, with consequential non market-based business risk to BGÉ's competitors. This is not encouraging to market entrants.

Competition issues

<u>k-factor effect</u>

Gas usage is extremely sensitive to weather influences, so the form of regulation applied to BGÉS is a key issue in the context of a competitive market. If consumption was relatively

[1] Para 2, page 13

[2] Para 2, page 12

stable and, for example, correlated with the number of exit points but not related to temperature, then k-factors might have little impact on retail price and could possibly be ignored by potential market entrants. However, as accurate consumption forecasts depend on weather forecasting ability a year ahead, revenue cap regulation must be regarded as a major risk issue for independent suppliers, unless a means can be found to apply the approach in a non market-distorting way.

CER/07/101 gave the allowed base supply cost of €28.2m for the current revenue control period. The current Consultation suggests an over-recovery of around €20m for the 2008/09 tariff year; some 70% of the business running cost. Supply margins so highly geared to the incumbent's price control mechanism are incompatible with market entry by privately-funded businesses.

<u>impact of unpredictable price control decisions</u>

- In November, BGÉS offered a voluntary contribution of €8.5m from its supply business. This had the effect of reducing competitive headroom in the tariff and transforming a competitive cash volume into a fixed supplier rebate to be delivered to customers. In the electricity market, the ESB rebate was consciously applied to wires charges to prevent damage to competition, yet the Phase 2 gas price review allowed BGÉ to squeeze competitive market headroom in the gas market. This type of unpredictable, non cost-reflective event significantly increases entrant risk.

- Prior to July 07, the BGES allowable margin was 1.3% with full pass through of price and volume risk. The Commission took the view that a re-assessment of this margin was required, as it had been set in the context of the competitive environment in 2003. Going forward it would be more appropriate to link margin to the amount of risk that BGÉ was willing to accept. For 2007/08, the margin was set to 2.0%, raised to 2.9% for 2008/09, but subsequently pulled back to 2.0% in the Phase 2 price review.

The Commission's approach to regulation of BGÉS prices has been to focus on headline prices paid by customers, but to ignore the impact of unpredictable policy changes on the risk faced by independent suppliers. It is difficult to see how this is compatible with the Commission's legal obligation not discriminate unfairly between holders of licences and BGÉ, nor how it promotes and protects the longer term interests of customers, or contributes to promotion of competition. Managing prices through imposition of unpredictable, non cost-reflective changes to competitive headroom or erratic risk transfers back and forward between suppliers (margin) and customers (k-factor), undoubtedly creates barriers to competition and favours the incumbent.

Airtricity strongly believes that effective competition can only become established if the regulatory environment is stable and predictable within a transparent policy framework.

<u>exchange rate</u>

In addition to weather-induced gains and gas price movements, the remaining reason cited for the projected €20m revenue over-recovery in 2008/09 is "exchange rate developments". This impact is not quantified, nor is sufficient information provided to determine the extent and value of BGÉ's currency exposure. In view of the scale of projected revenue over-recovery, we believe the Commission should provide information on BGÉ's currency hedging policy and whether this was properly implemented.

<u>dual fuel offering</u>

BGÉ is currently offering electricity to its gas customers at an additional 2% discount compared with those customers who do not have a gas account. Aside from being a clear breach of Conditions 14 of its gas supply licence (obligation to maintain full managerial and operational separation of its gas supply business) and Condition 16 (not to cross-subsidise between businesses directly or indirectly), the lower overall cost of this fuel package means that competitors seeking to enter the gas market must offer deeper discounts than would otherwise be the case; scope for such discounts having been reduced by BGÉ squeezing the competitive headroom. We believe that BGÉ is using its unregulated electricity business to tie customers into its gas supply business and thereby create a barrier to competition in its monopoly gas market.

Proposals

This consultation considers the options of, a 17-month tariff, a rebate through transport charges, or a reduction in the supply price. The parallel Consultation on electricity pricing[3] highlights the damage that can be caused to competition by an inappropriate approach to price-setting. If BGÉ's commodity hedging policy has left it sufficiently exposed to market price movements to benefit materially and if it has also benefitted from currency exposure, then the available €20m revenue cushion now presents the perfect opportunity to reverse some previous anti-competitive regulatory decisions and position the market for proper, level-playing field competition.

We believe that;

1. The gas price commodity price should retrospectively be fully recalculated on the basis of the approved benchmark,

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[3] CER/09/038 sets out very clearly why

2. exchange rates relevant to the benchmark purchasing strategy should be used for valuation,
3. the supply margin should be set at 3% and BGÉS be obliged to take on full price and volume risk, as faced by other suppliers,
4. in recognition of 3, the k-factor approach to regulation should be abandoned
5. transport charges should be adjusted to deliver the targeted 12% in delivered prices, and
6. BGÉS should no longer be allowed to flout its business separation obligations and use its electricity offering to undermine entry to its monopoly gas business.

Conclusion

The Commission cannot be sure that competition will develop in the NDM gas market, even if it creates a proper level playing field for all suppliers. However it can certainly create conditions that will slow, or even halt, development of competition. We believe that customers will benefit to the greatest extent through the development of vigorous competition; particularly in a highly weather-sensitive market like gas, where hedging of both commodity and exchange rates can have a significant impact on the cost of energy. As the world economy and energy demand recover, it is highly likely that gas price volatility will re-emerge. In such an environment only competition will ensure that customers receive the best possible prices. We therefore urge the Commission to take this opportunity to deliver the price reduction through the approach outlined above and at the same time create a robust and stable regulatory framework that will support imminent competition.