

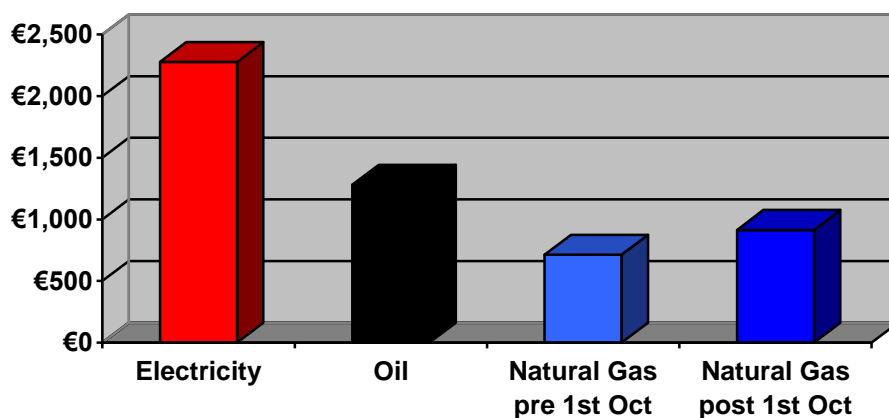
# **RESIDENTIAL GAS TARIFFS FOR 2011/12 IN ACCORDANCE WITH THE REGULATORY CONTROL FORMULA**

**20<sup>TH</sup> JULY 2011**

## EXECUTIVE SUMMARY

The residential tariffs charged by Bord Gáis Energy (BG Energy) are determined in accordance with a Regulatory Control Formula (RCF) as directed by the Regulator, the Commission for Energy Regulation (CER). BG Energy, as the only regulated entity in the retail energy market, cannot adjust prices for residential customers without approval from the CER.

The regulatory formula aims to ensure that tariffs are based on a cost reflective methodology and that BG Energy recovers its allowable costs. In accordance with this regulatory formula and based on forecasted customer numbers, volumes and forward gas prices, BG Energy forecasts a revenue requirement of €287.651 million for the coming year. This equates to an average tariff increase of 28.13% relative to last years' tariffs. Increased wholesale gas prices are the largest determinant driving this increase. Notwithstanding this proposed increase, natural gas still remains the cheapest and most efficient fuel for home heating as per the Sustainable Energy Authority of Ireland's (SEAI) latest data for April 2011.



This submission outlines the inputs to the residential gas tariffs, the movements in these costs and the assumptions made by BG Energy in deriving these costs for the coming gas year.

## **1. BACKGROUND**

In 2007, the CER introduced new arrangements to determine allowable revenues and regulated tariffs for the residential and small business customer segments. The detail of these arrangements is outlined in a decision paper published by the CER in October 2007<sup>1</sup>. These arrangements, or regulated formula, are designed to provide for cost reflective gas costs, transportation costs, operational expenditure, capital expenditure and a margin of 2%.

Gas costs are established using a 'laddered approach', which gradually builds up wholesale costs over the course of 24 months. This avoids large swings in gas costs due to short-term price spikes in the wholesale market. Transportation costs relate to the use of the gas network to deliver gas to the customer from the point of purchase in the UK. These costs are a direct pass-through cost and are calculated by reference to forecasted customer volumes and by reference to the network charges determined by the CER. Combined, gas costs and transportation costs account for approximately 86% of the overall total revenue requirement.

Operational costs, capital expenditure and margin account for the remainder of the required revenues.

The extraordinary economic circumstances facing customers is hampering their ability to manage their energy bills. BG Energy proactively works closely with customers and advocates on their behalf to the Joint Oireachtas Committee on Communications, Energy and Natural Resources and the CER for real solutions to lessen the burden on customers. BG Energy has expended considerable resources to address bad debt and help people in financial difficulty, but despite best efforts the issue has been escalating and is having an impact on the company's operational costs.

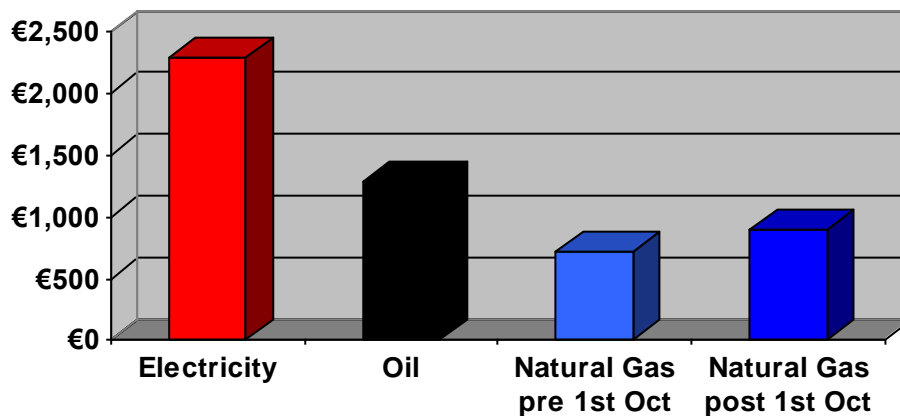
It is evident to all that the market environment has changed substantially since the regulatory formula was introduced in 2007. In the past 18 months two large energy suppliers have entered the residential gas market and an existing supplier has extended its offers outside of its franchise area. These competitors are offering choice and tangible discounts to customers. The entry of new competitors and the level of

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<sup>1</sup> CER/07/158 Final Decision on Bord Gáis Energy Supply Non-Daily Metered 5 Year Regulatory Review 2007/08 – 2011/12

customer churn in the market clearly demonstrate that the retail gas market is a competitive market, with no barriers to entry for new suppliers and no barriers to switching for customers.

Within this competitive market, BG Energy aims to ensure that tariffs charged to customers are set appropriately and are competitive; that is that they are fair and transparent and that natural gas is provided at the lowest cost to customers. Since 2008, BG Energy has implemented 3 tariff reductions which have cumulatively reduced tariffs by 25%. Notwithstanding the proposed increases, tariffs for 2011/12 will still be lower than 2008 levels and natural gas will remain the most cost effective and efficient home heating fuel in the Irish market. This is clearly demonstrated in the graph below, which indicates that natural gas is 60% cheaper than electricity as a home heating fuel<sup>2</sup>.



As a company operating in a competitive and fully open dual-fuel market, BG Energy must perform effectively. Within this context, the sustainability of the company is dependent on BG Energy being allowed to recover its reasonable and genuine costs and to meet its financial obligations. It is therefore imperative that the regulatory formula, applied to the company's regulated business, provides for the recovery of all legitimate and genuine costs. In this regard, the regulatory formula must be sufficiently flexible to account for the changing market environment and the added costs of servicing this market in the current economic climate.

<sup>2</sup>Source: SEAI Publication, "Ireland Domestic Fuel Price Comparison", April 2011.

In the meantime, BG Energy would urge any customer who experiences difficulty in meeting their energy bills to contact the company. As a company, BG Energy is acutely conscious of the difficulties faced by customers and will endeavour to provide appropriate support to customers who make contact and attempt to address their financial difficulties. BG Energy will also continue to work with agencies offering advice and support to the public and those experiencing fuel poverty.

The remainder of this document outlines the cost inputs to the regulatory tariff submission and the driving forces behind the proposed increase.

## **2. REGULATORY CONTROL FORMULA COST INPUTS**

### **2.1 GAS COSTS:**

#### **Gas Benchmark Costs**

The forecasted gas costs are determined by a regulatory determined 'laddered benchmark' approach. The laddered approach aims to reduce the impact of wholesale price volatility by smoothing gas costs over a period of 24 months. It essentially provides for the purchasing of forecasted gas volumes over a gradual period leading up to the delivery day. The aim of the laddered approach is to avoid exposure to short-term price spikes and to minimise the risk of such spikes on customers' costs.

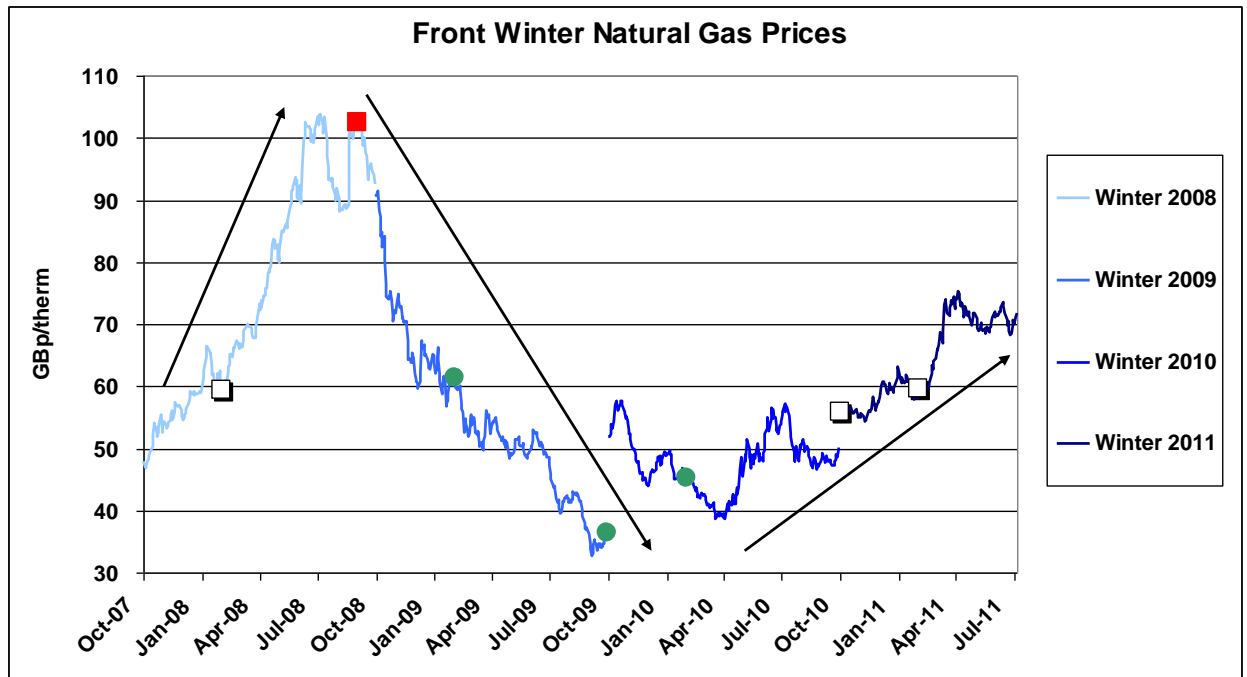
The benchmark calculation is based on contracted and un-contracted gas purchases at the National Balancing Point (NBP) in the UK. The contracted purchases are priced at the published wholesale gas price for that trading day and the un-contracted purchases are priced at published forward curve for delivery at a future date.

#### **Gas Procurement Costs**

Ireland currently imports over 90% of its gas requirements from the UK. As such, the wholesale price of gas in Ireland is dictated by the traded price and market developments/influences in the UK.

The last year has been characterised by a general trend of rising wholesale gas costs, both in prompt prices and on the forward curve. The below graph demonstrates how wholesale gas prices have moved over the past number of years. Note that the current upward trend in rising prices began in April 2010. The laddered approach to gas purchasing had cushioned the customer from these initial increases. However, the sustained nature of increases since April 2010 and the forecasted continuation of

these high prices out into the foreseeable future, is now forcing the need to increase tariffs.

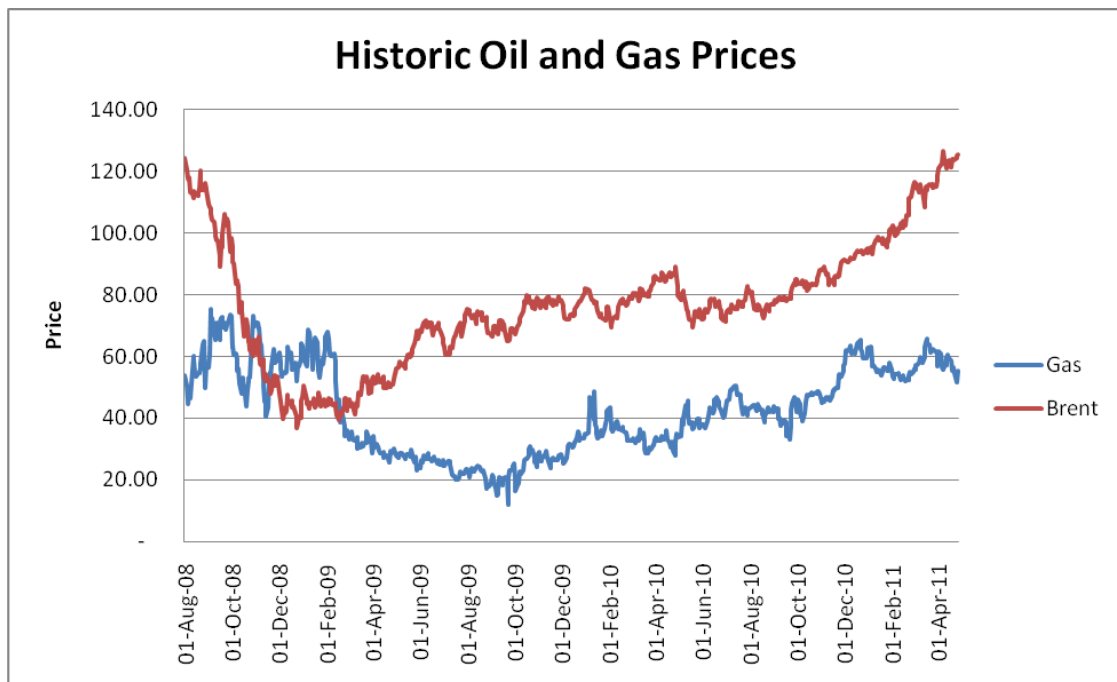


There are a number of factors that have influenced this volatility and that continue to influence the forward curve:

- The colder than average, or 1-in-50 winter, last December and January tightened the demand/supply scenario;
- Wholesale gas prices tend to mirror global oil prices but with a lag of approximately 6 months. Proposals to cut oil production and the geopolitical unrest in the Middle East in the Spring caused spikes in oil prices that are now transferring over to gas prices;
- Demand for fossil fuel from the growing economies in Asia is also driving up prices for both oil and gas;
- The earthquake and tsunami in Japan and the subsequent disruption to Japan's nuclear power stations switched Japan's reliance from nuclear to gas

for the purposes of power generation. LNG cargo's bound for the UK were diverted to Japan, with the effect of bidding up the price of UK bound gas, and

- The announcement by Germany to relinquish its commitments to nuclear power will increase Germany's dependence and demand on gas fired generation into the future. This announcement has affected gas prices across Europe.

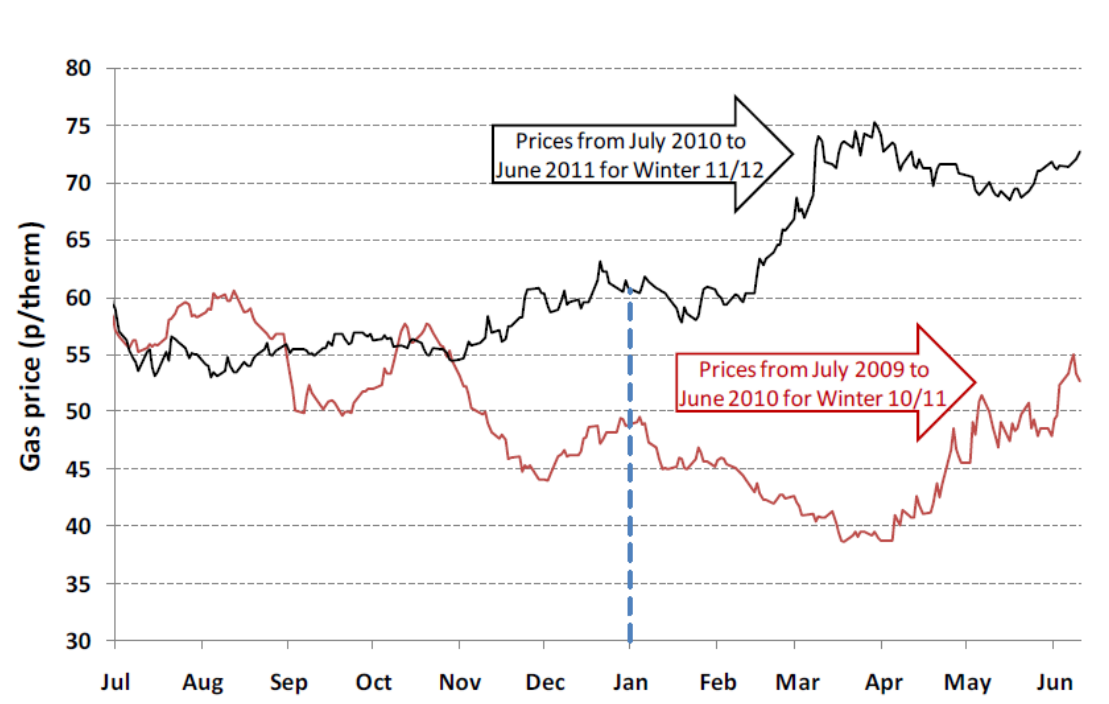


The graph below, produced by British regulator OFGEM, provides another useful comparison of the average wholesale gas price for the 2010/11 tariff year and the pending 2011/12 tariff year. Essentially the graph shows that the cost of gas is more than 30% higher for the coming year relative to the price of gas for the same period in 2010/11. The graph also shows the unprecedented high price for gas during the summer months. Typically, gas bought during the summer months is lower than that bought during the winter months. However, contracts for winter gas for delivery during the 2011/12 gas year are higher this summer than for the same period last year.



Although BG Energy aims to purchase gas as cost effectively as possible on behalf of its customers, these rises cannot be avoided given the sustained pattern of the price increases over the past 15 months and forecasted for the coming year. On average, forecasted gas prices for 2011/12 are 50% higher than those forecasted for the same period in 2010/11. Although the laddered purchasing strategy element of the formula has protected customers from the increase in wholesale prices over the last 15 months, tariffs must be amended to reflect the higher costs of supplying gas and purchasing wholesale gas going forward.

**Winter gas price contract comparison in 2010 and 2011**



In its submission to the CER, BG Energy has based its gas costs on previously contracted prices and the forward price as of the 20<sup>th</sup> June 2011 for all un-contracted volumes. To be clear, although a portion of BG Energy's forecasted gas volumes have been purchased and the price is known, there is an outstanding portion yet to be

purchased and for the purposes of this submission, these contracts are marked to market using the prevailing forward curve prices as of 20<sup>th</sup> June 2011.

BG Energy endeavours to ensure that its tariffs are reflective of the wholesale gas price for gas. As wholesale gas prices reduced during 2009 and 2010, BG Energy, through its interactions with the CER, implemented 3 tariff reductions which have cumulatively reduced tariffs by 25% since March 2009. BG Energy will continue to monitor wholesale gas prices on an ongoing basis and will propose changes to tariffs should the market fundamentals change to a material extent.

## **2.2 Transportation Charges – Transmission & Distribution**

BG Energy calculates its expected costs for transporting and distributing gas based on a best estimate for forecasted volumes and CER approved Network charges. Transportation costs are treated as pass-through costs for the purposes of setting tariffs as they are approved by the CER and applied to all market participants.

The CER is currently undertaking a comprehensive review of the transportation costs and tariffs. Indicative tariffs have been published for consultation. The costs applied to the regulatory formula are therefore subject to change depending on the outcome of the CER's consultations on transmission and distribution charges. A final decision is expected to be published in August and BG Energy will update the relevant transportation costs accordingly.

## **2.3 Allowable Supply Costs**

The supply cost element of the regulated formula comprises BG Energy's forecast of the operating expenditure associated with servicing its residential customers. It relates to operating costs such as call centre, billing, trading, bad debts and other related overheads.

Under the regulatory formula, supply costs are base-lined and benchmarked to BG Energy's estimated 2006/07 supply costs. This baseline figure is revised annually in line with changes in CPI, customer volumes and customer numbers. A 3% annual efficiency factor is also built in and bad debt is capped at 0.5% of revenues.

Under a supply cost 'Z-factor' element of the regulatory formula, BG Energy is allowed to share 50/50 with the customer the difference between its actual supply costs and those allowed for under the regulatory formula. Z-factor supply costs have become a consistent feature of tariff submissions over the last few years as the benchmark supply cost figure has significantly underestimated BG Energy's actual supply costs. Indeed, it has been a consistent criticism from respondents during recent tariff reviews, suggesting that it makes it more difficult for competition in the residential gas sector to develop.

BG Energy also believes that given the CER's recent commitment to reduce and minimise the impact of K and Z factors as part its decision on a Roadmap for Deregulation that it is appropriate to move away from the current regulatory formula for calculating supply costs. On this basis, BG Energy is proposing a realistic and cost reflective supply cost figure for a retail supplier operating in the current market environment. This figure is based on a robust analysis of the company's costs and the allocation of these costs to the residential customer segment.

In its projection for supply costs, BG Energy has also provided for bad debts in excess of the 0.5% cap provided for under the regulated formula. The 0.5% allowance was calculated to reflect the "normal" cost of bad debt at a point in time. It is now inadequate for current market circumstances. Although hesitant to include the cost, BG Energy has consistently advocated to the CER that an effective solution to reduce bad debt in the market is needed and that failure to do so would drive up costs for all other customers. Bad debt levels have increased exponentially in the past two years and although BG Energy has borne the majority of this cost to-date, as a commercial business, it must seek to recover some of these costs from the market.

Notwithstanding this, BG Energy is acutely aware of its responsibilities to those customers who are in financial difficulty and encourages customers to make contact with BG Energy's customer care team who will help customers manage their debt in a fair and considerate manner.

Overall, **BG Energy believes that the current methodology of calculating supply costs is no longer fit for purpose** as it fails to recognise a number of legitimate costs of operating in the current retail energy market. On that basis, BG Energy proposes to move away from the regulatory formula and has instead provided what is a cost reflective forecast of supply costs for the coming tariff year. The supply cost figure provided by BG Energy is in line with industry average and to be clear, in proposing this supply cost figure for 2011/12 it will remove the supply cost related Z-factor from future tariffs.

## **2.4 Margin**

The margin is capped in accordance with the regulatory formula to 2% of turnover. This is to allow BG Energy to earn a return on its business.

## **2.5 Allowable Capital Expenditure (Capex)**

As part of the ongoing initiative to unbundle the Networks and Energy businesses, BG Energy was directed by the CER to develop a new customer information and billing system (CIBS). As per the regulatory formula, capital expenditure is depreciated over a 6 year period and accordingly included as a cost item in the regulatory.

## **2.6 Correction-Factors (2009/10 & 2010/11)**

Traditionally, regulated tariffs are set for a 12 month basis. This was designed to provide transparency and predictability for customers. However, these tariffs are based on demand and cost forecasts for a period of 12 months. Inevitably, differences between the forecasts and the actual demand and cost figures will arise. As per the regulatory formula, these differences are captured in correction factors (K-factors) in the tariffs of the following year. K-factors are essentially a mechanism to ensure that the customer pays for the real costs incurred by BG Energy in delivering its services, i.e. that all over-recoveries are repatriated back to the customer or that under-recoveries are recouped by BG Energy in the following year.

Z-factors are another element of the regulatory formula which provide for a sharing between BG Energy and the customer for the differential between the gas and supply costs as per the regulatory formula and the actual gas and supply costs incurred by BG Energy during the year. These Z-factors are designed to ensure that the gas tariffs are truly reflective of the costs of procuring and delivering gas on behalf of customers.

In its submission to the CER, BG Energy is including a supply cost Z-factor relating to the recovery of bad debt in 2010 and 2011. As referred to previously, bad debt has become an increasing concern and cost for BG Energy and the Irish economy in general. BG Energy has made representations to The Joint Oireachtas Committee on Communications, Energy and Natural Resources and the CER to highlight the scale of the problem and to propose a number of recommendations to help alleviate the issue, its costs and wider social implications.

While BG Energy, as a commercial entity, must endeavour to recover its costs, a key objective of the organisation is to help customers who are experiencing financial difficulties and fuel poverty and to avoid the withdrawal of supplies to customers. This is achieved through a proactive approach involving; early engagement with customers to contain debt; the provision of flexible payment plans to deal with debt; the

installation of Pay-As-You-Go meters, and close interaction with agencies such as MABS, St Vincent de Paul and other such agencies to ensure that customers have appropriate advice and have access to appropriate financial supports when needed.

Although K and Z-factors are designed to ensure that tariffs are cost reflective, it has been suggested over the course of the latest regulatory period that they cause volatility and uncertainty in tariffs year-on-year. As per the CER's recent decision on a Roadmap for the Deregulation of the retail gas market, BG Energy will work with the CER to minimise the impact of K and Z-factors through regular monitoring of input costs and their impact on this years tariffs. If there are material changes in these input costs, BG Energy will approach the CER to review the regulatory approved tariffs.

### **3. SUMMARY**

BG Energy, as a regulated entity, is obliged to apply to the CER for changes in its tariffs for residential customers. These regulated tariffs are derived by a regulatory formula which determines the total costs and therefore required revenues for BG Energy to supply its forecasted customer demand for the coming gas year. This required revenue in turn determines the tariffs to be charged by BG Energy.

In accordance with this regulatory formula, BG Energy is forecasting a required revenue of €287.651 million for the 2011/12 tariff year. This gives rise to a 28.13% increase in tariffs relative to those for 2010/11. This increase follows a series of tariff reductions over the past number of years, which cumulatively reduced tariffs by 25% since March 2009.

The principle driver of the proposed increase is wholesale gas prices, over which BG Energy has no control. Although BG Energy has adopted a prudent purchasing strategy for gas for the coming year, global wholesale gas prices have experienced significant and sustained increases over the past 18 months. To this end, BG Energy can no longer cushion customers from the true costs of wholesale gas.

Another significant contributor to the rise in tariffs is the cost of bad debt. BG Energy has over the past year been working with the regulator and aid agencies to address the issue of bad debt. BG Energy has also implemented a number of measures, such as flexible payment plans and Pay-As-You-Go meters, to support customers experiencing difficulties in paying their bills. Despite these measures, the level of bad debt has increased significantly, particularly as customers leave BG Energy for other suppliers, leaving their bad debt behind. This practice, known as debt hopping, results in higher costs for all customers. BG Energy is working on a number of measures to try to alleviate this cost and its impact on tariffs and customers in future.

Recognising the current economic environment and the social implications of rising prices, it is with regret that BG Energy is applying for a tariff increase at this time. Recognising that the increase is significant, BG Energy would also like to assure customers that every effort is made by the company to provide the most competitive and cost effective tariffs. BG Energy commits to continuously monitor wholesale gas prices over the coming year and to alert the CER of any material changes in a timely manner. BG Energy also commits to work with customers experiencing financial hardship and difficulties in managing their debt. BG Energy urges customers to make contact with our customer care team as soon as possible to devise an appropriate payment plan which best suits their individual capabilities.