Proposed Decision on BGN Allowed Revenues and Gas Transmission Tariffs for 2011/12 – CER/11/121

BGE Response

1. Introduction

BGE welcomes the opportunity to comment on the CER's proposed Decision on BGN allowed revenues and gas distribution and transmission tariffs for 2011-12.

In particular, BGE would like to comment on CER's proposal that there should be no inclusion of any provisional amount for 3rd Directive costs in BGN's allowable revenue for 2011/12 in contrast to the CER's approach for 2010/11.

BGE is very concerned that this proposal would have a significant negative impact on its operations. BGE believes that such a proposal:

- Would not be in line with the CER's own principles for setting allowed revenues;
- Is not consistent with previous regulatory precedents and practices; and
- Would significantly impact on BGE short term finances.

BGE strongly requests the CER to reconsider this proposal, on the basis of the evidence presented below, and to make provision for 3rd Directive costs that must be incurred by BGE in order to achieve compliance through certification as the Transmission System Operator for Ireland.

BGE notes the three regulatory issues the CER is weighing in respect of a decision on whether to allow the 3rd Directive costs:

- The extent to which costs efficiently incurred in implementing the ITO model should be charged to the gas customer;
- The way such charges should be allocated between customer categories; and
- Whether costs, if allowed, should be defrayed over a number of years.

BGE believes that the CER has correctly identified the issues that are central to any decision to allow 3rd Directive costs. In the remainder of this paper BGE provides comment on each of the issues. Before doing so, however, we also provide a brief review of the background to the choice of ITO model for Ireland.

2. Background

Directive 2009/73/EC requires Member States to ensure that vertically integrated undertakings undergo further steps to unbundle their network operations. The Directive allows Member States to choose from a number of different unbundling options:

- Full Ownership Unbundling (FOU);
- Independent System Operator (ISO);
- Independent Transmission Operator (ITO); and
- Article 9.9 exemption.

It is important to note that the choice of option for achieving Directive Compliance rests with the Member State through the transposition process and not with the shareholder. The shareholder can only choose from among those options that are made available by the Member State in the transposition of the Directive into national legislation.

The gas arrangements currently in place in Ireland would not meet the requirements of the Article 9.9 exemption, and so that option was not available to the Member State. In consequence, the Government was left with a choice from among FOU, ISO and ITO. All three options require substantial restructuring of the current BGE business, and the Shareholders and Board (having consulted CER) came to the view that the ITO option was the most appropriate:

- FOU would have given rise to similar costs as the ITO option. However it would have also given rise to additional costs relating to tax, pension and financing arrangements;
- The ISO model, as allowed for in the Directive, would have resulted in additional costs to the ITO model, and would have given rise to significant regulatory and governance challenges. It is noteworthy, to the best of our knowledge, that not a single country in Europe is seeking to implement the ISO model as set out in the Directive.

The relevant authorities in Northern Ireland and in Great Britain also chose to allow the ITO option on the grounds that it represented an appropriate and the least cost route for the Irish gas industry to achieving compliance.

Following the decisions by the authorities in the three jurisdictions, which required BGE to undertake the current restructuring, it falls to the National Regulatory Authority (NRA) in each jurisdiction to certify that the restructured BGE group is compliant with the ITO provisions of the Directive. As BGE operates in Great Britain, Northern Ireland and Ireland, it must be certified in each of these jurisdictions.

As CER will be aware, BGE has been working closely with the CER and the other Regulators since early 2009 to identify the least costly means of restructuring that would achieve Directive compliance, and has sought guidance from the Regulators on interpretation of the Directive before undertaking any significant investment or restructuring decisions.

In particular, the detailed submissions which were provided to the three Regulators in May 2011 and subsequently discussed in a follow up meeting with CER, set out in detail the approach BGE proposed to take to achieving compliance, and set out the indicative costs of the compliance programme. BGE indicated to the Regulators that it was following a three stage process with respect to its compliance programme:

- Identify and agree with the Regulators, based on specific interpretation of the Directive, necessary changes to the business;
- Identify the efficient costs associated with achieving those changes; and
- Agree the costs with the Regulators.

BGE had anticipated that it would be allowed to recover fully the efficiently incurred restructuring costs associated with achieving compliance with the Directive. This view appeared to be supported by the CER's decision in CER/10/149 and CER/10/150 to provisionally 'allow' revenue of €11 million for the gas year 2010-11. The €11 million represented a proportion of BGE's initial estimate of the cost of the compliance programme. In CER 10/149, CER noted that:

"the CER is mindful therefore that these costs… …must be sufficient to ensure that the structure of BGE is consistent with requirements of the Third Package."

Should compliance costs be charged to the gas customer?

The first issue raised in the CER's proposed decision is:

"*The extent to which costs efficiently incurred in implementing the Government's decision to opt for the 'Independent Transmission Operator' unbundling model for BGE, provided for in Directive 2009/73/EC should be charged to gas customers".*

In BGE's view the CER should allow such efficiently incurred costs to be recovered as:

- The costs are being incurred in order to achieve compliance with an EU Directive – in the absence of restructuring BGE would be in breach of the Directive, and could not be certified as the Transmission System Operator, which is an obligation on Member States;
- Allowing such costs is in line with CER's duties (including its duty of ensuring licence and authorisation holders are capable of financing their activities) and with its published principles for transmission and distribution tariffs; and
- Allowing such costs is in line with established regulatory principle in this jurisdiction and elsewhere in Europe.

BGE must undertake restructuring

Absent the Third Energy Package (TEP), the current level and approach to separation within BGE has been reviewed by relevant regulatory authorities and found to be efficient and fit for purpose. It has provided substantial benefits for customers. In particular, the current structure has been designed in a way that maximised scale economies across the business, minimised duplication of services, delivered the most efficient cost structure for customers and facilitated competition in the gas market.

However, under the provisions of the Third Directive, BGE and its shareholder has had minimal discretion as to how to achieve compliance with the Directive:

- The Directive clearly required BGE to undergo some form of restructuring (FOU, ISO or ITO);
- The Government in its role as Member State made the ITO option available and the Shareholders and Board (having consulted with the CER) chose that option as being in the best interests of Irish consumers;
- The Directive sets out clearly the restructuring that is required in order to achieve compliance with the ITO model.

BGE has engaged in detailed and highly constructive discussions with the CER since early 2009 regarding the interpretation of the Directive requirements, and the costs to date have been incurred efficiently.

The choice by Government of the ITO followed detailed analysis by BGE and Gaslink of the cost impact of the options, which was discussed in depth with the CER and indeed with NIAUR in Northern Ireland also. The Government also sought its own independent advice on the matter.

3. Principle of Recovery of Compliance Costs

In accordance with Section 9 of the Electricity Regulation 1999, the CER is required, inter alia, to have regard to the need to secure that licence holders are capable of financing the undertaking of the activities which they are licensed to undertake. In BGE's view, this requirement would clearly require the CER to allow BGE to recover those costs that are necessarily and efficiently incurred in order to carry out BGE's functions under its System Operator license.

The Consultation Paper *Transmission and Distribution Tariffs Objectives and Principles Consultation Document* (CER/03/060) details the duties of the CER with respect to the regulation of transmission and distribution services and the maintenance of a financially viable gas sector. It notes that the Commission's task "*essentially consists of creating a framework within which, in return for providing monopoly services to an acceptable quality, the regulated business receives a reasonable assurance of a revenue stream in future years that will cover its efficient costs, including an appropriate rate of return on investments and the recovery of capital invested*".

The CER also set out, in BGE's last network price control (CER 07/110), the approach it would take to allowing costs that could not be foreseen at the time of the price control. It noted that BGN would be allowed to recover costs:

> **"***where an event genuinely outside of BGN's control, which was not forecast at the time the control was set, leads to BGN incurring significantly more costs than expected, and which could severely impact on BGN's financial position. …For example there are a number of potential developments outside of the control of BGN which may have a substantial impact on the level of opex required that are not currently quantifiable. These include, but are not restricted to, the Regional Gas Initiative (ERGEG), Moffat Exit Reform and the All Ireland Gas Market. Items of this nature will qualify as events for which BGN may receive additional opex allowances not covered in the PR2 opex allowances.*"

We believe that the recovery of TEP compliance costs falls directly within the circumstances contemplated by CER, in which it would allow additional costs:

- Achieving Directive compliance is an event that is genuinely outside of BGE's control;
- It will impose one off restructuring costs on BGE in excess of €30 million[1]

  [Noting that BGE has committed over €18 million to date]; and
- Failure to allow such costs will indeed impact severely on BGE's financial position.

We understand the pressure on gas end user tariffs as alluded to in the draft decision papers. However, we do not believe it to be appropriate to take such matters into account when assessing cost recovery issues for the Networks business and for setting network tariffs. We suggest that to do so raises two serious concerns:

- It is not consistent with Regulation EC715/2009 which sets out the European principles governing the setting of network tariffs; and
- It introduces an element of risk to the tariff setting process that could impact investor confidence and thus potentially have a negative impact on BGE's credit rating.

[1]This estimate is dependent on completion of the programme in March 2012 and assumes that certification will be completed at that time.

Tariff principles

Regulation EC715/2009 deals with the conditions for access to the natural gas transmission networks. The regulation states that tariffs, or the methodologies used to calculate them, shall:

- be transparent;
- take account the need for system integrity and its improvement;
- reflect the actual costs incurred (insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent);
- include appropriate return on investment; and
- be applied in a non-discriminatory manner.

The CER's approach in its proposed decision document, while understandable, is not consistent with these principles. Choosing not to allow efficiently incurred costs due to concerns regarding final gas prices is not appropriate, not transparent, does not result in cost-reflective tariffs and does not allow for an appropriate return on investment.

Undermining investor confidence

One of the key drivers of lender confidence and investment grade credit ratings for network businesses is the perceived low risk associated with such activities. Moodys, in a recent discussion of BGN's credit rating, noted as "a positive the *low business risk profile of gas transmission and distributions and stable returns under well established and transparent regulatory frameworks"*.

The CER's proposed decision infers links regarding cost recovery decisions to concerns not linked to the EC715 principles set out above. This has the potential to impact investor confidence as to the low risk profile of gas networks in Ireland and the well established and acknowledged track record of the CER.

In any event, we would fear that any short term benefit would cost customers in the long run if it were to increase debt costs and lower the company's rating, which is otherwise under pressure due to sovereign concerns.

Allowing recovery of compliance costs is in line with regulatory precedent in this jurisdiction and elsewhere

There is strong precedent in Ireland and elsewhere that such costs are recoverable. The costs of various unbundling initiatives have been agreed as recoverable by the relevant Regulators in ROI and in Northern Ireland, including:

- The first element of TEP compliance costs (allowed in CER 10/149 and CER 10/150)
- those associated with the Market Opening Programme in gas in RoI;
- those associated with the separation of ESB's networks business in RoI; and
- Those associated with the separation and sale of Phoenix's transmission business in NI.
- The costs associated with the separation of transmission system operation activities from the Scottish electricity companies as part of the BETTA programme.

Below we provide further information on each of the above precedents:

Third Directive compliance costs

In CER 10/149 and CER 10/150, the CER allowed additional pass-through costs of €11 million to cover the costs of implementing the networks driven aspects of the Third Package. The CER noted that this amounted to a proportion of the high level estimate of revenue required to achieve compliance. It noted further that it would continue to examine the additional pass through costs carefully as part of subsequent annual reviews of the network tariffs.

In allowing the costs the CER noted that:

> *"this has been introduced as an additional pass through cost and is consistent with the CER's approach for costs incurred to set up an ISO in 2007"*

Market opening costs

In the 2003 Distribution price control (CER/03/143) the CER allowed BGE to recover the costs associated with the market opening programme required to comply with EU and National Legislation which included the related establishment of the GPRO function and the separation of IT systems across the Networks and Energy parts of BGE.

BGE has modelled the current restructuring programme on that market opening programme, and has followed the same approach in terms of seeking engagement and agreement from the Regulator as it did with respect to the costs of market opening.

ESB separation costs

In compliance with the requirements of the Electricity Regulation Act 1999, Statutory Instrument (SI) 445 of 2000, and the specific conditions of the Distribution System Operator (DSO) and Transmission System Owner (TAO) licences granted to ESB in 2001, ESB was required to separate its ESB Networks business from other businesses of ESB Group.

As set out in CER 03/232, the CER approved the recovery of both the one-off and ongoing business separation costs of ESB.

Phoenix

NIAUR allowed the associated costs of the separation and mutualisation of the Phoenix transmission operation. In the transfer of the transmission assets from Phoenix to Mutual Energy, the transaction costs were rolled into the overall financing costs, thus compensating Phoenix and recovering the costs through transmission tariffs in due course. "*The transaction costs associated with the acquisition are estimated to be approx £4m, including legal, technical, financial advisors, etc., and we estimate reserves to be £9m, which is a similar figure to PTL. These will also need to be funded from financing.*"[2]

[2] Sale of Phoenix Natural Gas Limited, Proposed Acquisition by Northern Ireland Energy Holdings Limited, June 2007

Ofgem Betta cost recovery

In GB, there is also precedent from Ofgem, regarding the costs associated with the separation of transmission system operation activities from the Scottish electricity companies as part of the BETTA programme. Ofgem set out explicitly the principles which it believed should govern cost recovery[3]:

> "*The criteria that Ofgem will use to guide its decision as to whether particular costs of transmission and distribution licensees should be permitted for recovery should be that:*

- *At the time that the work was undertaken, the work could reasonably have been considered to be necessary for the timely introduction of BETTA and was work that would not otherwise have been undertaken*
- *The costs associated with the work were efficiently and prudently incurred*
- *Clear and supporting documentation exists to validate each element of any claim for recovery and clear and identifiable costs have been recorded, and*
- *the costs are not already allowed for under existing revenue restrictions or via any other route.*"

BGE's approach to achieving compliance is clearly in line with the above criteria.

Precedent Summary

The CER have raised the issue of whether BGE should be able to recover the efficiently incurred costs associated with achieving compliance with the Third Energy Directive.

BGE believes strongly that it should be allowed to recover such costs:

- BGE has no discretion with respect to the manner in which it achieves compliance and has sought to work constructively with the Regulator to ensure such costs are minimized.
- Allowing the recovery of costs is in line with the CER's statutory duties and the principles it has set out in relation to the setting of tariffs and the allowance of costs.
- There is significant regulatory precedent in support of allowing such costs.
- Linking decisions on cost recovery to concerns that are not consistent with EU guidelines will increase regulatory uncertainty, potentially resulting in an increase in the cost of debt and hence increase the costs for customers in the medium to long term.

4. Cost Allocation Issue

The second issue set out in the CER's proposed decision document relates to the way in which such allowed costs should be allocated between customer categories.

As BGE operates and serves customers in Northern Ireland and Ireland, a question reasonably arises as to appropriate allocation of costs between jurisdictions. Both in the case of inter-jurisdictional allocations and intra-jurisdictional allocation, it is important that the appropriate customer categories are identified.

[3] Ofgem (2003) "Recovery of costs under BETTA"

BGE notes that the CER addressed the intra-jurisdictional allocation issue in its previous decision document CER 10/149 where it divided the proportion of allowed ROI costs on an 80:20 basis between the transmission and distribution tariffs. The CER noted that the rationale for this apportionment related to:

- Being consistent with how Gaslink setup costs were apportioned; and
- Taking into account the objective of the EU Third Package to allow for greater market integration in Europe.

BGE believes that the previously applied apportionment continues to remain valid – the bulk of the compliance costs relate to the requirement to unbundle the transmission element of the business, and so it would appear reasonable that the bulk of costs are apportioned to the transmission tariff.

We note the separate issue of inter-jurisdictional allocation i.e. the allocation of costs between customers in the Republic of Ireland and those in Northern Ireland. While this is a matter for the two regulatory authorities, rather than BGE, we would suggest that the Regulators may wish to consider whether the principles governing the current cost allocation methodology for shared services may be an appropriate starting point or alternatively market size/system throughput could serve as an objective measure to determine the allocation.

The two key principles in question are:

- Costs that are specifically identifiable and directly attributable to a business unit will be re-charged directly to that business unit; and
- Costs that are common to or shared by more than one business unit will be shared on a cost causation basis wherever practicable.

5. Delayed Defrayment

The final issue raised by CER relates to whether the compliance costs should be defrayed over a number of years.

BGE believes that defraying costs over a number of years would lead to significant negative financial impacts on its business in the current macroeconomic environment. In particular, the current financial crisis impacting on the Irish State has had a serious knock on effect on BGE. This has seen BGE's credit rating reduced to Baa3 by Moodys, the lowest investment grade, with the rating also remaining on a negative outlook. BGE had anticipated that it would be allowed to recover fully the efficiently incurred restructuring costs associated with achieving compliance with the Directive.

The downgrading of BGE's credit rating has resulted in a substantial increase in its debt costs, and any further downgrade to sub-investment status would have further consequences both for BGE's borrowing costs, working capital requirements and even its ability to access the debt markets to fund its operations.

One of the positive factors noted by Moodys in assessing BGE's business was the *low business risk profile of gas transmission and distributions and stable returns under well established and transparent regulatory frameworks*.

Disallowing the significant costs of achieving Directive compliance, or directing that they be defrayed over a number of years may be construed by the ratings agencies and lenders as a significant change from existing precedent in the regulatory environment. Defrayment over a number of years, as

opposed to allowance at the time of incidence, is also likely to place further pressure on BGE's key short term financial ratios. Disallowance would also increase perceived risk and damage confidence, as rating agencies and lenders anticipate further future compliance costs in relation to further integration of the gas market via ACER.

6. Summary

BGE has always sought to achieve legal and regulatory compliance at the lowest possible cost to consumers and to do so in a timely manner. With respect to the Third Directive, BGE has engaged actively and constructively with the Regulators since early 2009 to ensure that it achieves compliance in the most appropriate way.

While CER has rightly identified the key issues it must address in determining whether to allow BGE to recover the compliance costs, BGE believes CER should allow the costs to be fully recovered:

- As there is no discretion for BGE with respect to the costs it must incur to achieve compliance
- Allowing recovery is in line with CER's own principles on tariffs;
- Allowing recovery is also in line with the approach adopted previously both by the CER and by other regulatory authorities

Failure to allow such costs would increase regulatory uncertainty, result in an increase in the cost of debt and hence increase the costs for customers in the medium to long term.

BGE believes that the current split of 80:20 between transmission and distribution for ROI customers is appropriate. While there is a valid issue regarding cost allocation between customers in the Republic of Ireland and in Northern Ireland, BGE believes that this is a matter for the Regulatory Authorities to decide. However, BGE would be happy to furnish the regulatory authorities with any such information they require in order to determine an appropriate allocation.

Finally, BGE believes that defraying the costs over a number of years could also have a significant negative impact on its finance costs, which would ultimately result in the imposition of higher costs on consumers.

On the basis of costs incurred so far and existing commitments, BGE therefore strongly requests that the CER, in keeping with the precedent of year 2010/11, allow the provisional costs of €11 million in this year's transmission and distribution tariffs. This is appropriate and also respects BGE's short term financial position. BGE is committed to continuing to work with the CER on both the implementation of the 3rd Directive and the finalisation of the efficiently incurred cost amounts to be ultimately allowed. BGE welcomes a full review of the unbundling project and its budget by the CER but it is imperative that BGE's short term financial position is kept whole as we remain on time for Third Directive implementation in March 2012.