

MEMORANDUM

TO: Matheson Ormsby Prentice
FROM: The Brattle Group (Dan Harris, Carlos Lapuerta)
SUBJ: Response to CER's Draft Decision on the Treatment of the BGE Interconnectors
DATE: March 15 2012

1 SUMMARY

- 1) This memo summarizes our comments on the CER's draft proposals for the regulatory treatment of the BGE interconnectors.¹
- 2) The CER assumes that tariffs should be based on the creation of future costs – a 'marginal cost' approach. But in a system that is not congested, tariffs that fairly allocate historic costs are a more valid policy objective. The CER has agreed with this principle for tariff setting as recently as 2008. Basing tariffs on forward looking costs will fail to allocate the large costs that have already been incurred to the parties that have benefited from the associated infrastructure.
- 3) The CER proposes tariffs based on marginal costs. But absent long-term contracts, marginal costs fail to allocate the actual costs incurred. Once an entry point is expanded, the marginal cost falls and shippers can buy short-term capacity at the new lower price. With short-term contracts, the marginal cost is a mirage which disappears from the tariff when it is incurred, and therefore remains unpaid.
- 4) The CER's proposal to use a marginal cost also seems to be at odds with ACER's proposal to use a tariff based on historic costs for the reserve price in auctions of annual capacity products.
- 5) It is not clear that the CER's objectives of:
 - a) Recovering 50% of revenue from entry points and;
 - b) Auctioning entry capacity;

¹ CER 'The Regulatory Treatment of the BGÉ Interconnectors' Proposed Decision Paper CER/12/013, 17th February 2012. Hereafter referred to as 'the CER report'.

Are compatible or feasible. The auction would be both setting a quantity and a target level of revenue, which implies the average price that must be met from the auctions. The auction process seems to be over-specified, so that a solution may never be reached. The CER's 50% target could only be reached by raising and lowering reserve prices in the auctions in successive years so that the 50% target is reached on average over time.

- 6) The requirement to recover 50% of revenues from entry points would override any economic signals from using marginal costs as a reserve price. The 50% target seems to nullify the economic signals that the CER identified as a reason for the marginal cost approach. Moreover, the CER offers no reason why 50% should be recovered from entry charges, other than this would be the same as the GB system. But there is no standard ratio of cost recovery from entry and exit in the EU, and the 50% requirement imposes another constraint which complicates the existing stranded costs issues. The Moffat entry point cannot recover its own historic costs, but the CER's decision unnecessarily increases the burden of cost recovery on entry points.
- 7) The CER proposes that where the auction revenues fall short of the 50% cost recovery target, the difference will be made up by common charging at entry points. This means that producers, rather than consumers, will end up bearing the majority of the stranded IC costs. The decision on who should bear the stranded IC costs is an important one. If it is the CER's policy that producers, and not consumers, should bear the stranded IC costs then this should be stated explicitly.
- 8) We stand by our August 2011 recommendation that stranded costs should be allocated to exit points, for two reasons. First, this allows production to compete on the basis of its fundamental economics, which is what we proposed in our 2000 report. Second, according to the CER the decision to invest in the ICs was taken on behalf of consumers, and so it is fair that they should bear any cost. If the government can make an investment decision and pass on the costs to parties to which it is not accountable – in this case producers – this removes incentives for sound decision making.
- 9) The CER claims that Option 3 will put upward pressure on prices relative to current tariff levels. However, Option 3 does not rule out that the cap on the IC tariff could be set at current levels. The CER presents a calculation which shows that tariffs will rise under Option 3, but does not present a similar analysis for Option 4 where all of the IC costs will be allocated to exit points. The CER also rejects Option 3 because it is not forward looking,

but as we note above this is not a valid economic reason for rejecting the tariff. Most EU tariff systems are based on the allocation of historical costs. In future, ACER is minded to set auction reserve prices by reference to historic costs.

- 10) In terms of process and managing legitimate expectations, the CER does not seem to have followed best practice. The CER presented four options in its July 2011 Consultation paper. It has rejected all of them, and instead proposed a marginal-cost approach which the CER itself rejected in 2008, and which is contrary to the ‘minded to’ opinion expressed the ACER report published two weeks previously.
- 11) Having analysed the CER’s proposal for the IC tariff, we conclude that nothing in the CER’s report changes the recommendations of our report for SLNG of August 2011, in which we recommended that the CER should set IC tariffs by auction with a reserve price based on the historic costs of the ICs. Any shortfall in revenue should be recovered from exit tariffs, and there is no need to recover 50% of the costs from entry points.

2 FORWARD LOOKING TARIFFS VS. HISTORIC COST ALLOCATION

- 12) The CER’s approach assumes, without any reasons presented, that a “forward looking rather than an historic” approach is optimal for setting the tariffs for the BGE interconnectors (the ICs).² It is not obvious why this should be the case. In our 2002 report for the European Commission, we noted that:

“Cost-reflectivity has fundamentally different implications depending on system growth and actual or prospective congestion. With growth or congestion, capacity is scarce and tariffs face the principle challenge of ensuring efficient allocation. With no growth or congestion, the primary concern is allocating the costs of previous network investments among system users.”³

“In the absence of congestion however there are no efficiency implications to the choice among alternative pipeline routes. Tariffs should have a retrospective focus, allocating the costs of existing investments in ways that correspond to intuitive notions of fairness. Allocation methods should consider the extent and nature of system use by customers.”⁴

² CER report p.42.

³ Convergence Of Non-Discriminatory Tariff And Congestion Management Systems In The European Gas Sector, September 2002, Carlos Lapuerta and Boaz Moselle, The Brattle Group p.37.

⁴ *Ibid.*

13) Clearly, the situation in the Irish market, as with most western European gas markets, is one of limited growth. There is no congestion on the ICs, and none is forecast for a long time to come. Nor is there congestion as far as we understand at other entry points. Therefore the goal of the tariff should be to allocate historic costs in a fair and equitable way, rather than trying to allocate resources that are not at present scarce.

14) In the past, the CER seems to have agreed with this view. In its 2008 report on the Common Arrangements for Gas (CAG], the CER (together with co-author Northern Ireland Authority for Utility Regulation or NIAUR) stated that:

“The main benefits of LRIC [Long Run Incremental Costs] relate to the investment signals it sends, that is when to invest and where to invest. As such it is reliant on the assumption that from time to time demand for the service is such that demand growth will result in demand exceeding capacity and that the investment signals contained within prices are the primary objective of tariff setting. Where demand is not expected to exceed capacity in the foreseeable future and there is permanent and significant excess capacity such that cost recovery is the primary aim of the regulatory prices setting mechanism then backward looking approaches (such as average cost pricing) are likely to be more appropriate.”⁵

15) In its CAG Decision paper published in December 2008 the Regulatory Authorities made no mention of a marginal pricing approach to entry capacity.⁶ The CER does not offer a reason for the reversal of its 2008 opinion. Such a change in policy without a clear explanation of the reasoning creates uncertainty for market participants.

3 THE USE OF MARGINAL COSTS

16) The CER’s focus on a forward-looking cost allocation methodology drives the main recommendation of the CER’s report, which is that tariffs at entry points should be set by reference to marginal costs. Marginal costs are concerned with the costs created by incremental future use of the asset, rather than considering historic or sunk costs.

17) In the absence of long-term contracts, the use of long run marginal costs (LRMC) to set entry tariffs can result in inefficient outcomes. To see this, suppose that at a particular entry point there is congestion and the LRMC is relatively high at 600 €/MWh/year. The LRMC

⁵ CER, NIAUR, Common Arrangements for Gas, Draft Conclusions on Transmission Tariff Harmonisation in Ireland and Northern Ireland, 17th October 2008 p.29.

⁶ CER, NIAUR, Common Arrangements for Gas Conclusion on High Level Transmission Tariff Structure in Ireland and Northern Ireland 19th December 2008.

tariff is calculated as the tariff that would support the costs of expanding the entry point if it was applied over a long period of time – for example 20 years. Shippers sign up at this rate under a one year contract. The TSO then carries out the work, by for example installing larger pipelines and a compressor station. Because expansion costs are ‘lumpy’ after this work is carried out the LRMC then falls to €100/MWh, since the costs of further expansion are relatively low. For example, perhaps the compressor can be de-bottlenecked at relatively low cost. Shippers then sign up for another year at the new LRMC price of €100/MWh. But this is far less than the actual costs that were incurred of €600/MWh. Because there are no long term contracts, and the LRMC is updated annually, there is no one to pay for the actual costs that were incurred. Absent long-term contracts, the LRMC-based tariffs are like a mirage – as you move towards them they disappear, because shippers are always paying for the next phase of expansion, not for the costs that they just incurred.

- 18) The problem we describe is not simply theoretical. Transco, the old GB TSO, had exactly the same experience as we describe above. In the 1990s Transco used the LRMC to set the price of entry capacity, but without long-term contracts. The problem we described materialised, at which point Transco introduced auctions but with long-term contracts. In the GB system, it is possible to buy entry capacity for 15 years. Indeed, National Grid Gas is not allowed to build new entry capacity unless 50% has been sold under long-term contracts.
- 19) The CER implicitly recognises the issue we raise above when it acknowledges the need for tariff stability. The CER notes that a methodology based on a Long Run Incremental Average Cost (LRIAC) would be preferable to one based on the Long Run Incremental Cost (LRIC).
- 20) The CER report considers both short run marginal costs (SRMC) and long-run marginal costs (LRMC) as a reserve price.
- 21) The CER should definitively reject the use of the SRMC. Even assuming that a forward-looking view of tariffs is correct, which it is not, use of the SRMC to set entry tariffs would not be efficient. An LRIAC methodology recognises that incremental use of an entry point accelerates the date at which reinforcement at that entry point is required. This acceleration of expenditure has a cost in present value terms.⁷ The LRIAC methodology would reflect

⁷ For example, suppose that with current demand growth, €100 million must be spent to enlarge an entry point 10 years from now. Assuming a discount rate of 5%, this cost has a present value (PV) of about €61 million. Suppose that a new customer now uses the entry point, and so brings forward the date by

this cost and direct shippers to use the entry points for which the present value of future investment is the least. Therefore, assuming that a forward looking tariff methodology is warranted, the LRIAC methodology will ensure that use of the entry points should minimise the present value of future expenditure – even if it does not allocate historic costs fairly absent long-term contracts.

22) However, an SRMC methodology fails to minimise the present value of future costs. A particular entry point could have a very low or zero SRMC, but could require very large capital costs if demand at that point increases much more. Another entry point could have a high SRMC – perhaps because it requires a compressor – but a large amount of spare capacity. An SRMC tariff system would direct shippers toward the first entry point, accelerating the large capital costs, while leaving the entry point with spare capacity empty. The SRMC tariffs would not minimise future system costs, and would not result in an efficient use of the network. We know of no jurisdiction where SRMC-based tariffs are applied, most likely because they do not result in efficient use of capacity.

23) The proposal to use a marginal cost is also at odds with ACER’s ‘minded to’ opinion that the reserve price in annual capacity auctions should be based on historic costs. Specifically, in its consultation document which was published before the CER report, ACER says that it “proposes to define a reference price [i.e. auction reserve price] for the annual [capacity] product, which corresponds to a regulated tariff determined on an annual accounting basis aimed at covering costs, while taking into account the assumptions on capacity bookings. Reserve prices for different kinds of products shall therefore be determined according to this proposal.”⁸ Therefore the CER’s proposal for a marginal cost approach conflicts with ACER’s ‘minded to’ position on harmonised transmission tariff structures. The CER could maintain a marginal cost approach for short-term capacity products. But the ACER report makes clear that only about 10% of capacity should be sold on a short-term basis.

4 AUCTIONS AND COST ALLOCATION

24) The CER proposes auctions of entry capacity with a reserve margin set by the marginal costs. The CER also proposes that 50% of the gas network’s required revenues come from

which the enlargement work is required by one year. The PV of the work is now €64 million. The new customer has created a cost of €3 million by accelerating the required expenditure by one year.

⁸ ACER, Scope and main policy options for Framework Guidelines on Harmonised transmission tariff structures Consultation Document DFGT-2012-G-004 08 February 2012, Part II Section 1 p.15.

entry tariffs. It is not clear from the CER's report how this will be combined with the entry auctions in the absence of a separate commodity charge as in the GB system.

- 25) Perhaps the CER is imagining that the 50% target would be achieved every year, by adjusting the reserve prices in the auction. But this would not be technically feasible. In an auction, a party concludes a contract to buy a specific quantity of a service at specific price. Therefore the CER cannot change the capacity prices *after* the auction, to add on the required amount to reach the 50%.
- 26) To accommodate the 50% cost recovery objective the auction would need to be multi-round, and re-calculate prices so that the 50% revenue requirement is met in each round. Therefore the auction seems to be specifying both the quantity of capacity being sold and the aggregate price of entry capacity. Normally an auction would specify only the quantity on offer or the price. To recover the 50% of revenues from entry capacity auctions in every year the auction mechanism would need to specify both the price and the quantity, which is not possible.
- 27) An alternative would be that the CER tries to adjust the reserve prices in the auctions so that 50% of the costs are recovered from entry charges on average over time. If too little is recovered in one year, the CER would raise the reserve price the next year. Such a system would be technically feasible. However, it would also largely nullify the supposed advantages of using marginal costs, which is to send economic signals regarding scarcity. The uplift required to recover the 50% of required revenues could override the marginal cost.
- 28) These problems are generated by the new requirement that 50% of the required revenues derive from entry fees. The CER's new objective of 50% cost allocation is not explained in its report. Perhaps it is aiming to replicate the GB system, where there is a 50/50 split of cost recovery between entry and exit points. But it is not clear why the GB model of cost allocation is the right one for Ireland. Figure 1 below illustrates that there is a wide variety of entry and exit cost allocation across the EU. Some TSOs allocate about 80% of costs to exit points. The CER is already grappling with difficult issues regarding the allocation of stranded IC costs. The 50% requirement adds another constraint which further complicates the issues. We recommend that the CER should not adopt the requirement that 50% of revenues be recovered from entry capacity.

Figure 1: Division of costs between entry and exit points for a sample of TSOs and gas transport transactions⁹

Table 6: Entry/Exit split for distances 60km, 110km, 260km and 350km.

		60 km	110 km	260 km	350 km
France	GRTgaz	83/17	73/27	63/37	59/41
France	TIGF	34/66	34/66	32/68	33/67
Belgium	Fluxys	19/81	19/81	19/81	19/81
Denmark	Energinet.dk	50/50	50/50	50/50	50/50
Hungary	MOL	77/23	77/23	77/23	77/23
The Netherlands	GTS	59/41	54/46	38/62	26/74 (1) 50/50 (2)

29) More generally, there are essentially three ways of allocating the stranded costs that cannot be recovered from IC tariffs. They could be recovered from:

- a) A commodity charge levied on a per MWh basis.
- b) Entry capacity charges, as the CER proposes;
- c) Exit capacity charges.

30) In our August 2011 report for SLNG, we argued that allocating IC costs that cannot be recovered from the IC tariffs to onshore exit points, as opposed to entry points, would be consistent with the recommendations in our 2000 report. This allows producers to compete on the basis of their fundamental economics. The same objective could be achieved with a commodity charge, though this could distort marginal incentives.¹⁰

31) Another way of viewing the issue is that someone must bear the stranded IC costs. Specifically they must be borne by either BGE, producers or consumers, or some combination of all three. The CER has already ruled out the option that BGE bear the stranded costs, which leaves the allocation between producers and consumers.

32) By proposing to allocate all of the stranded costs to entry points, the CER has determined to allocate the stranded costs as far as possible to producers/importers. As long as the entry

⁹ Gas Transmission Tariffs An ERGEG Benchmarking Report C06-GWG-31-05 18 July 2007 p.16.

¹⁰ In GB the commodity charge is relatively small. However, a larger commodity charge could result in inefficiency, because it is a marginal charge which does not reflect the marginal cost of using the gas system. For example, suppose a shipper has bought entry capacity, which is therefore a sunk cost. The commodity charge could prevent the shipper from using this capacity, even if it was efficient to do so.

costs at all entry points other than Moffat are less than the IC tariff, then allocating costs to entry points will mean that gas importers and producers pay the stranded IC costs.

33) The decision on who should bear the stranded IC costs is an important one. To reduce regulatory risk, market participants should understand the reasoning behind the regulator's decisions. Therefore if it is the CER's policy that producers, and not consumers, should bear the stranded IC costs then this should be stated explicitly as the reason behind the decision to allocate costs to entry points.

34) However, we note that if this is the CER's policy, then it provides poor incentives for future investment decisions. According to the CER, the Irish government as the elective representative of the Irish people, approved the IC investments. Therefore it is consistent that Irish consumers, rather than producers, bear any stranded costs, because the investment decision was taken on their behalf. Under the CER's proposal, producers are left carrying the costs of a decision that was made by a body that it not accountable to them. If a government can make decisions and then pass on any costs of the decisions to a third party to which it is not accountable, this removes incentives for good decision making. In contrast if a government knows that the consumers which elected it bear the costs, it has a strong incentive to make sound investment decisions. Accordingly a decision to allocate costs to producers promotes poor decision making.

5 THE CER'S REJECTION OF OPTION 3

35) In our report for SLNG dated 10th August 2011, we noted that Option 3, if it is amended to respect certain principles, would best balance the interests of Irish consumers, gas producers and investors in the gas industry. Specifically, Option 3 should set an IC tariff that is consistent with previous policy decisions, and conforms with the expectations that investors had when they committed capital to projects in Ireland. The stranded costs of the ICs should be recovered from onshore exit points. Option 3 would be most consistent with Irish gas transport tariff policy to date, where entry points can compete based on their proximity to the Irish market, and other Irish gas sources are not forced to subsidise the import of gas from GB.

36) The CER has rejected Option 3 for two main reasons. First, that it puts upward pressure on prices. Second because it is based on the historic costs and is therefore 'not efficient'.

- 37) Regarding the first point, specifically the CER claims that Option 3 “puts further upward pressure on gas tariffs to all consumers of gas by reference to current tariff levels or to tariff levels which would likely prevail if a premium were removed altogether (Option 4). This is due to the retention of some diversity premium¹¹ for all producers, albeit at a lower level than under the status quo (Option 1).”¹²
- 38) Since Option 3 includes the possibility that the IC tariff could be capped at current tariff levels, no one can conclude that Option 3 would put upward pressure on prices relative to the current tariff levels.
- 39) The CER then gives a numerical example which purports to show that moving 50% of the IC costs to the exit points would increase gas costs for Irish consumers by 1.3%.¹³ However, the CER then fails to mention in its discussion of Option 4 that *all* of the IC costs would move to the exit points, raising consumer costs by twice as much. The increase would be offset by the reduction in the gas price that results from the elimination of the IC tariff, but the CER does not quantify this effect. The CER does not make a like-for-like quantitative comparison between the options, and its use of quantitative analysis for rejecting Option 3 seems to be selective. In this sense the rejection of Option 3 seems to fall short of the requirement that it be “fully reasoned”.¹⁴
- 40) The CER’s second reason for rejecting Option 3 is that it “would be based essentially on historic, or legacy, considerations which are far from being optimal or efficient. Option 3 is not forward looking or grounded on economic principles.”¹⁵ As we discuss above, in our 2002 report for the Commission we noted that tariffs based on historic costs were fair in a system that was not congested and where the primary consideration was the equitable allocation of historic costs. In its 2008 report the CER and NIAUR agreed with this conclusion. Making people pay for investments that have been made on their behalf and which they are using *is* an economic principle. Moreover, it is a principle that is applied in the vast majority of gas transportation tariffs in the EU, and more broadly in all sectors of the economy. It is the use of marginal pricing that is unusual for setting tariffs. Again, the

¹¹ We have discussed objections to the term ‘diversity premium’ in previous submissions to the CER and do not repeat the arguments here.

¹² CER Report section 6.3 p.39.

¹³ *Ibid.*

¹⁴ Directive 2009/73/EC of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, Article 41(16).

¹⁵ CER Report section 6.3 p.40.

CER seemed to agree in 2008, noting that “LRIC is a well-established pricing methodology in the field of regulated telecoms. There are significantly fewer examples, however, of its application in other regulated network industries.”¹⁶ The CER’s rejection of the use of historic costs to set tariffs lacks any foundation or reasoning.

41) In terms of process and managing legitimate expectations, the CER does not seem to have followed best practice. The CER presented four options in its July 2011 Consultation paper. It has rejected all of them, and instead proposed a marginal-cost approach which the CER itself rejected in 2008, and which is contrary to the ‘minded to’ opinion expressed by ACER in its report published two weeks previously.

¹⁶ *Op. cit.* footnote 5.