

Stuart Coleman,
The Commission for Energy Regulation,
The Exchange,
Belgard Square North,
Tallaght,
Dublin 24.

16th March 2012

Re: CER/11/112 - The Regulatory Treatment of the BGE Interconnectors

Dear Stuart,

Bord Gáis Networks (BGN) welcomes the opportunity to respond to the Consultation Paper "The Regulatory Treatment of the BGE Interconnectors" and also wishes to thank the CER for the opportunity to give BGN's perspective on the treatment of the IC System at the public meeting on the 1st of March '12. As part of BGN's response to the consultation I attach to this letter a copy of the presentation which was given by BGN at the public meeting.

With reference to the public meeting on the 1st March '11 I wish to highlight the fact that no party spoke in support of stranding and that those who did speak were supportive of both the IC System and of its contribution to the gas market. BGN believes that the CER must now firmly state that there will be no stranding of any part of the Interconnector System, and then ensure that any proposed new tariff structure is robust, establishes a stable regime for the future and ensures that the asset owner is allowed recover their revenue entitlements.

BGN have divided the response into two main parts. Part 1 directly dealing with the issue of the 'Treatment of the IC System' and Part 2 addressing the 'Entry Tariff Structure'.

Part 1: Treatment of the IC System;

Strategic Importance of the Interconnector system

BGN wish to restate that the Interconnector system ('IC's'), incorporating both IC1 and IC2, has been and continues to be, a critical part of both the Irish gas and electricity systems. The IC system provides the main (c.95%) source of gas into Ireland along with essential security of supply, which is critical to the operation, support and ongoing development of both the gas and electricity markets. The IC System delivers significant economic benefits in terms of lower gas prices (refer to SEAI and Household Energy Price Index), reduction in carbon costs and assist in the sustainability and creation of employment.

The following describes the benefits delivered by the IC System in terms of Security of Supply, the economy, the environment, meeting market demands and supporting operational flexibility.

Security of Supply

- The IC's provide essential security of supply, and will continue to provide such security in the event of temporary troughs of utilisation when other sources of supply become available. Across a range of scenarios, including scenarios with both Corrib and Shannon LNG, the IC's ensure that both the gas and electricity markets would not be exposed to production outages, production failures and/or LNG cargo diversion.
- IC2 has brought Ireland's security of supply in line with countries such as France, Italy, Sweden and Denmark, all of which have strategically duplicated sub-sea pipelines to ensure availability of alternative sources of natural gas (ref: Government Press Release Sept '04).

Economic Importance of the IC's

- The IC's provide access to the liquid UK market, which is essential to deliver a competitive wholesale gas market. Without this access, there would be significant adverse impacts on competitiveness as both gas and electricity prices would be higher.
- By providing a secure link to the UK NBP market, the IC's provide confidence to international business to invest in Ireland. This has led to the creation and retention of jobs in Ireland and

examples of this can be seen through the recent job announcement at Allergan, Westport as well as other recent investment such as Nutricia and Eli Lilly for example.

- Through its access to the liquid UK market brings price stability which gives major users, such as potential power station investor's confidence to invest knowing that they will not be exposed to interruption in supply and undue market volatility.
- The arbitrage brought about by access to the liquid UK gas market brings price stability as investors will not be exposed to undue market power which could be exerted by producers and equally provides market prices to producers.
- The IC system has continued to facilitate the development of the gas market in Ireland. It has allowed the introduction of the IC Inventory storage product which allows Shippers to profit from differentials in gas commodity prices. A reverse-flow service has been developed, allowing producers and storage operators access to the GB market. Back-up capacity on the IC's was also introduced at the request of Shippers and it ensures that the Inch and Corrib entry points can provide a firm gas delivery product.

Environmental

- Natural Gas is the cleanest fossil fuel and has brought great environmental benefits to Ireland (in terms of reduced carbon dioxide, nitrogen oxides, sulphur-dioxide and particulate emissions), significantly improving air quality. Without the IC System Ireland could not meet its emissions targets as Natural Gas would not be available.
- It has provided CO₂ savings estimated at up to €200m p.a. in the cost of carbon emissions permits alone.

Meeting Market Demands and Utilisation

- IC System utilisation is well in excess than that originally envisaged with booked capacity and throughput exceeding the capacity of IC1 during winter periods for a number of years. Please refer to the attached presentation showing the utilisations levels with respect to capacity booking and usage.
- During the December 2010 and January 2011 extreme weather conditions, the IC system was close to full capacity and in recent years the usage of the IC system has been well in excess of

the capacity of IC1. The IC system has ensured that power stations and customers have not been interrupted during extreme weather conditions.

Providing Operation Flexibility

- IC System Subsea line-pack provides within-day flexibility to the domestic, industrial and power generation sectors. Please refer to the attached presentation showing the utilisations levels with respect to within day flexibility.
- The flexibility provided to gas plant provides the required operating flexibility to respond to wind driven demand variations. Increased wind requires power plants to be able to react quickly to demand and this is provided by the IC System. This flexibility requirement will become even more critical as greater amounts of electricity are wind generated.

Stranding Assets

Investment in a regulated environment requires certainty with respect to future treatment, particularly the return on and return of any funds invested. Any adverse amendment to a regulatory decision, including the stranding of regulated assets, would adversely impact not only on the gas sector but also on electricity and other regulated sectors. It would lead to higher costs as developers would require a higher cost of capital to compensate for the risk of regulatory uncertainty. This would increase costs to customers, who in the end pay for all infrastructure.

The IC System is being utilised well in excess of what was anticipated at the time of its construction, it has received all of the required approvals and is delivering significant benefit to consumer through the gas and electricity markets. Several products are being offered on the IC system including Back-Up, Reverse flow and Inventory. As other sources of supply are currently not available, then IC2 will continue to be essential to the operation of the Irish energy market. BGN does not believe there are grounds for the stranding of any IC assets.

BGN believe it is essential that full economic value of the IC system is rewarded and that it is not acceptable that such a strategic asset would be stranded or that such stranding costs would be placed on the taxpayer.

Part 2: Entry Tariff Structure;

Protecting Consumers

One of the CER's primary duties is to protect the interests of consumers and this is embedded in statute through the Electricity Regulation Act of 1999 and the Gas (Interim) (Regulation) Act of 2002.

Consumers should reasonably expect that as additional sources of gas are available, the additional supply should result in reduced prices. However, because of the current tariff structure the opposite effect would materialise if no action is taken when new sources of supply come on stream. The cost of gas to the Irish market could become unsustainable and damage the development of the gas market.

While maintaining the overall principle of an Entry/Exit Tariff structure BGN believe it is necessary for the CER to examine the structure and form of the Entry Tariff itself in order to protect the gas consumer.

With capacity bookings on the IC's temporary reducing the effect on the IC tariff will be to drive an increase in the IC tariff during the period of reduced bookings. As IC System gas sets the wholesale price of gas in Ireland, the cost to the final consumer would therefore increase as producers price up to the IBP and gained margin (creating a premium) at the expense of the end consumer and the overall development of the gas market.

An excessive premium is inefficient as it signals for additional (and possibly what would otherwise be uneconomic) investments to be built displacing cheaper IC flows and further adversely impacting consumers who ultimately bear the cost of this additional infrastructure. Since the prospect of west coast gas emerged, this issue has been under consideration by the CER and it is generally accepted by the gas industry that the Entry Tariff structure would have to be reviewed accordingly.

Long Run Marginal Cost (LRMC)

Accepting that the mechanism for the recovery of IC revenue should be modified in order to ensure stable Entry tariffs, and to ensure an efficient gas market is developed into the future, setting the IC tariffs at a level reflecting the LRMC would ensure that tariff structures reflect the underlying marginal costs of gas transmission, allowing producers and consumers to allocate resources efficiently in response to tariff price signals.

The LRMC approach could support diversity of supply as by setting a stable tariff for the IC's, the impact of tariffs on the price of gas on the Island would be relatively predictable. This will encourage investment in a stable environment.

An LRMC approach has a number of characteristics which should be attractive from a regulator and policymaker perspective (as well as a producer/storage operator/LNG operator perspective).

- It should support the development of the gas market. Arguably the current methodology would result in IC tariffs which would be too high relative to an efficient level. This results in a higher gas price on the island than would be efficient, and hence at the margin customers will be dissuaded from burning gas. This could result in reduced consumption by current gas customers, or a lower rate of conversion of potential customers (commercial and residential). A lower tariff, and a lower price of gas on the island, would encourage gas use, and hence be in the long term interest of all parties (including producers as the market for them to sell their product will be larger).
- It should minimise long term costs to customers. If users respond to efficient network tariffs, the overall cost of development of the industry (including the cost of network investment) should be minimised. As described above, this is part of the objective of setting cost reflective network tariffs. Over the long term, this should ensure that potential development of the gas market is maximised.
- It should support diversity of supply. By setting a relatively stable tariff for the interconnectors, the impact of tariffs on the price of gas on the island should be relatively predictable. This should provide a more attractive environment for producer interests, and hence should encourage security and diversity of supply.

Volatile and changing tariffs can undermine the value of an investor's investment. LRMC offers tariff stability in the event of bookings moving away from the IC and will maximise investor confidence as any tariff changes should take place according to a predictable and stable set of objectives. Cost reflectivity and basing tariffs on marginal costs is a well recognised and understood principle with which investors in exploration and production are likely to be familiar. Relative to the current arrangements, its implementation should therefore be considered to increase the predictability of tariffs and improve investor confidence.

At the request of the Commission, BGN has calculated estimates of LRMC (using LRAIC) taking the current 'best view' of investment over the long term following the optimal expansion path. On the basis of our initial analysis we estimate the LRMC for the IC System would be in the range from €100 to €160 p.pk.day/MWh. This range will be affected by the assumptions used including the inclusion, or not, of compression fuel costs and on the prevailing pressures.

Revenue Recovery under LRMC

Under an LRMC approach, the revenue collected at each entry point may differ from the regulated allowed revenue and this will result in a requirement for an under/over recovery mechanism. The establishment of the Revenue Recovery mechanism is critical in any final Tariff structure design. There are different approaches to dealing with any over/under recovery that arises including:

- Calculating a single commodity charge to be levied on all entry flows, or
- Allocating the total over/under recovery to the Onshore system and collecting through Exit tariffs.

Regardless of the approach adopted it is critical that the asset owner recovers its allowed revenue in a timely manner. To achieve this, it may be necessary to have frequent re-calculations of over/under recoveries to ensure that revenue is recovered (or returned) in a timely manner, thus minimising any cash-flow issues that could arise for the asset owner.

Summary and Conclusion

The IC System is of strategic and economic importance to consumers and continues to make a significant contribution to the Irish state. The presentation attached in Appendix 1 outlines the contribution made and the benefits received. BGN believes that the depreciation period must be reduced to 50yrs to reflect the benefits delivered to date and which will be continued to be delivered into the future.

BGN believes that there is no basis for stranding any part of the IC system and the Commission must now implement its draft decision and the stranding of any part of the IC System must be definitely ruled out. BGN would also encourage the Commission to progress and finalise the new Entry Tariff structure such that this uncertainty is removed from the market and confidence is restored for existing investors.

BGN are available to meet with the Commission in the event that you have any queries in relation to the issues raised in the response above or in the attached presentation.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'D. Twomey', written over a horizontal line.

Denis Twomey,
Commercial Manager
Bord Gáis Networks