



**BGN Response to CER Consultation
CER /13/122**

**Access Tariffs and Financing the Gas Transmission
System**

1. Contents

1. Introduction.....	3
2. Recent experience and the impact of lower bookings.....	4
3. Removal of All Secondary Transfers at the Exit.....	7
3.1 Capacity transfer arrangements are not formally required by EU legislation.....	8
3.2 Capacity transfers worsen rather than improve economic efficiency.....	8
3.3 Capacity transfers result in inequity	10
3.4 The results of capacity transfers may not be consistent with EU legislation	11
4. Restriction on latest time of purchases and transfers of capacity at the exit	12
5. Alternative Options	13
5.1 Mandatory bookings	13
5.2 Removal of mandatory 1-in-50 bookings for NDM.....	13
5.3 Long term booking incentives	14
6. Conclusion	14

1. Introduction

CER's consultation paper "Access Tariffs and Financing the Gas Transmission System CER/13/122" calls for a review of the way capacity is reserved and paid for within the Irish gas market. Bord Gáis Networks (BGN) recognises the issues referred to in the paper, including the current upward stress on tariffs. We welcome the opportunity to present views on these issues.

BGN is a licensed regulated networks entity. Our allowed revenue is determined by the CER following a thorough price review process, and our current price control (which runs from 1 October 2012 to 30 September 2017) sets challenging OPEX and CAPEX targets for our business over the coming years. Our allowed cost of capital, a key part of the regulatory regime, reflects investors' expectations of the stability of the regulatory regime and the relative certainty of our ability to earn a return on the capital we invest in our network. The sustainability of our business and our continued ability to operate and invest in a safe and reliable gas network to the benefit of all energy consumers depends on certainty of recovering our allowed revenue.

Any elements of uncertainty in relation to BGN's ability to recover allowed revenue would impact significantly on cost of capital. For example, in relation to the recent Competition Commission (CC) enquiry in the Northern Ireland gas networks sector, the CC noted in relation to regulatory uncertainty that "both Fitch and Moody's take the predictability of the regulatory regime into account when setting credit ratings, hence we consider that there is clear effect on the cost of debt". The revenue impact of an increase in BGN's cost of capital as a result of regulatory instability would far outweigh anything under consideration at the present time.

In simple terms, tariffs are calculated by dividing BGN's allowed revenue by (expected) capacity bookings. The continued availability of Exit Capacity Transfers reduces significantly these capacity bookings at exit. The solution to this or any other revenue shortfall has been an increase in tariffs (i.e. the same revenue divided by a reduced capacity booking) and indeed tariffs have already increased in 2013. However, solely increasing tariffs is not the solution to the continuation of the current exit capacity transfer regime in Ireland. In particular, only some sections of our customer base benefit from Exit Capacity Transfers – so other customers bear a disproportionate share of the burden of tariff increases.

The reduction in capacity bookings is taking place against the backdrop of lower electricity demand, increased output from wind and the full commissioning of the East

West interconnector. These have all adversely affected gas demand in the power sector over the last number of years, and so have led to tariffs being higher than they otherwise would be. This is impacting power generators, industrial customers and residential customers, all of whom are facing economic challenges themselves.

In CER/013/122, the CER suggests a number of alternative remedies to the problem aside from tariff increases, including changes to the structure of access products and shippers' ability to transfer them. BGN believes that it is right to consider alternative remedies. We support capacity arrangements which promote flexibility and efficient growth in utilisation of the network. However, we do not believe the current arrangements do this. We argue in this response that they create economic inefficiencies by increasing prices to some customers and deterring potential new customers from connecting to or using the network. We also believe that they may result in a cross-subsidy and hence cause inequity among current customers.

BGN is currently implementing the business rules associated with the restriction on secondary trading, to take effect from the 1st October 2013. We believe the full removal of the secondary market at exit is now justified and should be implemented by the CER.

BGN believes the question of restrictions on the within-day capacity product is less clear cut. It is right for the CER to consider changes, but we believe it is important that a balance is struck between competing objectives of network utilisation and ensuring those who cause network investment pay for it.

In the remainder of this document, we set out:

- some evidence on recent experience and the impact of lower capacity bookings;
- our views on the removal of secondary capacity transfers at exit;
- our views on restrictions on the time of purchases and transfers of capacity at exit;
- our views on the alternative options considered by the CER; and
- our conclusions.

2. Recent experience and the impact of lower bookings

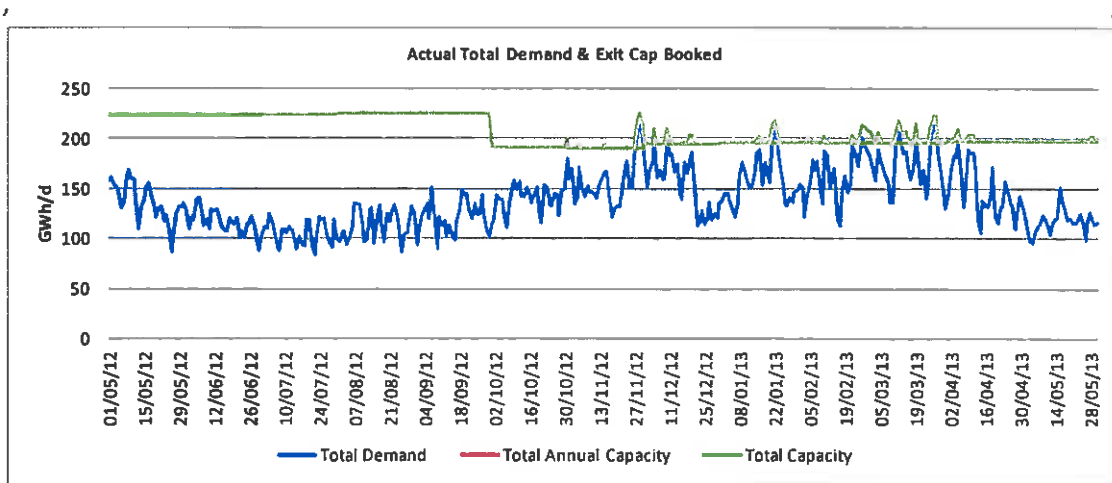
On the 23rd of November 2012, the CER published its decision on Bord Gáis Networks Transmission Revenue for the 1 October 2012 to 30 September 2017 period. As part of this process CER conducted a review of both CAPEX and OPEX resulting in a decision on

revenues which represents a major challenge for our business, representing a cut of 15% on BGN's initial proposals.

Through 2012, BGN experienced an unprecedented fall off in capacity bookings – most notably in the power sector. Reduced gas demand, driven by increased wind and coal generation, led shippers to significantly reduce their annual capacity bookings and to increase reliance on a combination of secondary capacity and short-term products (particularly within-day).

From October 2012/13 annual capacity bookings fell by 14%, most notably in the power sector. This can be seen from Figure 2.1, which indicates that the power sector moved from booking 95% of their actual peak in 2011/12 to a projected 64% in 12/13.

Figure 2.1: Actual total demand versus Exit Capacity May 2012 to May 2013



BGN wrote to the CER in Jan 2013 with reference to this reduction in capacity bookings highlighting the extreme under-recovery that was materialising for the 2012/13 gas year. At that time BGN requested that the CER address this anomaly to ensure that all gas users pay towards the network infrastructure built to supply them. On the 28th February 2013 CER sanctioned a 10.2% increase in the Transmission Capacity tariff (CER 13/080). This addressed some of the under-recovery in 2012/13, but while tariff increases have traditionally been the solution, we believe that looking for alternative solutions to ongoing increases in tariffs (while retaining the cost of capital benefits of revenue certainty) is essential.

To understand this position, it is useful to consider the distribution of the impact of lower bookings among customer groups, and the scale of that impact. We consider two scenarios, based on data presented in CER/013/122.

First, we look at a scenario where all users book capacity based on their potential 1-in-50 consumption, as the NDM sector is required to do. This is an important scenario because 1-in-50 demand is the basis on which the network is sized. If a user connects to the network, reinforcement may be required to ensure the system can still meet 1-in-50 demand. Payments based on such bookings therefore in some ways reflect the costs which users cause when they connect to the network. Second, we look at expected average 2012/13 bookings.

In both situations we calculate the unit exit capacity tariff which would apply, assuming allowed exit revenues of €121.2m (the value used in setting tariffs for BGN for 2012/13 (CER/12/145)), and then calculate the payments of exit tariffs by each sector.

Table 2.1: Scale of the impact of lower bookings, 2012/13¹

Customer	1-in-50 peak demand (MWh/d)	Expected average capacity bookings (MWh/d)	1-in-50 total payments (€m)	Actual total payments (€m)	Saving (cost) relative to 1-in-50 bookings (€m)	Saving (cost) relative to 1-in-50 bookings (%)
Power	147,918	87,208	57.3	47.0	10.2	18%
DM IC	29,598	10,954	11.5	5.9	5.6	48%
NDM	98,414	98,414	38.1	53.1	-15.0	-39%
Shrinkage	5,307	5,307	2.1	2.9	-0.8	-39%
Total	281,237	201,883	108.9	108.9		0%

¹ We note that the data in this table relate to booking behavior prior to the introduction of the restriction on secondary trading, scheduled for October 2013. Changes to booking behavior can be expected as a result of the restriction.

From the above table, a number of things are evident:

- Bookings by power generation and DM IC customers are significantly lower than those associated with 1-in-50 consumption, although these customers would expect the network infrastructure to be able to support their consumption in such peak conditions (whatever other customers were consuming at the time);
- Power generation and DM IC customers are collectively benefitting from the existing arrangements by around €16m per annum. This is because their saving from lower capacity bookings outweighs the impact of higher unit tariffs to date;
- NDM customers are net losers from the arrangements; and
- The financial impact of lower bookings is “zero sum”. Since under the established regulatory regime BGN has to recover a fixed amount of revenue, lower payments by one group of customers equate to higher payments by another.

It is also clear that, simply looking at booking volumes, the power and DM IC sector book proportionately less capacity than that which would be implied by their 1-in-50 consumption. Based on 1-in-50 peak demand, power generation and DM IC customers represent 63% of the market and NDM 35%, but based on expected average bookings, these values are 49% for both sectors.

These effects create issues in terms of economic efficiency, equity and compliance with EU legislation. And they are significant in terms of scale. Therefore we believe the situation requires urgent resolution. In the next sections, we present our views on the CER’s suggested solutions to resolve this problem.

3. Removal of All Secondary Transfers at the Exit

The first of the CER’s suggestions is the removal of secondary transfers at exit. This would mean that shippers have to rely on annual and short term primary capacity products to match their capacity holdings to their demand portfolio.

We support this proposal because we believe that maintaining secondary transfers at exit:

- is not formally required by EU legislation;
- does not result in an improvement in economic efficiency, and in fact creates economic *inefficiency*;

- results in significant inequities among customers groups and potentially between shippers; and
- is as a result potentially inconsistent with EU legislation

We expand on these arguments below.

3.1 Capacity transfer arrangements are not formally required by EU legislation

In CER/13/122, some of the legal arguments in relation to capacity transfers are presented. Here, we simply wish to note that in other mature gas networks with entry / exit systems, provisions for the type of exit capacity transfers currently in operation in Ireland do not exist. It does not seem plausible that they are *required* by EU legislation when evidence exists that such provisions are far from uniform across the EU.

For example, in GB, the structure of the exit capacity regime is such that it is not possible for users to transfer capacity around the network between exit zones. Indeed the arrangements are designed to ensure that users commit to paying network charges in relation to exit capacity for a material period of time, so that they contribute to the long term costs they may cause.

Neither are capacity transfers available to shippers in the French or German markets. In both markets, exit capacity is purchased for a specific exit point, and is not transferrable to other exit points.

3.2 Capacity transfers worsen rather than improve economic efficiency

The capacity booking regime should encourage economic efficiency by ensuring that all those who wish to use the gas system can do so at an efficient price. In contrast, the capacity transfer regime can reduce economic efficiency if it creates price or administrative barriers to particular loads using the system.

3.2.1 Capacity transfers do not improve economic efficiency

We do not believe secondary capacity transfers encourage economic efficiency.

Capacity transfers were initially introduced in 1998 to address a specific issue, i.e. to encourage counter-seasonal loads onto the system. The introduction of the capacity transfer mechanism allowed seasonal gas loads to transfer their un-utilised capacity to counter-seasonal loads at off-peak times and therefore was a pragmatic approach to encourage counter-seasonal loads to use gas rather than alternative fuels. At the point

in time they were introduced, no short term access products were available on the network.

With the introduction of the entry/exit regime in 2005 the concept of exit capacity transfers was retained, largely on the grounds that there were still no short-term products available. Since the introduction of short-term products in 2007, the rationale for retaining secondary capacity transfers no longer exists. Counter-seasonal loads, such as the dairy industry, are able to avail of short-term capacity products at a significantly lower cost than long-term primary capacity products, and are thereby encouraged onto the system. The prices of these primary products are determined through regulatory oversight according to well established principles. BGN would be open to considering a holistic review of short term booking and pricing arrangements.

Therefore, given today's suite of access products, it is clear that secondary capacity transfers do not increase economic efficiency.

3.2.2 In fact, capacity transfers actually reduce economic inefficiency

We believe there is a strong argument to say that in fact, capacity transfers at exit reduce economic efficiency.

Network access charges should be cost reflective. If they are, loads will only use the network when it is efficient (from their and the network's perspective) for them to do so. As we note above, the network is sized to be able to serve the 1-in-50 peak, so the cost of a load using the network is linked to the cost of facilitating their 1-in-50 demand, alongside the other loads already connected.

As we also noted above, power stations and DM IC customers are not booking anything like their 1-in-50 load - they are not even booking capacity equivalent to their average load. This implies their contribution is likely to be below the level to serve, and the contribution of NDM customers is likely to be above cost to serve.

While it is true for all loads, this failure to recover cost is perhaps most obviously seen in the case of new connections. Under today's connection policy, up front connection charges do not cover all of the costs of the system - they cover a proportion of the cost of connection assets. Future transportation tariffs cover any remaining connection asset costs *and* the costs of the rest of the system which ensures that 1-in-50 demand

can still be met². The connection policy requires some sites to book exit capacity for a number of years to ensure a reasonable proportion of this additional cost is covered. However, exit capacity transfers allow shippers to avoid this cost, because the commitment to book firm capacity can be avoided by a reduction in capacity bookings of an older site within the shipper's portfolio. As a result, following some new connections there may be no net increase in network revenue to recover costs genuinely incurred. The shipper of the connecting customer(s) has clearly not covered the costs caused. This cost will have to be borne by other customers, resulting in them paying more than the costs caused.

If some shippers face tariffs which are above cost, it will result in inefficient use of the network. This may result in lower numbers of customers connecting and network utilisation being inefficiently low. This inefficiency will reduce Ireland's overall economic welfare as resources will be used where they are not most valuable.

Therefore, far from resulting in greater economic efficiency, secondary capacity transfer arrangements can be considered to be damaging to overall economic welfare.

3.3 Capacity transfers result in inequity

The continued existence of secondary capacity is resulting in a sharp reduction in primary capacity bookings causing upward pressure on network tariffs, as stated previously. This is clearly inequitable, as customers who are not gaining from the flexibility offered by the exit capacity transfers will pay higher tariffs than the costs they impose on the network. They may then be cross-subsidising those who do benefit, who will pay less than the costs they impose.

As stated in the CER consultation paper, the gas sector in Ireland has been built out in large part to meet the demands of the power sector. At present, the fall in long-term capacity bookings (with little or no corresponding increase in the monthly or daily bookings) is resulting in the burden of this cost falling on the NDM sector. BGN believes change is required to ensure the network is remunerated in a fair and equitable way across customer categories.

Even for those sectors that are currently benefitting from secondary transfers, tariffs could reach a level whereby any advantage arising from use of transfers could be

² It is important to note that, just because power generators make a 100% contribution to their connection assets, they do not cover all network investment costs associated with the supply of gas to their power station.

nullified by the rise in network tariffs, see example in table 3.3. This shows that for some customer types, it is possible that removal of the secondary market can plausibly result in lower capacity costs because, although booking volumes are higher, unit tariffs are lower.

Table 3.3: Illustrative impact on Cost of Capacity under Two Tariff Scenarios.

	Unit	Current Regime 30% Tariff Increase	Restructuring 5% Tariff Increase
Peak	MWh	100	100
Capacity Booking	MWh	85	100
Cost	€/MWh	€54,290.09	€51,587.87

**Please note the tariff increases shown above are used for comparative purposes and are not reflective of any actual tariff calculation.*

We note that secondary exit capacity transfers also potentially give rise to inequity between players in the market where some shippers are in a better position to avail of transfers than others. Shippers with a diversified portfolio may be able to exploit more effectively secondary transfers than shippers who would have to trade with other organisations to optimise their capacity holdings.

3.4 The results of capacity transfers may not be consistent with EU legislation

Article 13 of Regulation 714/2009 states that:

“Tariffs, or the methodologies used to calculate them, shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users and providing incentives for investment and maintaining or creating interoperability for transmission networks.”

We have shown above that capacity transfers may result in a cross subsidy between network users. Specifically, based on cost reflective tariffs, the NDM sector is currently likely to be paying more in aggregate for network access than the incremental cost they impose. Conversely, the power and DM IC sectors are paying less.

We therefore believe there may be a legal risk in relation to the exit tariffs for the Irish network, as a consequence of the current secondary transfer arrangements at exit.

4. Restriction on latest time of purchases and transfers of capacity at the exit

In contrast to the position on secondary exit capacity transfers, we believe the arguments in relation to the CER's proposed changes to within day capacity are more balanced.

BGN supports arrangements which increase shippers' flexibility and result in more efficient utilisation of the gas system. Currently shippers have a suite of options available which allows them to book capacity right up until 03:00 into the gas day. This ensures that, even if the value of consuming gas becomes apparent at very short notice, shippers face no administrative barrier in relation to using the gas system.

The energy market as a whole is becoming more unpredictable and more volatile, due to the connection of increasing volumes of intermittent renewables. It is important that the gas network is able to facilitate gas power stations acting as backup to this renewables capacity.

However, the current booking arrangements provide shippers with an opportunity to fully optimise with almost perfect foresight and very little risk. Currently, the gas network is always there should they wish to use it. In effect this transfers risk onto the transporter and so, because our revenue is fixed, onto other customers. The Transporter is required to make capacity available 365 days of the year whether it is used or not, and the cost of this is ultimately passed on to all customers through higher network tariffs.

The range of products offered by BGN should reflect the variability of gas consumption, and should facilitate network utilisation by all users. However, this needs to be balanced against the need for the cost of putting infrastructure in place to be paid for by the customers who required it to be built.

We believe it is relevant to consider whether restrictions should be placed on the timing of capacity purchases. However, we also note that there may be other approaches to ensuring an appropriate balance between objectives. These include, for example:

- a review of short term product pricing – as we note above, BGN is open to a holistic review of short term booking and pricing arrangements; and
- pricing short term products depending on time of booking (i.e. charging a higher price for within day bookings to reflect the option value being provided to shippers).

We agree that change is required, but believe it is important that the change needs to get the balance right between system utilisation and customer equity.

5. Alternative Options

In the consultation paper CER put forward a number of proposals which were not for consultation but for consideration by industry. In this section, we briefly provide our view on those proposals.

5.1 Mandatory bookings

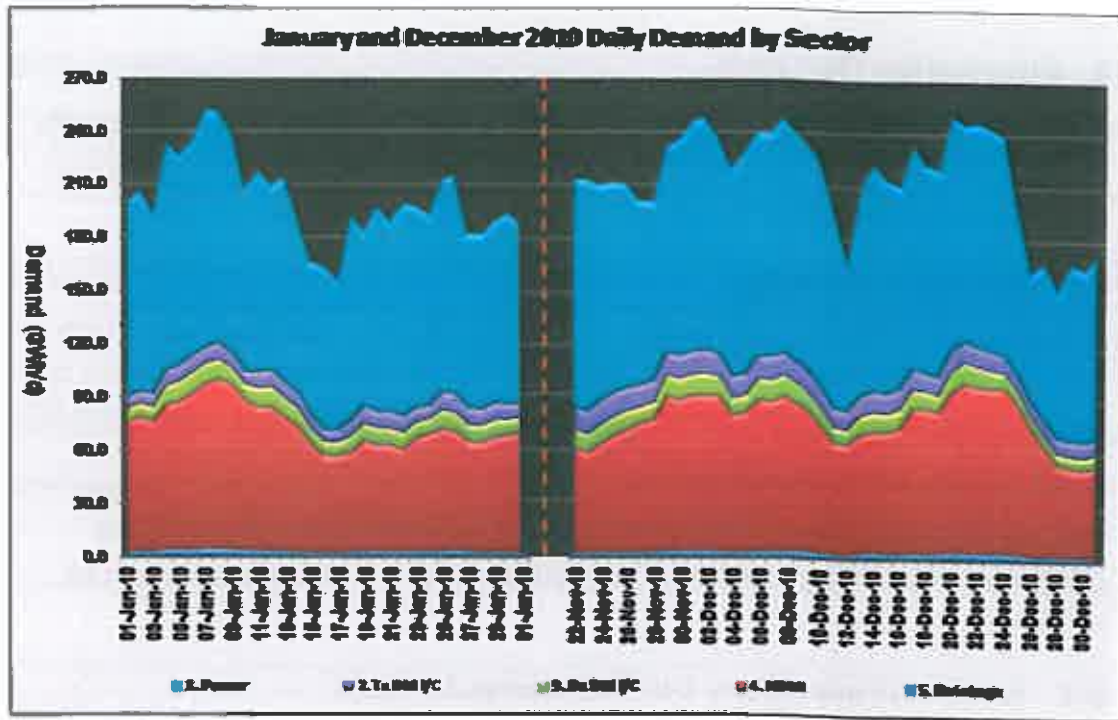
BGN does not believe that mandatory bookings for all is necessarily an appropriate way forward. Moving to mandatory bookings for all sectors would involve forecasting by site, and individual customers will inevitably have better information at that level than BGN.

However, should it not be possible to implement changes to the current arrangements, BGN would wish to revisit this position, as we believe the current position is not sustainable and that therefore consideration of second-best approaches would be necessary.

5.2 Removal of mandatory 1-in-50 bookings for NDM

BGN disagrees with the removal of Mandatory Bookings at the 1-in-50 level for NDM customers. The transmission system has historically been built to meet a 1-in-50 peak day requirement, and has been used to its fullest capacity most notably on two occasions in 2010 when 1-in-50 conditions occurred, as shown in Figure 6.1 below.

Figure 6.1: Daily Gas Demand over Jan & Dec 2010



For security of supply reasons BGN will, subject to being financed to do so, continue to build out the system to meet this standard. And in situations of peak demand, the NDM customers are the last customers who would be interrupted. BGN therefore believes it is appropriate that NDM customers book according to the 1-in-50 standard.

5.3 Long term booking incentives

BGN believes that the proposals being considered will provide the right signals to incentivise long-term bookings.

6. Conclusion

BGN is a regulated entity, and our investors value the stability of the regulatory regime and the revenue certainty which it creates. The sustainability of our business depends on the certainty of recovering our allowed revenue. The revenue and tariff impact of an increase in BGN's cost of capital as a result of regulatory instability would far outweigh anything under consideration at the present time.

Given our revenues are fixed, a reduction in capacity bookings would traditionally have been met with an increase in tariffs. This has happened already in 2013. However, we

do not believe that solely continuing to increase unit tariffs is the solution to the continuation of the current exit capacity transfer regime in Ireland. Therefore, we welcome the CER's decision to consider alternative solutions which focus on the drivers of the reductions in capacity bookings.

We support the removal of the secondary market at exit. Capacity transfers are reducing exit capacity bookings for the power and DM IC sector, which is in turn:

- resulting in economic inefficiency, as a result of the potential for sub-optimal use of the network;
- resulting in inequity between customer groups, as NDM customers are paying above cost; and
- potentially resulting in tariffs which may be inconsistent with EU legislation, as a result of cross-subsidies.

We do not believe that the continued existence of exit capacity transfers is required by EU legislation – other countries have capacity regimes in place which do not include such arrangements. Neither do we believe they result in any efficiency benefits. Short term products can provide for efficient utilisation just as well as secondary exit capacity transfers. BGN is open to a holistic review of short term booking and pricing arrangements.

Following the removal of secondary capacity transfers at exit, arrangements to facilitate change of shipper maybe required. BGN would support the introduction of the "rucksack rule" for all sectors similar to the NDM sector.

BGN believes it is relevant for the CER to consider changes to arrangements for within day capacity. We believe a balance must be struck between optimisation of network use and ensuring those who create the need for network capacity pay for it. Restrictions on within day capacity are one possible answer. Changes to the pricing of short term capacity, and/or the introduction of "within day" short term prices which increase close to the end of the day may be another.

