

## **Access Tariff and Financing of the Gas System (CER 13/122)**

### **Response to CER's Proposals**

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**15 July 2013**

#### ***Background, Introduction and Summary***

For a number of reasons firm capacity bookings on BGN's transmission system have fallen and this is eroding BGN's revenue from the provision of transmission services. The CER presents, but does not comment on, the factors advanced by BGN to explain the fall in bookings of firm capacity:

- Secondary capacity availability,
- Reduction in price for short term capacity during summer starting in 2013,
- Wind displacing gas off the merit order in the SEM,
- East West Electrical Interconnector (EWIC),
- Coal & Peat being in merit more than gas.

BGN's primary objective is secure full recovery of transmission network revenues awarded by the CER. The CER has already demonstrated a commitment to support BGN fully in its efforts to achieve this objective. It decided (CER 13/080) to award BGN an effective 10.2% increase gas transmission tariffs as an interim measure to allow BGN to recoup some of its projected under-recovery of revenue. This consultation document presents further confirmation of the CER's commitment to support BGN in the achievement of its primary objective.

The remainder of this document examines how the CER has ended up in its current invidious position and arrives at the following conclusion:

#### **Conclusion**

It is entirely unreasonable to expect, require, or, by withdrawing existing flexibility services, compel gas-fired power generators to reserve a level of firm gas transmission capacity that satisfies the revenue recovery desires of BGN, when gas-fired generators are increasingly being required to back-up intermittent wind generation. In the first instance, it is the responsibility of the state to address the unintended, but predictable, consequences of its policy on renewables in electricity generation. This, of course, does not mean that gas-fired generators can expect to emerge unscathed. But if the burden is imposed on generators they will seek to pass any additional costs through to final consumers.

It is the responsibility of the CER to adjudicate on an allocation of the costs imposed between the network business and the gas-fired generators so as to protect the interests of final consumers. It is totally disingenuous for the CER to make threats that if the current '1 in 50' level of capacity is not booked it may not be available in the future and that the security of supply required by household consumers may be prejudiced. The obligation is on the CER, as

the responsible party for determining the level of required gas capacity in Ireland, to assess future electricity demand for gas transmission capacity and to distinguish between a base level demand for capacity and the demand for additional capacity required to back-up wind generation – and to determine different tariffs for each type of capacity.

It will be for the state to decide whether to absorb any shortfall in revenue as the majority owner of the network business, or to compensate for the shortfall directly or indirectly, or to require a contribution from wind generators – or, indeed, some combination of all of these.

It is not the responsibility of the CER to impose unnecessary costs on market participants or final consumers to compensate for the state's failure to ensure efficient financing of the energy network businesses.

### ***How the CER ended up in this invidious position***

#### **When one is a hole, stop digging...**

The CER is in a hole. The dimensions of the hole are mainly as a result of its own efforts. But the fact that there is a hole – and that the CER is in it – is the result of decisions by a succession of governing politicians and policy-makers since the mid-1990s. Some of these decisions were driven by the requirement to transpose primary EU legislation and regulations in to Irish law; others were driven by perceived political imperatives and by requirements to pander to the desires of various powerful and influential sectional economic interests.

#### **..but the CER won't stop digging**

So, for example, successive governments were not prepared to contribute directly to the financing of gas network investment – irrespective of the scale of this investment. (They similarly refused to contribute directly to the financing of electricity network investment where, on average, the scale of investment is far greater than for the gas networks.) As a result, the CER, when it was given regulatory responsibility, was required to place a value on the energy networks to generate a return on, and of, investment much higher than that which would be generated by an appropriate regulatory valuation of the assets. This was required to ensure that final consumers, indirectly but ultimately, would make an up-front contribution to finance investment and this would compensate for the failure by the state as the majority shareholder to contribute to investment financing. Despite making this up-front contribution to investment-financing, consumers continue to pay the full return on, and of, this investment. This is an implicit financing tax and, as a result, final electricity and gas prices are much higher than they need be. This is gloriously inefficient.

#### **Creating fictions...**

But it has supported a fiction that the ESB and BGÉ are 'self-financing'. They are, indeed, self-financing because the CER awards them network revenues that are sufficiently large to compensate for the failure of successive governments to finance a share of network investment directly. And this fiction of self-financing has proved to be convenient for successive governments and for the various influential special interest groups opposed to any restructuring of the ESB or BGÉ or to any changes to ownership and financial structure that would be unambiguously in the broader public interest.

### **...and denying reality**

The ESB and BGÉ have become totally addicted to the excessive network revenues awarded by the CER. The surplus cash flow has allowed them to finance investment in non-network activities and, in many instances, to cross-subsidise these activities. This is particularly the case for BGÉ as the demand for gas network investment has fallen. But the CER is determined to ensure that BGN – and, ultimately, BGÉ – will recover the network revenue it has awarded and the surplus cash flows generated – irrespective of the changing pattern of demand for gas transmission services. This is clearly evidenced in this consultation document.

The CER seeks to camouflage its commitment to BGN with pious declarations about the need to ensure safe and secure supplies of gas and to avoid tariff increases that would damage the interests of consumers, but its intent is clear.

“Tariffs are set by dividing the allowed fixed revenues by the expected bookings; if expected bookings decline, the tariff will rise. The recent unprecedented drop off in primary capacity bookings is, in the CER’s view, unlikely to be a short term phenomenon. The gas network needs to be paid for if consumers, businesses and electricity generators want safe and secure supplies of gas. If the current pattern of capacity bookings continues, then without any remedial action there will continue to be increases in gas networks tariffs to the detriment of consumers.” (p4)

It is bad enough that the CER awards excessively high network revenues to both the ESB and BGÉ/BGN, but it is even worse that the CER is determined to ensure BGN will continue to recover these excessively high network revenues while the underlying pattern of demand for transmission network services is undergoing significant change. The CER, of course, will simply deny that it is awarding excessively high network revenues to either the ESB or BGN. But all it has to do is to engage with and refute the evidence advanced.<sup>1</sup> Its failure to do so is instructive, and its silence, and that of all of the other public bodies either aware of the largesse awarded by the CER or aware and benefitting from this largesse, speaks volumes. The National Consumers’ Agency, which one would expect would seek to protect the interests of consumers, simply doesn’t want to know.

### **The CER fails to understand why it should stop digging...**

The CER not only wants to maintain this award of excessive transmission network revenues to BGN, but it also wants to ensure that BGN will recover them fully – even as demand for its core transmission services falls. Of the five reasons advanced by BGN to explain the fall in firm capacity bookings, two (wind generation displacing gas fired generation and the EWIC) are the unintended, but entirely predictable, effects of the implementation of government policies. The extent to which peat-fired generation is displacing gas-fired generation is also, in some respects, the consequence of a specific government policy to subsidise peat-fired generation.

The fifth reason - coal-fired generation displacing gas-fired generation - is primarily the result of the massive increases in shale gas production in the US driving down gas prices and allowing gas-fired generation to displace coal-fired generation there. And this has released large volumes of lower priced coal on to the international market which is available for purchase by the ESB.

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<sup>1</sup> <http://www.dublineconomics.com/papers/energy.pdf>

The first and second reasons relating to the availability and pricing of short-term and secondary capacity merely reflect the rational commercial use of these services by gas-fired generators responding to the displacement of their generation by wind, coal, peat and the use of the EWIC.

To meet a legally binding EU requirement for renewable energy to comprise a 16% share of energy consumption by 2020 the share of renewable energy (mainly wind) in electricity generation will need to increase to 40%, so that the gas-fired generation displacement impact is set to increase. Coal will continue to displace gas in electricity generation while coal prices remain low, wholesale gas prices in North West Europe remain higher than they need be and the EU ETS continues to malfunction.<sup>2</sup> Peat will also probably continue to displace gas in electricity generation while the current subsidisation policy continues. There is probably little that can be done about the impact of the EWIC since flows will be determined by the pattern of demand and supply in both markets and relative wholesale prices.<sup>3</sup>

### **...and continues to dig even more furiously**

Therefore, in the context of the CER's commitment to support BGN in the achievement of its objective to fully recover the transmission revenues the CER has awarded to it, it is not surprising that the CER has decided to focus on the electricity generation sector and on the use of short-term capacity products and services by gas-fired generators to manage the continuing reduction in demand for their send-out and the increased volatility of their send-out. But the increased use of short-term capacity products and services is merely a symptom of, and a perfectly rational response to, the problems that gas-fired generators are confronting.

The pricing and use of short-term capacity products – and the flexibility they provide – are not the problem. But it is typical of the CER, having dug itself so deeply in to this hole, to continue digging by treating them as the problem and proposing to reduce the availability and flexibility of these products and services.

### **Getting to the root of the problem**

The root of the problem lies in the manner in which EU primary legislation has enforced and governed the liberalisation of national electricity and gas markets and their increasing integration at both a regional and EU-wide level. In most instances, and Ireland is no exception, this has involved a transition from monopoly, vertically integrated, often state-owned firms providing bundled network and supply services to unbundled regulated network businesses providing network services on a non-discriminatory basis and energy supply business competing with other supply businesses. Most of the network businesses have retained their monopoly privileges and many supply businesses, whether emerging from unbundled, but network affiliated, gas or electricity supply businesses, have expanded their activities both within national markets and across the EU to create vertically integrated businesses along both the

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<sup>2</sup> It is beyond the scope of this document, but there has to be considerable doubt about the continued relevance of these binding requirements to achieve a specific share of renewable energy in final energy consumption by 2020 when the EU's institutions are incapable of reforming the EU ETS to ensure it is working as originally intended and generating the prices for emission allowances (EUAs) required to support this penetration of renewable energy in a cost-effective manner.

<sup>3</sup> Of course, eliminating the overcharging on the Irish electricity transmission network would reduce SEM prices relative to British wholesale prices and reduce the impact on Irish gas-fired generation, but, to make any progress, Irish governing politicians, the regulator and policy-makers would have to cease denying that this over-charging is taking place.

electricity and gas supply chains. The corporate objectives at all times are to secure or retain economic or market power and to seek to exercise this power without restraint.

Examples and features of these developments may be observed in the electricity and gas markets in Ireland. And the manner in which EU primary legislation has been transposed in to Irish law – by exploiting any loopholes or ambiguities – has strengthened the ability of the incumbent market participants to exploit their market (and political) power to the detriment of the interests of final consumers.

However, in the context of this consultation document, the key feature is the extent to which the network businesses have actually strengthened their ability to recover fully any investments they had incurred prior to the application of economic regulation – and not only to recover these investments fully, but to extract part-financing of new investments up-front and to secure a higher rate of return than the implicit rate secured under pre-regulation arrangements. All of this generates surplus, unearned cash flow for the parent companies at the expense of final consumers.

### **Is it possible to solve this problem in the midst of so much policy and regulatory dysfunction?**

The short answer is probably no. The extent to which so many institutional arrangements and procedures have been embedded in EU and national legislation – and the extent to which layers of excessively complex and costly policy, regulatory and commercial arrangements that have been constructed on these – suggests that ‘root and branch’ changes will be required. However, this is not the way the EU works. Even when agreed institutional arrangements prove to be seriously flawed and their failings and inadequacies impose enormous costs on EU economies and citizens, as in the case of EMU and the Euro, progress to achieve even a limited measure of resolution is painfully slow.

Therefore, it is not surprising that progress in other areas, such as energy and climate change policy where the failings and inadequacies are not perceived as being as severe and obvious, is even slower and more haphazard. But some progress is being made.<sup>4</sup>

But in other areas where significant changes are required, such as the use of Entry-Exit gas transmission pricing, currently failing approaches are being pursued enthusiastically with even more cost and complexity being added.

The best we can hope for is that the EU, as is its wont, will ‘muddle through’ eventually and the outcome of this muddling will have some beneficial impacts on Irish energy policy and regulation. But it isn’t sufficient to rely on the expectation of such a benign outcome. In this instance, the CER is proposing to curtail even the more use of short-term capacity products in a gas transmission capacity market that is already seriously flawed.

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<sup>4</sup> The conclusions of the European Council meeting of 22 May 2013: [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/137197.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/137197.pdf) include a direction to the Commission to present an analysis of the drivers and composition of energy costs and prices in Member States before the end of 2013. DG COMP has initiated an investigation of Gazprom’s gas contracting practices in eastern Europe: [http://europa.eu/rapid/press-release\\_IP-12-937\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-12-937_en.htm?locale=en) And the European Parliament has recently decided to modify the working of the EU ETS: <http://www.europarl.europa.eu/news/en/headlines/content/20130701STO14754/html/ETS-how-to-boost-green-innovation-at-a-time-of-crisis>

### **The search for a ‘second (or third) best’ solution**

However, final consumers really deserve some relief and there is a requirement to focus on this apparently absolute regulatory commitment to ensure the full recovery of network investments, irrespective of the extent to which the relevant assets are used and useful, and the associated gas network over charging in Ireland, and to examine options that might remove – or, at least, reduce - the resulting unnecessary and excessive burden on final consumers. It may not be a ‘second best’ or even ‘third best’ solution, but in the same way that some loopholes and ambiguities in EU primary legislation have been exploited by successive governments and policy-makers to pander to the desires of various vested interests – and at the expense of final consumers, it should be possible to apply the spirit of the EU’s primary legislation in the interests of final consumers.

It makes sense to start from first principles. Gas transmission assets are long-lived and specific. Private sector investors will not commit to finance these assets unless they have a solid assurance of investment recovery or there are deep and liquid markets in transmission capacity which remove barriers to exit or in which they can hedge their exposures. Despite compelling evidence in the US that deep, liquid markets in transmission capacity can emerge which reduce the requirement for regulatory assurance of investment recovery, the EU has decided to opt for the virtual definition of gas transmission capacity using Entry-Exit gas transmission pricing and to forgo the potential to facilitate the emergence of such markets.

In addition, since EU primary legislation permits its transposition in to national law in a manner that recognises specific characteristics of national markets, some national markets are simply too small in scale to facilitate the emergence of such markets – even if Entry-Exit pricing were not mandated. This appears to be the case in Ireland.

It is generally accepted that the transition from vertically integrated, monopoly businesses delivering bundled transmission and supply services to unbundled supply and transmission businesses has the potential to reveal some under-utilisation of existing transmission assets. It is also generally accepted that the emergence of competition in supply and electricity sector restructuring may also reveal under-utilisation of some transmission assets. In other words, some assets, or portions of these assets may be ‘stranded’. Not surprisingly, transmission businesses exhibit an almost total opposition to any stranding of assets. However, ensuring full recovery of stranded assets will impose unnecessary and excessive costs on final consumers and could postpone for a long time the benefits they are entitled to experience from the introduction of competition in supply. In most jurisdictions, it is the responsibility of the sector regulator to adjudicate on the sharing of the burden of stranded assets between investors and final consumers.

But this is not the case in Ireland – even though the CER is empowered (and bleats continuously about how it performs its duty) to protect the interests of final consumers. The CER has demonstrated, again and again, that it is unambiguously on the side of the state-owned energy companies. This is simply the most recent example.<sup>5</sup>

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<sup>5</sup> As we have seen above, the CER was captured prior to its establishment to ensure that the state, as the majority owner, would not be required to part-finance network investment directly and that there would be more than full recovery of the investment in place so as to finance the antics and ambitions of the state-owned energy companies. And last year the CER decided to impose the recovery of the costs of any portion of stranded gas interconnector assets on prospective suppliers who do not plan to make any direct use of these assets. This decision prompted a High Court judicial review. A judgement has yet to be handed down.

The CER finds itself seeking to protect the network subsidiary of a state-owned company from the unintended, but entirely predictable, consequences of a national policy to increase the share of renewables in electricity generation to 40% by 2020 in the context of a binding EU agreement. And the consequences have become more severe and immediate because European gas prices are higher than they need be, international coal prices are lower than expected and the EU ETS is not working as it was originally intended.

It is entirely unreasonable to expect, require, or, by withdrawing existing flexibility services, compel gas-fired power generators to reserve a level of firm gas transmission capacity that satisfies the revenue recovery desires of BGN, when gas-fired generators are increasingly being required to back-up intermittent wind generation. In the first instance, it is the responsibility of the state to address the unintended, but predictable, consequences of its policy on renewables in electricity generation. This, of course, does not mean that gas-fired generators can expect to emerge unscathed. But if the burden is imposed on generators they will seek to pass any additional costs through to final consumers.

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