



Access Tariffs and Financing the Gas Transmission System

A response to CER/13/122

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Final**



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1. Introduction

In a world where competition for capital is fierce, important investment decisions are made based on a number of key criteria. In regulated markets, these include regulatory certainty and risk.

Every stakeholder is looking for as much assurance as possible that the regulatory environment is stable, secure and that decisions by regulatory authorities are consistent. In our view the Commission for Energy Regulation (“CER”) is acting contrary to this; evidenced by its changed opinion many times over the past 3 years to justify removing exit capacity trading – from supporting the removal of the Regulated Tariff Formula, to the fair and equitable remuneration of the network, to effectively forcing all shippers to book too much capacity for their needs just to secure Bord Gáis Networks (“BGN”) revenue base.

The energy sector in Ireland is now entering a new phase as we progress towards an integrated target model for energy across the EU, one in which renewables will feature more. The CER has a duty to ensure that the market structures are fit for purpose and it should be taking courageous decisions that are in the best interests of all stakeholders, not favouring one over the other. The latest consultation paper on access tariffs and financing the gas transmission system challenges this principle.

This paper is the latest attempt by the CER to solve BGN’s problems with their out-dated network recovery model, which has now clearly been shown as not fit for purpose.

Since the introduction of capacity trading in 1998 the CER has overseen a number of structural changes in the capacity structure from full and open trading of secondary capacity to the introduction of short term day-ahead and later within-day capacity.

The CER was obliged to make certain changes to comply with European legislation and the latest iteration of the capacity trading regime is in response to a recent significant change in booking behaviour, mainly by the power generation sector, which is undermining BGN’s revenue stream.

We have stated on a number of occasions that the CER was in a dilemma with the current arrangements due to the interdependence between the gas and electricity. To date the CER had not recognised the impact its decisions in the gas sector were having on the electricity market.

It concerns us that the CER did not issue its consultation paper on its proposals until the Single Electricity Market Committee (“SEMC”) issued a guidance note regarding the treatment of gas transportation costs in the SEM. That note uses the analysis of external consultants who suggested a number of rule changes in the gas market that would mitigate the impact of primary daily gas capacity products.

2. Executive Summary

2.1 Summary

The original decision to restrict exit capacity trading in 2010 was premature. The CER did not understand the market drivers 3 years ago and was trying to solve an immediate problem without full awareness of other factors that would have a direct bearing on the wider energy market.

From our position as a non-vertically integrated player the proposals are logical, given the October 1st implementation date of decision paper CER/10/089.

“Logical” does not imply that we agree with the CER’s overall handling of capacity and, in particular, secondary capacity, as we continue to believe that the CER has erred gravely in this area.

However, on the assumption that the CER remains closed to changing its mind on restricting exit capacity trading per decision CER/10/089, despite overwhelming evidence to the contrary, then the two proposals are a logical follow on if implemented as is and indeed a necessary follow on to prevent regulatory distortion of and discrimination in the market.

This means that they cannot be treated separately, but must be regarded as one. Furthermore, if approved, they must also have an implementation date no later than 1st of October 2013. This is so, because taken together, the proposals:

- a) Prevent the power generation sector having a material disruptive impact on BGN’s revenues (which is the CER’s primary objective); and
- b) Prevents distortion of the retail market by handing a competitive advantage to vertically integrated players.

The CER must recognise that any implementation of decision CER/10/089 without a simultaneous implementation of the two proposals benefits the vertically integrated players, which is tantamount to the CER discriminating against non-vertically integrated players.

Additionally, we note that in respect of the two proposals, the CER has not conducted a regulatory impact assessment. Inevitably, any such assessment would cause a delay in the implementation date of the two proposals.

Therefore, in the interests of clarity, if the proposals have an implementation date that is later than 1st of October, then the effective implementation date for decision paper CER/10/089, which restricts capacity trading must also be put back to coincide with the implementation date for these two new proposals.

The table below clearly illustrates the position:

Action	Market Impact
Restriction of capacity trading implemented and no simultaneous implementation of new proposals	Market distortion; retail market failure; and transport costs significantly increased
Implement new proposals and restriction of capacity trading is <i>not</i> implemented	No market distortion; retail market stability; and no increases in transport costs
Restriction of capacity trading and new proposals implemented simultaneously	No market distortion, retail market stability and fairer transport costs

Billions of euros have been invested in the Irish energy sector. If the CER and other stakeholders want to maintain investor interest they must not be seen to engage in any regulatory intervention that distorts the competitive retail market.

In terms of achieving its aim of granting BGN complete cashflow predictability, on top of its guaranteed revenues for the next five years, the CER can claim success with the approach put forth in CER/13/122.

However, this ignores the collateral damage inflicted on the retail gas market and especially on residential and small business consumers. We would refer the CER to the analysis and reasonable proposals presented in Vayu's submission to proposed decision paper CER/13/034.

The CER's protection of a monopolist state-owned company is deplorable. BGN enjoys:

- A monopoly position;
- Guaranteed revenues based on a return on assets;
- Limited requirements to be efficient and weak oversight of same;
- Revenue collection done by third parties free of charge;
- Zero credit risk; and
- Full cashflow predictability.

Clearly, these are features unknown to commercial enterprises, including Ireland's struggling indigenous SMEs. This dichotomy is patently unjust and unnecessary.

In addition to the two proposals, we would call on the CER to recognise the extremely privileged position enjoyed by BGN, which is enjoyed at the expense of both the shipper community and gas consumers.

A simple solution to lessen the extreme imbalance would be to reduce the amount of financial security that shippers provide to BGN from 72 days to 30 days. This should apply for shippers in respect of the

retail market only, who in effect act as unpaid rent collectors for BGN.

In addition, BGN should be obliged to financially recompense these shippers for providing a billing and revenue collection service on its behalf. This could take the form of direct payment and or providing credit insurance protection against non-payment and default.

If this is not deemed acceptable, then we would suggest that BGN takes responsibility for collecting its own revenues directly from end-users as happens in some other European countries.

Industry had been expecting an announcement on changes to the Moffat entry tariffs. In the proposed decision paper on the interim increase in transmission tariffs (CER/13/034) the CER noted that it would “consider the long term profiling of revenues” on the interconnectors to deal with the under-recovery expected in 2012/13.

However, this paper does not mention what has been done in the intervening period. This paper only deals with exit capacity issues. This is now of real concern given that the model used for profiling Moffat entry capacity revenues suggests that an increase of over 40% in this tariff would be expected if no action is taken.

The CER considers that its position does not contravene any relevant EU legislation, but has not referred to any legal opinion to support this position.

Nothing has convinced us that the CER has made a correct analysis of the situation given that Regulation (EC) No 715/2009 (repealing Regulation (EC) No 1775/2005) on conditions for access to the natural gas transmission networks makes numerous references to “capacity”, not entry or exit capacity taken in isolation.

2.2 *Alternative Options*

In our previous submission on this issue, we proposed a number of solutions to the current problem. We were surprised that only one of which was mentioned in the consultation paper – long term booking incentives.

Other solutions that we believe have genuine merit are:

- Impairment of an overvalued asset or at least implementation of a network recovery model that puts a realistic value on the assets. Either solution should give the same result – lower tariffs and decreased costs for end-users.
- Recognise that industrial, commercial and domestic customers are a totally different proposition in the use of the gas network and cannot be treated in the same way as the power generation sector.
- Different short term capacity rates for retail suppliers and the power generation sector.
- Review of policy for new connections.

- Revisit the capacity/commodity split for transmission charges.
- Prompt adjustment to BGN's Weighted Average Cost of Capital ("WACC") in response to changes in the sovereign credit rating.

Further details on each of the above are contained in Section 6.

3. EU Position

The European Union is founded on the freedom of movement of goods and services.

Each of the three legislative packages and the ancillary regulations in relation to the internal market for electricity and gas endorse this view. The 3rd legislative package and the subsequent development of the target model for the gas market support the concept of allowing gas capacity to be traded between entities.

In the decision making process the CER must be mindful of the proposed Capacity Allocation Mechanisms and Congestion Management Procedures Network Codes and a recent paper by the Agency for the Cooperation of Energy Regulators (“ACER”) on the framework guidelines on rules regarding harmonised transmission tariff structures for gas¹.

Trading Gas Capacity

The EU rules on capacity trading, which give formal direction to member states to allow all forms of capacity trading, are laid down in Regulation (EC) No 715/2009 (repealing Regulation (EC) No 1775/2005) on conditions for access to the natural gas transmission networks.

Article 1(c) of 715/2009 states the regulation is aimed at “facilitating the emergence of a well-functioning and transparent wholesale market”. The objectives of

Article 1 “shall” include the facilitation of capacity trading.

Article 13 states that tariffs should avoid any cross-subsidies between network users and that these tariffs should be “*set separately*” for every exit point. It is arguable therefore that, on the basis there is one exit tariff for Ireland, there is one virtual exit point and that trading should be possible at an overall level.

Article 16 deals with the principles of capacity-allocation mechanisms and congestion-management procedures concerning transmission system operators. Paragraph 1 notes that the maximum capacity at “relevant points” should be made available to market participants. Such “relevant points”, according to paragraph 3 of Article 18, shall include entry *and exit points*.

Article 22 of this regulation on the trading of capacity rights is even more categorical and unequivocal. It states that each Transmission System Operator (“TSO”) “shall develop harmonised transport.....contracts and procedures on the primary market to facilitate secondary trade of capacity and shall recognise the transfer of primary capacity rights where notified by system users”.

¹ http://www.acer.europa.eu/Official_documents/Public_consultations/Pages/PC_2012_G_14.aspx

4. Proposal 1 – Removal of all secondary capacity transfers

The CER has a simplistic view of the proposal to remove exit capacity trading in its entirety. The issue is far more complex than this and yet we have seen very little additional material from the CER to justify this hardened view.

An obvious area where this is evident is the CER's position regarding the power generation sector. In 2010 the CER viewed the facility of Large Daily Metered ("LDM") to LDM trading as an "efficient" use of capacity, yet the position now is that this facility is now deemed to be "economically inefficient". This is just one example of where inconsistency in treatment / views has far reaching implications for the wider market.

In the previous consultation (CER/10/037) the CER carried out a market impact assessment regarding the impact that removing exit capacity transfers would have on tariffs in the Non-Daily Metered ("NDM") sector. In that exercise the CER noted that NDM tariffs would actually increase if capacity trading was removed. It is not acceptable that a similar analysis was not carried out.

The paper notes the increase in the level of secondary capacity trades over the past 3 years, which would suggest that the NDM sector of each shipper / supplier has benefitted from excess capacity sales and

helped to keep the tariff to this Customer group lower than it would otherwise be.

We do not believe that the CER was correct in their thinking in 2010 where they believed that capacity trading would create a barrier to entry. Bord Gáis Energy was obliged to publish and make spare NDM exit capacity available to the market. We can see now that this thinking was wholly incorrect. Removing this facility will curtail competition and new entrants will be reluctant to enter this sector of the market.

The proposal paper also suggests that LDM and Daily Metered ("DM") capacity should move with the Customer and that the incoming shipper would be obliged to take it over. This would represent a retrograde step for the shipping community. Shippers should still be allowed to decide the level of exit capacity to be booked for these LDM and DM customers as they are well aware of the implications of capacity breaches. If done at a DM level it could give rise to distortionary impacts and open to abuse.

We firmly believe that shippers to the DM sector should also be allowed retain the ability to manage the end-users capacity requirements on a portfolio basis as this sector is treated as an aggregated pot for capacity breach purposes.

5. Proposal 2 – Removal of ability to buy/transfer within-day exit capacity

Adopting a user pays principle for peak consumption, this proposal is being made to counteract actions being taken by the power generation sector to reduce their fixed costs and force them to increase their primary exit capacity bookings.

The CER accepts that this would reduce the current flexibility in the market. However, it is ironic that the modification that was proposed by Gaslink and approved by the CER in 2008 that allowed within-day capacity bookings is now being opposed by these two organisations.

From a market participant's perspective BGN is getting the CER to sort out its problems and as we noted before, is making sure that, above all, BGN's revenues are protected, regardless of the impact this has on business costs or their competitiveness.

Although the CER is statutorily bound to ensure that BGN can finance the efficient operation of the gas network, it must consider if the underlying model is the most appropriate for the market. The price control process ("PC3") used the exact same methodology as it had used in the previous process. Fundamental flaws have been identified in the methodology and the CER is looking at an amended model based on Long Run Marginal Costs, rather than Indexed Historical

Costs. In our submissions on PC3 we suggested that the process should have been suspended, pending a wider analysis of the current methodology.

The CER notes that it does not want to remove a disproportionate amount of flexibility and therefore is bringing the window for within day capacity bookings and transfers to 0900 on D-1. It should not be overlooked that this proposal will also adversely impact shippers to industrial and commercial LDM end-users. For example an LDM site could still have a large exit capacity breach even though it booked the Transporter recommended capacity level.

The CER could consider introducing a sliding scale of breach penalties for these sites as they now would have no option to mitigate these costs, other than switching off their gas usage at critical points in the day. Unlike gas fired generators who have an obligation to have standby fuel supplies, the vast majority of manufacturers are not in a position to fuel switch. Otherwise, the CER is promoting further gold-plating of the network by encouraging end-users over book their exit capacity requirements.

6. Alternative Options

The CER detailed a number of alternative options in the paper that we support, but it has already arrived at a “minded to” position to reject these without giving industry a chance to respond and possibly improve upon them. All such options should be given an equal opportunity.

- There is little doubt that the focus of this paper is to increase primary capacity bookings, mainly by the power generation sector. The CER recognises that this may be argued on a security of supply basis for that sector. Business users have a very different relationship with BGN. They employ shippers to ship gas on their behalf and these shippers should therefore be treated differently.
- Following on from the last point, the CER argues that if mandated bookings were imposed only on the power generation sector, then large industrial and commercial end-users would be the only sector that had flexibility. This can be overcome if the CER amended the connections policy to ensure that all new connection points must be fully paid for, without any transferability of the exit capacity.
- The CER should recognise that much of the BGN gas network has been fully paid for, but also that the asset is not being used nor will be used as much as anticipated. The logical step in this case

as with any other asset that is underutilised or obsolete is that its value should be written down. The pain of this will be short lived, but it would mean a significant difference to business in terms of reduced transportation costs.

- Introduce short term capacity products at prices lower than the current rates that would only be available to retailer suppliers. This is to recognise that retail suppliers have little chance of ever mitigating exit capacity breach penalties. This would also have the added benefit of reducing any penalty charges.
- Gas shippers with a retail arm are no more than rent collectors for BGN, yet receive no benefit for this service. We believe that these retail shippers should be looked on more favourably. We propose that a) these shippers be financially rewarded for acting in this role as the rent collector and b) that the financial security obligations for these shippers be reduced to 30 days from the current 72 days’ worth of transportation charges. Under the new proposals the market will become even more collateralised and this has consequences in terms of costs for shippers.
- In the past the CER noted that they would not consider a change to the capacity commodity split (90% capacity; 10% commodity) on the basis of tariff volatility. This should now be revisited.

- BGN enjoys unparalleled protection and revenue security. Our submission to the PC3 process noted the CER's commitment to amend the WACC in line with changes to the sovereign credit rating of Ireland. However, it some months since Ireland's rating has been reduced, yet we have not yet seen any evidence of this commitment. A prompter reaction to the adjusted credit rating is vital and clearly necessary.

7. Conclusion

The energy sector in Ireland is at a critical point in its development. We are almost at full de-regulation at a retail level and are moving rapidly towards an integrated market that is going to impact every organisation and every person in some way.

It is crucial that policy makers and implementers of this policy have the competence and confidence to take leadership positions that will drive the right results for Ireland Inc. as we struggle to fight our way back onto a firmer financial footing. The road back to competitiveness is not going to be easy, but the CER can help ensure the business community is not hindered by vested interests that undermine this target.

The Irish Government is committed to pursuing a strategy of increased renewables, with a target of 40% of all generated electricity from these sources by 2020 to comply with the state's overall renewable aims. The CER must inevitably be aware of the unintended, but expected, impacts of this strategy on the wider market. Inevitably, Customers will end up paying for this policy.

The CER plays a unique role in this process. It must present fair and impartial arguments during the consultative process, but also take on board all views of respondents. It must also be mindful of the principles of better regulation, which seem to be lacking in this current consultation. As a basic

example, there has been no regulatory impact assessment, nor has there been any demonstration of the need to maintain regulatory certainty and consistency.

These proposals unashamedly look to protect the states interests in ensuring there is no volatility in BGN's revenue stream. Whilst this paper concentrates on exit capacity costs, representing 60% of gas transmission charges from using UK gas, there is still much work to be completed in resolving the inherent structural changes to entry capacity needed at Moffat. Again, the CER must take leadership of the situation to ensure that entry tariffs do not escalate out of control.

In our view the CER cannot adopt an either / or approach with the two proposals. If it wants to achieve its stated goal of getting additional exit capacity bookings there must be simultaneous adoption of the proposals and this must coincide with the effective date of the decision to restrict exit capacity trading i.e. 1 October 2013. The CER cannot solely adopt proposal 1 as it will not result in firm bookings by the power generation sector. Equally, it cannot adopt proposal 2 on its own; otherwise, it hands an advantage to vertically integrated utilities to the detriment of purely retail suppliers. This is not what the market wants or deserves.

To conclude we believe that CER is looking for an optimum solution, but the rationale for removing exit capacity trading was ahead of time. Hindsight is wonderful, but it would have been better for the long term stability of the market to have kept short term exit capacity bookings on a day-ahead basis. We believe that, if this had happened, the Irish market would still permit exit capacity trading to take place on a more uniform basis.