Future Gas Entry Charging Regime – Initial Modelling Evidence, CER/14/455, 2 September 2014

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By email to Colm O Gormain:

Introduction

1. In this 'consultation' document the CER presents outlines of the modelling of the four cost allocation methodologies (published as separate Excel workbooks) as advised in its Information Note of June 2014 (CER/14/127) and summaries of the initial modelling results. The CER advises that the outputs (tariffs) produced by the models at this point are expected to vary considerably between this paper and the draft decision paper, which it indicates will be published in January 2015. The CER also advises that the goal of this paper is to provide stakeholders with a clear view on the operation of the models, the underlying assumptions and the significance of the relevant inputs in each case.

2. This submission (1) describes the context in which this consultation exercise has emerged and identifies the explicit and implicit government policies which the CER has been compelled to implement, (2) outlines the tactics being pursued and the weapons being deployed by the CER to implement these policies, (3) focuses on how the CER's proposed use of an Entry-Exit gas transmission tariff regime is intended to contribute to the implementation of these policies, (4) demonstrates that none of the variations of Entry-Exit regimes being considered by CER will achieve its objectives and (5) explains why it is futile, at this time, to contest what is being proposed by the CER – even though it is manifestly detrimental to the public interest.

Context

3. The CER refers to its initial decision on the future gas entry tariff regime (CER/12/087), to the judicial review of this decision in the High Court and to the judgement handed down in December 2013 (*Shannon LNG Ltd & anor v Commission for Energy Regulation & ors*, [2013] IEHC 568) which refused relief from the decision on all of the grounds advanced by the applicant.

4. Instead of the five options for changing the gas entry tariff regime which it set out in its initial final decision document, the CER actually had three fundamental options: 1. Estimate and direct Bord Gáis Networks (BGN) to write down the portion of the net asset value of the two Scotland-to-Ireland Interconnectors (IC1 & IC2 – the ICs) that would not, and could not, be recovered due to the reduction in IC flows resulting from supplies at one, and possibly two, new entry point(s); 2. Estimate this portion of the net asset value that would be unrecoverable in entry charges and increase exit tariffs to recover it, ultimately, from final consumers; or 3. Restructure entry tariffs to compel the prospective new suppliers to defray, to the greatest extent possible, the revenue under-recovery on the ICs. These three basic options generate a further four options comprising three pairwise combinations of the initial options and a fourth comprising a combination of all three. And there was a further dimension to the optionality available to the CER in terms of the mixes of the basic options applied in the four combination options and in terms of the transition to a new regime. The accepted international theory and practice applied to deal with 'stranded assets' (or 'stranded costs') of this nature almost invariably rely on a combination of the first two options – a mix of a write-down of the affected assets and the recovery of some of the stranded costs (for a limited period and on a declining basis) via higher tariffs, ultimately, from final consumers. The rationale is that the entry of new supplies or new technologies (or both) will benefit consumers and that incumbents should not be fully protected from the disruptive impacts of the entry of new supplies or

new technologies. This is supported by overwhelming evidence that the entry of disruptive new supplies or new technologies benefits final consumers and that incumbents, driven by a determination to maintain and exploit dominant or monopoly positions that are detrimental to the interests of final consumers, expose themselves unnecessarily to the impacts of the entry of disruptive new supplies or new technologies. Indeed, in some jurisdictions, some 'headroom' is provided to help consolidate the position of new entrants and is generally provided at the expense of the incumbent.

5. However, since it, despite strenuous efforts at maintaining the appearance, was not established and does not function as an independent economic regulator – it is a policy implementation agency of government, the CER has found itself compelled to reject the first two options and to advance the third whose objective is to compel the prospective new suppliers to defray, to the greatest extent possible, the revenue under-recovery on the ICs.

6. At the start of this regulatory process, BGN was almost entirely state-owned and is now fully state-owned. As a result, neither the previous government nor the current government was prepared to countenance any write-down of IC assets. At the same time, the previous government was not, and the current government is not, prepared to countenance any increase in final gas prices to defray any under-recovery of IC revenue. Final gas prices were and are much higher than they should as a direct result of the CER's implementation of a deeply-flawed government policy regarding the financing of investment in state-owned network, utility or infrastructure businesses. Despite being the sole or majority shareholder of these businesses, it is government policy not to invest equity, either directly or indirectly, in these businesses. This blatant dereliction of the state's shareholder responsibility on behalf of all citizens, by default, imposes the responsibility on the economic regulatory bodies which have regulatory responsibility in the sectors where these businesses operate to set charges and tariffs for the services provided by these businesses that extracts additional revenue from final service users and consumers to part-finance the investment that the state should be financing.[1] This is an implicit financing tax and is a more regressive tax (since it falls proportionately more heavily on lower income consumers than on higher ones) than if the part-financing of investment were funded by direct taxation. As a result, prices and charges for services provided by state-owned bodies are far higher than they need be and governments, not surprisingly, are adamantly opposed to any further imposition that could push them even higher. Therefore, it is not surprising that, since the start of this regulatory process at the beginning of 2011, the CER has been wriggling on the hook on which successive governments have impaled it. It finds it has no option but to impose on new and

[1] It is extremely rare for any government or for a government minister to reveal publicly the commitment to this wrong-headed policy in an official document. But, occasionally, a minister is forced out in the open. The Commission for Aviation Regulation (CAR), in its review of the cap it imposes on airport passenger charges, indicated in May 2014 that it was minded to disallow the recovery of some proposed investment by the Dublin Airport Authority (DAA) when it would set the cap on these charges towards the end of 2014. Based on its projections – including disallowing the recovery of this investment - the CAR proposed to set a cap that would decline by 5% in real terms over the five-year control period from 2015. This proposed profile of capped charge allowed excessive revenue recovery by the DAA, but the Minister for Transport felt compelled to issue a policy direction to the CAR to allow the investment and to confirm long-standing government policy to avoid any part-financing by the Exchequer of investment by state-owned businesses. Not surprisingly, the CAR has capitulated, has allowed recovery of the investment initially proposed by the DAA and has set a profile of capped charges higher than its proposed profile. This generates a revenue over-recovery of 18% for the DAA which means that, with a projected increase in passenger numbers, the charge per passenger will be 12.5% higher than it should be. This is the regressive financing tax which will be paid by passengers.

prospective suppliers, by fair means or foul, as much as possible of the responsibility to defray the under-recovery of IC revenue due to the entry of these supplies.

The CER's weapons and tactics

7. It might seem a daunting challenge, but the CER has, at least, four powerful weapons and tactics at its disposal which it has proved adept at deploying and which render any efforts to contest what the CER is proposing totally futile. The deployment of these weapons and tactics is not unique to the CER. These are deployed to some extent or other by all public bodies in Ireland – and, indeed, are deployed, mediated by culture and custom and practice, by all bureaucracies.

An impregnable legislative basis

8. The first weapon is the extent to which the CER has been fully empowered by the Oireachtas to make whatever regulatory determinations it chooses irrespective of how politically-driven or detrimental to the interests of final consumers these might be once it presents publicly the reasoning behind these determinations – however spurious and specious this reasoning might be. The High Court judgement unambiguously confirms this to be the case. And, apart from some observations that betray a fundamental ignorance of the economics and functioning of gas interconnectors and of gas transmission pipelines (presumably intended to be supportive of the CER's case), the judgement affirms both the right of the CER to make the decision it made in June 2012 and the substance of this decision.

9. The CER, not surprisingly, has interpreted the judgement as allowing it to proceed, unhindered, towards a further 'final' decision on the gas entry tariff regime. The judgement does, however, include a caveat: "What defines the boundary between a lawful and an unlawful tariff resulting from those policy choices [on securing a balance between the cost reflectivity principles being applied on an aggregated or individual basis] is whether or not the end result embodies or causes a degree of cross-subsidy or discrimination which is excessive, disproportionate and avoidable. That determination can only be made, in the judgment of the Court, when the terms of the actual methodology have been settled and published and the entry point tariffs have been fixed. It is only then that it will be possible to measure any discrepancies that are caused in the relative treatment of the individual entry points." (Para. 111, [2013] IEHC 568) The insertion of this caveat is a deft legal manoeuvre. It is clear that the Court had no desire to consider contentious arguments about the principles of economic regulation that might, or would, expose the policy and political machinations. It appears that the High Court accepted without question the CER's specious and spurious argumentation about the need to re-align entry tariffs and to impose costs on new suppliers, because a failure to do so would impose unjustified and unnecessary costs on BGN and consumers. The CER was able to wrap itself in a 'public interest' cloak and this was not contested. The reality is that the CER's decisions on the allowed revenues for the electricity and gas networks have been, and are, detrimental to the public interest, but the arguments advanced by Shannon LNG did not raise this crucial issue. However, with the inclusion of this caveat, there is a high probability that another judge will have to make a further judgement sometime after the CER makes its further final decision, currently scheduled for 1 June 2015, and more detailed quantitative information is available.

Delay: the weapon of choice

10. At first sight, it might appear that the CER, when it makes its final, final decision next year, would be averse to any further delay in the implementation of the gas entry regime that might arise as a result of a possible further court challenge. But that is not the case. It actually would allow it to continue to deploy what appears to be its weapon of choice: delay.

11. When the CER acquired formal regulatory responsibility for the gas industry in 2003 it was clear even then that the existing, but only recently established, tariff regime, based on two entry tariffs (one each for Moffat and Inch) and a single postalised exit tariff, would have to be changed to accommodate new indigenous supplies from the Corrib Field. There was, of course, no hurry while the Corrib Gas Field was the only prospective additional source of new gas supplies and the Corrib Consortium wrestled with the local opposition to the establishment and construction of its onshore raw gas supply and processing facilities. Nevertheless, it was recognised that Corrib supplies would reduce flows on the ICs and that the structure of entry tariffs would have to be altered to ensure that BGN fully recovered the excessive revenues allowed by the CER on the ICs. But a policy of 'masterly inactivity' and a view that 'sufficient unto the day is the evil thereof' appear to have determined the CER's approach. There would be ample time to develop some realignment of entry tariffs that would be acceptable to the Corrib Consortium once, finally, a definite date for 'first gas' from Corrib was announced. In any event, it was likely that the upstream economics for the Corrib Consortium would be such that it would not object strenuously to making some contribution via its gas entry tariff to defray the reduction in IC revenue its gas supplies were occasioning. In addition, it was expected that production would be ramped up quickly, reach a plateau for, possibly, six or seven years and then decline rapidly. Viewed from a longer term perspective, the impact might be significant, but it would be of limited duration. In 'due course' – probably the closest Irish political and civil service equivalent to the Spanish 'mañana' – a 'deal' would be done.

12. The decision by Shannon LNG to initiate the process of securing all necessary consents, authorisations and permits to construct an LNG import, storage and regasification facility on the Shannon Estuary in North Kerry and its steady progress in securing most of the necessary consents, authorisations and permits changed the circumstances dramatically not only for the CER, but also for BGÉ and the minister and department responsible for energy. The decision by Shannon LNG and its subsequent progress in developing the project were, of course, welcomed officially, but it was a welcome expressed through gritted teeth. This sort of development was the last thing the CER, BGÉ or the minister or department wanted. This project, if implemented, and coming in addition to Corrib supplies, would cause a major, and sustained, reduction in IC gas flows. It would continue in to the future and there was potential to ramp up the volumes so that it might more than compensate for the depletion of the Corrib Field. The project had to be forced to pay entry tariffs that would be sufficiently high to compensate BGN for the shortfall in IC revenue due to LNG supplies. The CER and all of the other public agencies involved knew that the Corrib Consortium would likely, if reluctantly, pay entry tariffs that would provide some compensation for the reduction in IC revenue its supplies would occasion, but, equally, they knew that the economics of the Shannon LNG project would be unlikely to facilitate an additional payment of this nature. They knew that forcing Shannon LNG to make this payment could actually kill the project – and, indeed, it is highly likely that that was, and is, their principal objective. But the entire effort had to be undertaken in a way that no evidence would be revealed of the malicious intent of the political and public agencies involved. Nobody wanted to be seen wielding the dagger. So, dragging the process out for as long as possible, and progressively diminishing the probability of a successful outcome, were seen as a potentially effective means of wearing down the resolve of Shannon LNG, and of its parent company, and would lead to a decision to abandon the project.

13. Therefore delay was the weapon of choice. That is why the leisurely pace at which the CER is progressing the revision of the gas entry tariff regime is so significant. The CER waited and waited while the project accumulated all of the necessary permits, consents and authorisation it required – with the exception of a decision on the revised gas entry tariff regime – until it was nearing 'Final Investment Decision' (FID). It then, finally, at the

beginning of 2011 issued a document (and launched a consultation) on the regulatory treatment of the gas interconnectors (CER/11/002). This was followed, later in 2011, by a second document (CER/11/112) on the regulatory treatment (and a further consultation). Eventually, at the beginning of 2012, there was a proposed decision document (CER/12/013) which led to the final decision document (CER/12/087). The entire thrust of these documents was to design a tariff regime that would result in Shannon LNG (and the Corrib Consortium) paying entry tariffs that would compensate BGN for reduced IC revenues There was, of course, a limit on how much delay could be used. A new tariffing regime would be required prior to 'first gas' from Corrib, but this date has drifted continuously. The CER was happy to fill the time that the delay in first gas from Corrib made available – or to allow Shannon LNG, futilely, to fill the time when it applied for a judicial review of CER's final decision. Even when the High Court refused Shannon LNG's application to quash the CER's final decision it took the CER almost half a year to outline various tariff regime options in an Information Note (CER/14/127) and then to develop the modelling of these options - which has finally led to this paper and consultation.

14. Even though the CER, almost certainly, will deny it, and is likely to be able to advance numerous, though invariably spurious and specious, reasons for the delay, the intent was, and is, clear. But delay, on its own, was unlikely to be sufficient. The CER and the other public agencies involved required external 'cover'. There is no reason why the CER, relying solely on the powers it has been granted by the Oireachtas, could not unilaterally make the decision on a revised gas entry tariff regime that would compel Shannon LNG and the Corrib Consortium to pay entry tariffs that were sufficiently high to compensate BGN for the reduction in IC revenue, but this would run the risk that its malicious intent (and that of the other public agencies involved) would be revealed.

Securing 'Cover' from the EU

15. As a result, the CER and the other public agencies involved, respectively, are seeking to exploit to the full the provisions of the Gas Directive 2009/73/EC and the Gas Regulation 715/2009 to justify the final, final decision on the gas entry tariff regime it wishes to make and they wish to see made. What the CER is attempting is totally disingenuous, flies in the face of long-established principles of economic regulation, runs counter to the intent and spirit of the Directive and the Regulation and is designed to advance the interests of BGN over those of all others and to the determinant of those of some existing and prospective participants in the Irish gas market. However, what the CER is attempting is legally permissible because the Directive and the Regulation both fly in the face of long-established principles of economic regulation and the economic analysis of gas transmission pipelines, are the result of political compromises that protect various Member State incumbent businesses, seek to harmonise, in so far as it is possible, existing gas Entry-Exit tariff regimes and seek to remove the stranglehold exerted by Gazprom on gas transit pipelines through Eastern Europe. As a result of these underlying deficiencies and of the attempts to balance conflicting policy objectives the Directive and Regulation present another example of a classic EU 'fudge' which is invariably exploited by national governments and their public agencies. Successive Irish Governments and their agencies have proved particularly adept over the years at exploiting fudged pieces of primary or secondary EU legislation of this nature in their own interests and to benefit the special interests to which they pander, but not in the public interest. And so it is in this case. The European Commission is powerless to intervene once some measure of compliance is demonstrated with specific prescriptions or proscriptions in the primary legislation – even if the Commission is well aware of the malicious intent of the CER (and of the Government and its agencies behind it) in this instance. It is this abuse and exploitation of primary EU legislation that contributes to bringing the EU in to public disrepute in many Member States.

16. The ‘options’ presented by the CER in its Information Note and extracted from the Gas Transmission Tariffs Framework Guideline issued by the Agency for the Co-operation of Energy Regulators (ACE) are simply a codification by ACER of existing Entry-Exit regimes with a view to increasing EU-wide harmonisation of these regimes, efficient trade and transfer of gas across and among these regimes and efficient investment in gas infrastructure. It provides a ‘menu’ of options only for those Member States which have not yet implemented an Entry-Exit regime. For those Member States, such as Ireland, with existing Entry-Exit regimes it provides some guidance on modifying these regimes to achieve a measure of harmonisation with neighbouring regimes.

17. However, the EU’s institutions and the Directive and Regulation do not require Ireland to scrap its existing Entry-Exit regime and to develop a new one from scratch. There are no infringement proceedings pending with regard to the current approach. The European Commission is perfectly content with ‘point-to-point’ (P2P) capacity on the interconnectors linking Bacton to Zeebrugge and to Balgzand. The proscription on P2P capacity is directed at situations where owners or operators of pipelines (or parties enforcing exclusive access to gas transmission capacity) exploit and abuse their control over the capacity defined in this way. That situation does not arise in Ireland. BGN operates a totally EU-compliant access regime on its gas transmission network – including on the ICs. Incorporating the ICs in to a new Entry-Exit regime will introduce additional and unnecessary operational and commercial complexities both in terms of normal operations and under possible ‘reverse flows’.

18. None of this is actually required because reversing some of the CER’s decisions on electricity and gas networks that are detrimental to the public interest would resolve the problem that has arisen. For example, BGN’s transmission regulatory asset base (RAB), as decided by the CER, is currently overvalued by €150 million. This has fallen from an overvaluation in excess of €200 million at the end of 2003 when the CER initiated formal regulation of the gas networks. Since then the weighted average cost of capital (WACC) has been set at a rate far in excess of what BGN could justify or requires. BGN has benefitted considerably in the last decade from this overvaluation of the RAB and an unjustifiably elevated WACC.[2] It has more than enough financial capacity to absorb the impact of a phased write-down of the IC assets in line with any future reduction in flows – and without imposing additional unjustified costs on final consumers or on new suppliers. But there is an over-riding policy commitment, supported and demanded by all the special interests who participate and benefit, to preserve and fatten up BGN at the expense of final consumers – and, if necessary, at the expense of new suppliers. The CER and the other public agencies involved are more than happy to draw-out the regulatory process, to abuse the under-scrutinised, unrestrained powers granted to the CER and to exploit and abuse primary EU legislation to achieve these ends – and the Courts are compelled to facilitate this when the cases they hear fail to focus on the fundamental flaws in the application of economic regulation in the energy sector.

Politeness: an insidious, but effective, weapon

19. The ability of those exercising power and influence to use politeness to evade engaging with dissent and critiques of their decisions and to suppress or smother inevitable conflicts between parties affected by their decisions is greatly underestimated. The CER, similarly to most other public agencies, is invariably mild-mannered and even-tempered in its responses to consultation submission and in any engagement it is compelled to pursue publicly with market participants or other interested parties. Those

[2] It is simply unfortunate for Irish citizens, who funded this largesse, that Bord Gáis, in seeking to expand its non-network activities, frittered away the surplus network revenues it had been awarded by the CER on unwise investments and by over-paying for acquisitions. The extent of this frittering away was revealed when the non-network businesses of Bord Gáis were sold.

who express dissent or advance critiques of the CER's decisions or proposed decisions are, almost by default, characterised as being 'rude', difficult or unhelpful. This allows the CER to be profuse in its expression of gratitude for all submissions received and to dismiss or ignore any critiques of its proposed decisions – irrespective of how well-founded these might be on facts, evidence and analysis.

The Current Entry-Exit Regime

20. Despite Entry-Exit being the least appropriate and most inefficient means of setting tariffs for gas transmission capacity, Ireland already has a reasonably functional Entry-Exit regime. It simply needs some modifications to make it fit-for-purpose and to minimise the inherent detrimental impacts of such a regime. There is no objective or valid requirement to consider assessing and choosing from the various options extracted by the CER from ACER's Gas Transmission Tariffs Framework Guideline document.[3] As we have seen above the primary motivation for this wasteful expenditure of time, energy and resources is the policy and regulatory desire to continue awarding BGN unjustified and excessive network revenues (ultimately at the expense of final consumers) and to ensure that unjustified additional revenue will be extracted from prospective gas suppliers to supplement and maintain the award of these excessive revenues to BGN.

21. The current regime has features that differentiate it from Entry-Exit systems in other member-states and that provide a basis for dealing with multiple entry points. The following figure provides an appropriate point of departure to examine these features.

[3] The EU's institutions and all of the key 'stakeholders' are resolved to apply gas Entry-Exit regimes throughout the EU and determinedly and stubbornly refuse to take account of the compelling evidence from the US gas market that demonstrates what a costly folly Entry-Exit is. In the US, the determination of revenue recovery and tariffs for transmission pipelines has been separated from the pricing of transmission capacity which is discovered in deep and liquid markets for pipeline capacity. A former NERA consultant has succinctly highlighted the flaws (and attractions to key EU stakeholders) of an Entry-Exit approach: "Adoption of an "entry-exit" definition of capacity would be particularly destructive to competition, since it breaks the link between capacity contracts (property rights) and actual pipeline assets. An entry-exit regime blocks competitive entry, entrenches the position of incumbent pipeline operators, and creates a need for more regulation and more complex regulatory rules." http://www.nera.com/nera-files/NL_ERI_EN454_Issue_36_Final.pdf
Needless to say, these views reflect those of the author and not necessarily those of NERA.

Figure 1: CEPA's Stylised Representation of the Gas Network (for the Virtual Point Approach)

Source: CER14455a Gas Entry Regime model for website

A Single, Large Exit Zone

22. The 'ring-main' system (defined by nodes 2 to 6) in the figure, with laterals supplying demand locations, comprises the exit-related gas transmission facilities. The policy decision to apply a postalised tariff to all offtakes from this system reinforces the rationale for treating all of these exit-related facilities (and the associated off-takes) as a single, large exit zone. In addition, it is not possible to define and quantify precisely the capacity used between any two points along this 'ring-main'. Externalities will always arise because the use of capacity by one shipper or trader will impact on the use of capacity by other shippers and traders. The facilities in this single, large exit zone may not provide precisely the same transmission services to all connected off-take points, but it is not possible to define, quantify and price the services that are provided to deliver gas at each off-take point. This further justifies the definition of a single, large exit zone. And this provides the basis for the current charging mechanism which applies a two-part, postalised, 'Transmission Onshore' tariff and two separate, two-part 'Entry' tariffs for transportation, respectively, from Inch and, via the ICs, from Moffat to the 'ring-main' system. The tariffs are derived from projections of the fixed and variable costs of these three separate sets of facilities.

Clearly Defined and Quantifiable Entry Capacity

23. However, in contrast to the single, large exit zone, the transmission capacity between the entry points and the delivery points on the 'ring-main' system may be defined and quantified. Externalities, almost by definition, do not arise. The use of capacity on the ICs is governed by a non-discriminatory, EU-compliant regime. There may be dominant, even exclusive, use of the capacity from the other existing entry point at Inch and, prospectively, from the Corrib and Shannon LNG entry points to the 'ring-main' system.[4]

[4] It is understood that Shannon LNG intends to construct and operate the transmission capacity connecting its proposed plant to the 'ring-main' system. But it has not been awarded, nor has it sought, an exemption from Third Party Access (TPA) to this pipeline. It is also understood that there is an arrangement between the Corrib Consortium and BGN to remunerate the

But there is no restriction on other suppliers accessing any capacity surplus to the requirements of the initial users. Nor is there any restriction on other suppliers contracting with BGN (or other parties) to expand capacity from these entry points. This demonstrates that the proscription in Regulation 715/2009 on P2P capacity has no basis, relevance or applicability in this instance.

The Nature of the Scotland-Ireland Interconnectors

24. Although the ICs are described as 'interconnectors' they do not operate, either commercially or economically, as would an interconnector between two markets each with deep and liquid trading of gas and transparent and continuous price discovery. For an interconnector of this nature, and in the absence of congestion, its fixed costs would be internalised in the traded prices in each of the two markets and the differential between the prices in each market would converge on the short-run costs of increasing or decreasing flows on the interconnector between the two markets. Gas shippers and traders would reserve and pay for the capacity on the interconnector, thereby ensuring recovery of the fixed costs of the interconnector, and pay the short-run costs of increasing or decreasing flows on the interconnector to capture any arbitrage between the traded prices in the two markets.

25. Such an outcome is unlikely to arise for the Scotland-Ireland ICs and is almost certain not to arise in the foreseeable future. While the UK NBP is the most deep and liquid traded market in North West Europe (NWE), there is limited trading at the Irish NBP. The commercial and economic incentives for traders and shippers operating in both Ireland and Britain to reserve and pay for IC capacity simply do not exist. There is unlikely to be sufficient depth and liquidity in the Irish traded market to permit transparent and continuous price discovery and, as a result, genuine arbitrage opportunities will not arise. Therefore, there is no real prospect of the fixed costs of the ICs being internalised in the traded prices in both markets.

Gas Pricing and Trading

26. As a result, the price of gas delivered on to the Irish onshore transmission system is, and will be, equal to the UK NBP price plus the unit cost of IC transmission. There is no requirement to modify the existing application of the Entry-Exit regime to define some sort of virtual hub (similar to the UK NBP) within this single, large exit zone where trading will take place to permit transparent and continuous price discovery. Trading will take place around and across this single, large exit zone if it is in the interests of shippers, traders and suppliers to do so. But, for the foreseeable future, there is no prospect of sufficient depth and liquidity of trading emerging to permit transparent and continuous price discovery. Market participants will trade around the price of gas via the ICs delivered to the 'ring-main' system – and this is the NBP price plus the unit cost of IC transmission. The only possible valid rationale for considering the application of one of the Entry-Exit tariffing options set out by ACER in its Framework Guideline (and even this is extremely dubious on a number of grounds) is when there is a requirement to set tariffs for the virtual capacity in to and out of a virtual hub at which there is a potential for

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latter for constructing the pipeline between the former's gas processing plant site at Bellanaboy in Co. Mayo and the 'ring-main' system near Galway. The continuing delay in first gas from Corrib allowed this pipeline to be gassed up by BGN and used to supply demand locations along its route. It is further understood that when Corrib gas comes on stream the Corrib Consortium intends to sell its production at the outlet of its processing plant (in effect, the inlet to this pipeline) and that buyers of gas at the inlet will reserve and pay for the capacity on the pipeline (in effect an entry tariff) to deliver their gas to the 'ring-main' system. Finally, it appears there will be some arrangement for BGN to use some of the revenue from this entry tariff to defray some of the remuneration of the construction costs being provided to BGN by the Corrib Consortium – to avoid double recovery of the costs by BGN.

transparent and continuous discovery of the gas price. That requirement, quite simply, does not arise in this case and there is, therefore, no requirement to consider these options.

The CER's attempts to achieve its primary objective

27. The CER is determined (and, presumably, feels compelled) to implement the flawed policy decision to ensure full recovery of the currently awarded IC transmission revenue and, therefore, if IC flows fall due to the entry of new supplies then the unit cost – and the delivered price of gas - will increase. From the particular perspective of the CER (and BGN, the minister, the energy department and all other public agencies with an interest), additional supplies of gas at new entry points are a 'problem' because they will reduce IC flows, increase unit costs (if full IC revenue recovery is maintained) and increase the price of delivered gas – and, ultimately, final gas prices. And, in the absence of modifications to the tariff regime, these new suppliers will capture unearned profits (in other words, economic rents) from the increased delivered price. In other jurisdictions additional supplies of gas at new entry points may pose a challenge because they reveal stranded costs, but, as noted above, the benefits in terms of competition in supply and of security of supply are generally recognised and mechanisms are developed and applied to address the challenge posed by the revelation of stranded costs.

An Irish Solution to an Irish Problem

28. In Ireland, in contrast, the official reaction is either to penalise the suppliers who are causing this 'problem' or, if possible, to force the prospective suppliers to abandon their projects. This is accompanied by a reflexive reaction to shut-out any possibility of considering the mechanisms established in economic theory and developed and applied in other jurisdictions that could be considered in these circumstances. The irony is that an enormous amount of time, effort and resource has been, and is being, expended in seeking to exclude the consideration of feasible alternative solutions and to validate the 'solution' preferred by the various influential special interests involved. In this instance the preferred solution is to impose additional unjustified costs on the prospective suppliers, with a hope and expectation that the LNG import project will be abandoned, and that the incidence of stranded costs will be minimised.

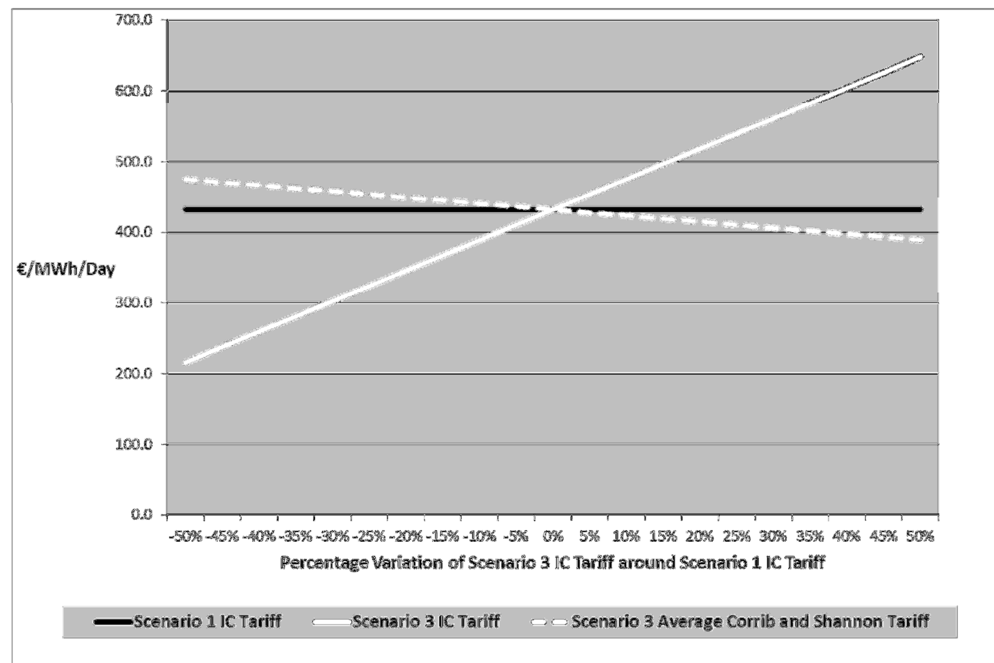
The Futility of the CER's Approach

29. By examining some of the data in CER/14/455a (Gas Entry Regime model for website) it is possible to gain some insight in to the trick the CER is trying to pull off. In the model, the CER assumes a total transmission revenue recovery requirement of €200 million a year, split equally between entry and exit. This is somewhat higher that the €187 million set for the gas year from 1 October 2014, but, since the CER indicates that it is publishing this model to illustrate the application of the various Entry-Exit models set out by ACER in its Framework Guideline, it should not impact significantly on the assessment here. The 50:50 entry split is presumably driven by ACER's expressed preference, but it will increase the average entry tariff, since, currently, approximately two-thirds of the revenue is generated by the postalised onshore transmission (exit) tariff.

30. The CER's modelling distinguishes between average peak day flows and a proxy capacity demand. Peak day flows are used in the analysis of the matrix options and are also used here. The matrix analysis is presented for four scenarios. Two are of interest here: Scenario 1 with entry at Moffat and Inch (reflecting the current situation) and Scenario 3 with entry, in addition, for Shannon LNG and Corrib gas. To simplify the analysis the Isle of Man off-take is excluded and inputs at Inch are allocated pro rata among the other entry points. In Scenario 1 this reduces the peak day input of GWh 237.7 to GWh 231.5 which is allocated totally to the ICs for Scenario 1 and matches total

exit flows. In Scenario 3 this reduced entry total of GWh 231.5 is allocated between the ICs (GWh 38.5) and combined inputs for Corrib and Shannon LNG (GWh 193). IC input falls from 100% in Scenario 1 to 16.6% in Scenario 3. In this simplified calculation the entry tariff in Scenario 1 is €431.9/MWh (for peak day flow related capacity). Irrespective of the method used the CER would much prefer to have the IC entry tariff in Scenario 3 considerably below the average tariff for Corrib and Shannon LNG. The following figure presents the relationship between the Scenario 1 IC Tariff and the Scenario 3 IC and average Corrib and Shannon LNG Tariffs.

Figure 2: Scenario 1 IC Tariff and Scenario 3 IC Tariff and Average Corrib and Shannon LNG Tariffs



31. Under the simplifying assumptions of excluding the Isle of Man off-take and allocating Inch inputs pro-rata among the other entry points both the Scenario 1 IC Tariff and the Scenario 3 Tariffs, when applied to the respective average peak day flows, generate the assumed entry-related revenue of €100 million. Obviously, the CER wants the Scenario 3 tariffs to be as close to the left as possible in this figure. This would minimise the IC Tariff and maximise the contribution to entry-related revenue from Corrib and Shannon LNG. It most certainly doesn't want the Scenario 3 tariffs to be to the right of the point of intersection. Corrib and Shannon LNG would capture an economic rent from the gap between the IC Tariff and the Average Corrib and Shannon LNG Tariff.

32. In its modelling analysis the CER focuses on three of the methods proposed by ACER – the Capacity Weighted Distance Approach (CWDA), the Virtual Point Approach and the Matrix Approach – in the vain hope of generating a Scenario 3 IC Tariff that would be less than the Scenario 3 Average Tariff for Corrib and Shannon LNG. It fails. It then goes a step further by applying a Variant A of the Virtual Point Approach and the Matrix Approach with Project Costs. It fails again. In all cases, the Scenario 3 IC Tariff is higher than the Scenario 3 Average Tariff for Corrib and Shannon LNG.

33. This is not, and should not be, surprising. Irrespective of the extent to which it attempts to manipulate these methods and to apply variations of historic costs, forward-looking costs or project costs or of average peak day flows or projected capacity bookings, the CER is locked in by the Scenario 3 physical configuration of the network, by the projected use of the network under Scenario 3 and its determination to recover the

assumed €100 million revenue in entry tariffs. It is simply not possible for the CER to use these models to generate a Scenario 3 IC Tariff that is less than the Scenario 3 Average Corrib and Shannon LNG Tariff. Therefore, it is not surprising that the CER states clearly that the outputs (tariffs) produced by the models at this point are expected to vary considerably between this paper and the draft decision paper. And, therefore, as a result, it would be totally futile to even attempt to respond to the 23 questions set out by the CER.

Another Rabbit Pulled from the Hat?

34. The CER will have to try and pull another trick to achieve its objective. And there can be no doubt that, given its past form, it will attempt to do so. It could, for example, be an additional IC security of supply premium that would be imposed on the other entry points. There are numerous possibilities. One should not underestimate the ingenuity of the CER in these circumstances. In any event, irrespective of whatever trick it decides to pull, it appears to be fully confident that it has the necessary statutory powers to ensure its implementation. And it is almost certain to get away with this unless and until the political cost of compelling it to abuse its statutory powers in this manner becomes excessive.

A Feasible and Efficient Solution

35. There is, of course, a perfectly feasible and efficient solution, but none of the parties involved are either willing or able to advance it. The core of the problem is the regulatory overvaluation of BGN's network assets (highlighted in Para. 18 above). As per the latest gas transmission and distribution tariff calculation models (CER/14/140b and CER/14/139b) published by the CER, it is possible to estimate that the current total overvaluation of the RABs is €323 million.[5] In addition, the cost of capital applied by the CER is excessive. Although it has reduced the real pre-tax Weighted Average Cost of Capital (WACC) from a 'crisis-related' 6.39% in the first year of the current price control period to 5.2%, the CER's implied estimate of the real risk-free rate and resulting cost of debt is excessive when it is related to a (nominal) yield of 1.63% on 10-year Irish Government bonds[6] and the current borrowing costs of Ervia and the ESB. In addition, the convenient assumption of a zero debt beta is made, but this flies in the face of the underlying financial theory of the cost of capital and real world evidence and inflates the cost of capital. Furthermore, the application of capital allowances and other legitimate means to reduce or defer tax liabilities will keep the effective rate of tax below the marginal rate. Using the marginal rate inflates the cost of equity and the cost of capital. An alternative calculation, employing a more appropriate technique and more realistic estimates of key variables and parameters, suggests that the real cost of capital is likely to be between 3 and 3.5%.

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[5] In 2003 the CER estimated the gas transmission and distribution RABs as if they had been valued on an Indexed Historic Cost basis prior to this date. However, the assets had been valued and depreciated in the books of Bord Gáis on a Historic Cost basis. The effect was to generate a significant increase in the value of the RABs compared to the depreciated value at that date in the books of Bord Gáis and allowed the CER to award BGN network revenues much higher than those to which they were entitled. The CER had previously applied the same magic to the ESB's network RABs. The CER, of course, was perfectly entitled to apply Indexed Historic Cost valuation to the electricity and gas network RABs on a forward-looking basis from 2000 and 2003, respectively, but it was totally inappropriate – and imposes unjustified and excessive costs on network users which are passed through to final consumers – to apply Indexed Historic cost valuation retroactively to all network assets as if they had been valued on that basis since their acquisition.

[6] http://www.ntma.ie/news/ireland-sells-e1000-million-of-its-10-year-bond-by-auction-2/

36. The IC Tariff set by the CER from 1 October 2014 is €357/MWh/day when expressed on a 100% capacity basis. Reducing the IC RAB by the estimated overvaluation of all network assets of €323 million and applying an appropriate WACC would reduce the IC Tariff to €236/MWh/day. If the CER were so minded it could work towards ensuring that the IC tariff would be at, or around, this level, in real terms, at the start of the next price control period and that arrangements would be in place in the subsequent price control to ensure that there would be a phased write-down or moth-balling of IC assets to ensure that this IC tariff is maintained in real terms. The tariffs at all other points would be based on the recovery of costs imposed on BGN to deliver gas from these entry points to the 'ring-main' system.

37. Reducing the IC tariff in this way would automatically reduce the 'cost-plus' element in the delivered price of gas on the 'ring-main' system and would reduce the ability of prospective suppliers to capture economic rents. All of this would be in the interests of final consumers. For far too long BGN has been able to extract surplus revenues from final consumers. The self-serving, frequently-raised concerns about its financeability are totally bogus. Its financeability should be assessed in the context of its 100% state ownership, the failure of the state to discharge properly its shareholder responsibilities, the surplus revenues it is being awarded, its *de facto* monopoly position in the provision of gas transmission and distribution services and the almost cast-iron assurance that the vast majority of final gas consumers will pay indefinitely for the full cost of gas supply services. This is a low risk asset class and even if these assets were in private sector ownership the cost of capital would be lower than the CER determines. It should be lower again due to state ownership and it is ironic that it is government failure to part-finance investment that is increasing the perception of risk by providers of debt finance.

38. But nothing like this proposed phased and proportionate write-down of these stranded costs will be contemplated unless or until the political cost of compelling the CER to abuse its statutory powers to keep the management, staff and unions of Ervia (and those of the ESB) in the style to which they have becomes accustomed and to protect government from the implications of its determination to renege on its shareholder responsibility to part-finance semi-state investment will become unbearable by whoever is in government.

Conclusion

39. It is the CER and Ireland, and not the EU's institutions, which are seeking to enforce a proscription on P2P capacity and to develop a new Entry-Exit regime in Ireland which abstracts even more from the underlying physical reality of the gas transmission pipeline system. The ostensible reason is to ensure full compliance with the Directive and Regulation, but everyone involved – even if most of them are constrained from revealing it publicly – knows that the real intent is to allow BGN to continue to extract revenue unjustifiably from final consumers and to extract additional revenue unjustifiably from the Corrib Consortium and, potentially, from Shannon LNG. The preference, though, is to force an abandonment of the LNG project. Such is the reality of 'independent' economic regulation in the energy sector in Ireland. BGN is also extracting additional revenue unjustifiably from final gas consumers via a corresponding regulatory overvaluation of the gas distribution assets and final electricity consumers are being ripped off in a similar manner.

40. This won't change until enough citizens inform themselves about how they are being ripped off by powerful and influential special interests and elect public representatives who will enact the necessary changes in law and policy. But the chances of this happening are vanishingly slim. The huge and complex edifice of energy policy and regulation that has been constructed since the late 1990s is virtually impenetrable to ordinary citizens – and it is designed to be so. Those with the necessary knowledge and

competence in the sector who understand the nature of the rip-off that is being perpetrated and who would be in a position to inform the public are compromised, conflicted or constrained in some way. It would be a very brave employee of any of the public agencies involved or of any of the firms participating in the market (or advising these agencies and market participants) who would blow the whistle. The media either lack resources to conduct the required investigation and reporting or appear too lazy to make the effort to inform their viewers, listeners or readers – or corporate interests or concerns about advertising revenues dictate editorial stances.

41. More and more ordinary citizens know they are being ripped-off – not only in the provision of energy services, but also in the provision of services by the sheltered private, other semi-state and public sectors, but they can't figure out precisely how or by whom. They know that the representatives of the mainstream political parties - and the representatives of the public agencies these parties appoint – are spinning webs of lies, half-truths and fictions, but they find themselves entangled in these webs. This fuels a growing sense of disgust and anger among voters and all of the indications are that it will lead many of them to reject representatives of the mainstream parties – all of whom are complicit in these rip-offs. But, unfortunately, the alternative prospective public representatives display even less of a capability to govern in the public interest.