



## Common Arrangements for Gas

### Draft Conclusions on Transmission Tariff Harmonisation in Ireland and Northern Ireland

17th October 2008



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**Annex 1. CER Position on Regulatory Treatment of IC2 Investment Costs.**

## Executive Summary

On 27<sup>th</sup> June 2008 the Commission for Energy Regulation (CER) and the Northern Ireland Authority for Utility Regulation (NIAUR) (the Regulatory Authorities - RAs) published a Consultation Paper entitled Transmission Tariff Methodology and Regulation in Ireland and Northern Ireland<sup>1</sup>. That paper set out current tariff regimes in Ireland and Northern Ireland and also options for harmonising the two regimes. The paper also dealt with the effect of declining interconnector utilisation on transmission tariffs, one of the drivers for change in Ireland.

There were 15 responses received to the consultation which are published with this paper (with the exception of one confidential response). The responses were generally positive towards the development of common gas arrangements in the two jurisdictions. Following consideration of the responses and further analysis, the RAs are now putting forward a number of draft conclusions. The draft conclusions presented in this paper will require detailed discussions with respective government departments with regard to their implementation and legislative impact.

On the overall tariff structure our initial preference is to implement an Entry Exit regime. This would see a move away from the postalised regime in Northern Ireland. We believe that Entry Exit is a more suitable regime than postalisation for common arrangements. This is mainly due to the resulting increase in transmission tariffs in Northern Ireland from postalisation (and the difficulty in implementing a revenue transfer with a single tariff) and also due to the impact that full postalisation could have on future investment in the market. Our initial conclusion is that the limitations of postalisation are such that it does not optimally satisfy the set criteria in comparison to other options. Furthermore, Entry Exit will meet a legal requirement if the proposed EU Third Package comes into effect.

In relation to the specific asset configuration we have not yet formed a definite opinion on the appropriate configuration for Entry. At this stage we feel that the most suitable solution is to either combine the Moffat interconnectors (while leaving all other entry points separate) or keep the ICs and SNIP separate (while leaving all other Entry points separate). We do not believe that a single Entry point is a suitable solution due to the potential impacts on investment. For Exit we are minded to implement two separate Exit tariffs as it allows for inter-jurisdictional

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<sup>1</sup> CER/08/107

revenue transfer if needed to address any negative implications of the common arrangements and will also allow the two jurisdictions to develop local infrastructure separately.

On the wider issue of the mitigation of the effect of lower IC utilisation we have further considered the need for mitigation under different scenarios. Fundamentally the implementation of an Entry Exit regime will set the underwritten BGN IC as the marginal Entry point of gas. Such a position needs to be addressed in times of low utilisation and therefore the treatment of IC mitigation is a key consideration in this process. As part of the consultation there were a number of proposals put forward by respondents. These include: the reprofiling of revenues over the remaining life of the pipeline; shifting investment costs onshore and pricing the IC based on the Long Run Marginal Cost (LRMC); and introducing a Public Service Order (PSO). We have carried out some initial assessment on the proposals and are yet to reach a firm view on whether they would provide an appropriate mitigation mechanism. The options are under active consideration.

Since the consultation the CER has examined further the case for stranding the IC investment costs as a means of mitigating the effects of lower utilisation and has concluded that such a course would not be acceptable. The reasoning is set out in Annex 1 to this paper.

Further to this, the transporters are currently carrying out modelling of the single gas system with initial results due in late October. The modelling output may have significant impact on this workstream, especially due to the potential links between the combining of the Moffat interconnectors and the achievement of operational savings. Also, there are security of supply aspects that may be important which will be examined further in other workstreams. This could also have an impact on the future IC bookings. In light of this we propose to examine the modelling results before offering any preferred solution but for the avoidance of doubt:

- The extreme “do nothing” scenario mentioned in the Consultation Paper is not an option the RAs would consider or allow to occur
- The aim is to design a suitably robust tariff regime at this time that can at least handle short term troughs in IC utilisation without being overly interventionist
- The RAs will intervene to make some adjustment to the manner in which the IC revenues are recovered if we believe the utilisation will fall below a level that would have a significant detrimental effect on the market

- Any intervention in the treatment of the ICs will involve a solution where BGN will recover their required revenues from the market and so stranding will not be considered as an option (see section 6.2).

Following consultation and an examination of modelling analysis we will undertake a further detailed analysis of the options.

## **1. Background**

This paper forms part of the consultation process on transmission tariffs started in May 2008 under the Common Arrangements for Gas (CAG) Tariff workstream. The purpose of this document is to set out the RAs' Draft Conclusions in relation to transmission tariffs in Ireland and Northern Ireland. On 26<sup>th</sup> June 2008 the RAs published a Consultation Paper<sup>2</sup> ("The Consultation Paper") entitled "Transmission Tariff Methodology and Regulation in Ireland and Northern Ireland". This paper examined the options available for the development of harmonised transmission tariffs in Ireland and Northern Ireland. The paper detailed the existing transmission systems and tariff structures in each jurisdiction, set out the main issues and examined the harmonisation options available. The paper also set out the proposed criteria by which the various harmonisation options should be assessed. Finally, the paper also dealt with issues arising from the effect of the expected decline in utilisation of the IC on the marginal source of gas pricing system under an Entry Exit regime. A tariff model<sup>3</sup> to complement the paper was also published. During the consultation period a workshop was held in the offices of the Utility Regulator in Belfast to discuss the Consultation Paper.

### **1.1. Structure of this paper**

The remainder of this document is set out as follows:

Section 2: Summary of Draft Conclusions

Section 3: Assessment Criteria

Section 4: Tariff Design Assessment

Section 5: Specific Asset Configuration

Section 6: Mitigating the effect of low IC utilisation

Section 7: Responses to Consultation

Section 8: Next Steps.

### **1.2. Common Arrangements for Gas**

On 14<sup>th</sup> February 2008 the RAs signed a Memorandum of Understanding (MoU) which sets out a vision for Common Arrangements for Gas (CAG) in Ireland and Northern Ireland. The latest

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<sup>2</sup> CER/08/107

<sup>3</sup> CER/08/132

work plan<sup>4</sup> showing the development of the CAG project is available on the CER and the Utility Regulator websites.

The development of CAG follows the establishment of the Single Electricity Market (SEM) which became operational on 1st November 2007. The SEM is the first cross-jurisdictional electricity market of its kind in Europe and represents a new culture of cooperation in the energy field.

The development of CAG also fits in with current aspirations at the European Union level. The European Commission has put in place a legislative framework within which all member states are working to achieve a Single Gas Market. This Single European Market is designed to bring benefits to all European citizens and contribute to Europe's competitiveness. Both Ireland and Northern Ireland are committed to the development of a Single European Gas Market and the development of CAG demonstrates this and acts as an example for other member states.

### **1.3. Reform of Transmission Tariffs**

The desire to reform transmission tariffs is reflected in the MoU signed between the Regulatory Authorities in February 2008<sup>5</sup>. Within the MoU there is also a strong statement about the objectives for this harmonisation:

“...to establish All-Island Common Arrangements for Gas whereby all stakeholders can buy, sell, transport, operate, develop and plan the natural gas market north and south of the border effectively on an all-island basis. This means that variations in the price and conditions on which gas is bought and sold will be determined by market conditions and economics, not by variations in regulatory arrangements.”

Four main reasons can be considered:

- common incentives within an integrated network – with the gas system becoming more integrated, through the South-North pipeline, it is important to consider the implications of different tariff methodologies in each of the jurisdictions (e.g. the distortional effect they may have on the SEM);
- reliance on flows from Ireland – linked to the above point is the fact that Northern Ireland is likely to become increasingly dependent on flows of gas from Ireland through the South-North pipeline as SNIP becomes fully utilised;

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<sup>4</sup> CER/08/171

<sup>5</sup> CER/08/055



- competition – create a larger market which is able to attract more players and which has the critical mass for competition to extend to more consumers; and
- attract investment to enhance security and diversity of supply – as with the above point, a larger market should be more attractive to investors and this should allow greater security and diversity of supply to be achieved.

All of these factors create practical pressure for reform and harmonisation of tariff methodologies.

Further, as mentioned above and discussed in the Consultation Paper, pressure for reform has been growing in Ireland owing to the impact that new indigenous gas developments like Corrib and the proposed Shannon LNG terminal have on tariffs for all users of the gas system. In Northern Ireland there is also increasing interest in the development of storage, with significant survey work already underway for a potential site at Larne. This may be partly dependent on the final transmission tariff methodology chosen.

As part of CAG, an indicative Cost Benefit Analysis<sup>6</sup> (CBA) was developed which sets out the benefits associated with the introduction of the new common arrangements. The CBA is envisaged as an ongoing document and will be updated over time to reflect different stages in the project.

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<sup>6</sup> CER/08/138

#### 1.4. Request for further comment

The RAs invite comment from interested parties on all aspects of this Draft Conclusion Paper. In particular comments are welcome on certain aspects of the paper which are listed in Section 8.1. It is requested that comments are received by close of business on **14<sup>th</sup> November 2008**. The RAs intend to publish all comments received – those respondents wishing for certain sections of their submission to remain confidential should submit the relevant sections in an appendix marked confidential.

Comments on this paper should be sent, preferably in electronic format, to:

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## **2. Summary of Draft Conclusions**

### **2.1. Preferred Tariff Regime**

The RAs propose that an Entry Exit regime is implemented in Ireland and Northern Ireland. This proposal has the following advantages (in no particular order);

- Least market impact
- Alignment to Europe
- Provides signals for new investment
- Ease of Implementation; and
- Allows a route for revenue transfer

The rationale for this preference is presented in Section 4 of this paper where the Entry Exit and Postalisation methodologies are objectively assessed by considering the advantages and disadvantages of each option and by comparing them to the proposed criteria. The majority of respondents to the Consultation Paper are in favour of an Entry Exit tariff methodology.

### **2.2. Proposed Asset Configuration**

The RAs have not yet formed a firm view of the final asset configuration. For Exit we are minded towards two separate Exit tariffs for inter jurisdictional revenue transfer and connection policy issues. At the Entry we propose to either combine the Moffat interconnectors (SNIP and the ICs) leaving all other separate or have SNIP and the ICs separate while keeping all other Entry points separate. A discussion of the issues around this is provided in Section 5. Further comment is welcomed from participants on the preferred configuration.

### **3. Assessment Criteria**

In the Consultation Paper the RAs put forward a number of proposed criteria against which any new tariff regime should be assessed. The criteria proposed were informed by statutory and Better Regulation considerations and also by practical aspects. In the Consultation Paper we sought comment on the proposed criteria and suggestions for alternative/further ones. A number of respondents commented on our proposals and put forward alternatives. The specific comments received and RA's responses are addressed in Section 7. Following further analysis of our proposed criteria and on consideration of responses received we have made some amendments to the assessment criteria. The revised criteria, against which we assess the proposals, are set out below.

The proposed criteria are;

- Developing the Industry
- Protecting Consumers
- Security of Supply
- Transparent and Practical Regime

#### **3.1. Developing the Industry**

Both RAs see an important role for developing a viable gas industry in their respective jurisdictions. Explicitly the principal objective of the Utility Regulator is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland. It is more implicit in Ireland where geographic postalisation within the onshore transmission Exit tariff ensures that there is no undue discrimination between different parts of the country. Following the consultation it was recognised that this criterion needed to be clarified further as the title could have differing implications for different industry participants. Ideally, the tariff regime should seek a balance between development on the demand and the supply sides. For instance, a tariff regime that greatly encourages the extension of the network could potentially result in inappropriately high tariffs for all customers. At the same time, a tariff that over incentivises exploration may not be appropriate either. We remain of the view that developing the industry is an appropriate criterion but recognise that a balance must be struck when applying it. Finally, the new tariff regime should ideally facilitate competition within the market. This was previously a stand alone criterion but it was felt that the promotion of competition is inherent in the development of the industry and also in the protection of

consumers and so was adequately covered elsewhere. The MoU clearly states that an objective of the RAs is to ensure that gas is bought and sold in competitive markets at the wholesale and retail levels and to encourage a “single market” approach.

### **3.2. Protecting Consumers**

Many respondents supported the protection of consumers criterion in the development of any new tariff regime. As stated in the Consultation Paper, ensuring that prices are as low and stable as possible, while ensuring the long-term viability of the industry, is key to protecting consumers. This is linked to the promotion of competition and the benefits it should bring to customers. This is set against the principle of cost recovery since without cost recovery the consumer may in time, be exposed to a volatile uncertain market in the future. The reduction of price volatility is another important aspect of the protection of consumers. Short to medium term tariff volatility can have some negative impact on consumers and the chosen tariff regime should be mindful of this.

### **3.3. Security of Supply**

The security of gas supply in Ireland, Northern Ireland and indeed the Isle of Man is a key consideration for the RAs. The tariff regime developed now should recognise the importance of security (and diversity) and should provide appropriate incentives for new developers and producers. This is very important as without sufficient security of supply there would be great uncertainty and volatility in the market and gas users may look to source alternative fuels. This would be to the detriment of the gas industry as a whole. A reasonable balance between the benefits of security of supply and the price that consumers pay for such security should be sought. For example, the tariff regime in place should not have a significant impact on a new field developer’s decision on whether to develop a new field. In reality it is likely that the taxation regime in the country would be of more importance. We do however; recognise that this may not be the case for storage and LNG. The tariff regime developed from this consultation process should, as a minimum, not unduly disadvantage new gas developments.

### **3.4. Transparent and Practical Regime**

Finally, the tariff regime implemented should be as transparent and practical as possible. Although a new criterion, the criteria proposed in the Consultation Paper mentioned these practical aspects. The regime should not be overly complex for users of the system. Essentially this means that the tariffs paid by shippers should be transparent and easy to calculate and

understand. This is supported at the European Union level where the general consensus is that tariffs should be straight forward and transparent. Another related aspect of this is the ease of implementation of the new regime. Both jurisdictions employ different tariff structures at present so any solution will cause one jurisdiction to move away from the current one. Ease of implementation is one consideration in the criteria. However the degree of difficulty should not deter from selecting the optimal solution.

## 4. Tariff Design Assessment

In this section we assess some of the tariff options put forward in the Consultation Paper. The assessment gives the advantages and disadvantages of the options and the initial conclusions. The tariff options considered are further assessed against the set criteria.

### 4.1. Postalisation

Northern Ireland currently employs a postalised transmission tariff regime. The regime has been in place since 2004. The success of the regime has been assisted by the fact that until recently Northern Ireland had only one Entry point namely the SNIP. The South North (SN) pipeline was constructed and commissioned recently and now provides a second Entry point (through the interconnector or other Entry points in the South as new sources of production become available). The South North pipeline provides gas to a number of regional towns but will not be flowing any considerable volumes to Northern Ireland until SNIP is full (around 2011).

The implementation of a fully postalised tariff would involve creating a revenue pot with the required revenues from all asset owners (NI Exit, ROI Exit, SNIP, IC1&2, Inch Entry assets, Corrib Entry assets and potentially other new Entry assets). This combined required revenue would then be divided by the total projected flows and capacity bookings to create a single tariff.

Table 1 below examines postalisation against the assessment criteria.

Criteria	Assessment	Comment
Development of the gas industry	Mixed	<p>Postalisation has different impacts on different areas within the industry. For example, postalisation would result in an average pricing mechanism where the different costs of each Entry and Exit points are averaged out to form a single tariff. This has the effect of averaging out the costs of the different Entry and Exit points and giving a single price which in some cases will be above and in other cases lower than the separate multiple Entry and Exit tariffs.</p> <p>Additionally, implementation of full postalisation would significantly mute the investment signals inherent in prices and so would not satisfy this criterion. For example, should the different jurisdictions have different investment needs this would not be reflected in prices due to the averaging effect.</p> <p>On the demand side it is unclear what the impact of postalisation would be. The averaging effect may result</p>

		<p>in stimulating demand among customer groups that would otherwise face higher prices. It would however, effectively eliminate any notional balancing point for trading which many would perceive as a disadvantage.</p>
Protection of consumers	Mixed	<p>By introducing average cost pricing postalisation would produce the lowest tariffs for Irish consumers, at least in the short term and also the least volatile tariffs. In contrast however for Northern Ireland consumers, postalisation would introduce a tariff increase and would therefore fail against this specific criterion. On the other hand, if postalisation discourages new market driven investment then there may be questions of the security (and diversity) of the supply of gas to consumers.</p> <p>If investment is undertaken, determined by Government policy, or determined by the regulator, there is the risk that over investment will occur, since the market test is missing. This could then push prices up in the medium to long-term.</p> <p>On the financial side, the move to postalisation should create certainty for financiers through the averaging of costs and spreading the risk across more consumers.</p> <p>A further advantage of postalisation is that it would also absorb price fluctuations by dampening volatility within the transmission tariff.</p>
Security of supply	Potentially poor	<p>As mentioned above postalisation should produce the lowest tariffs for consumers, at least in the short term and also the least volatile tariffs. This would though, come at the expense of market incentives for new infrastructure be it new fields, LNG or storage. This reduced security and diversity of supply may well impact on the market in the long term. It would also make the provision of security of supply more of a regulatory task rather than a market based outcome. In the long run this may make security of supply a defacto obligation for the system operators as the market signals will no longer exist.</p> <p>As stated previously, this lack of market signals may not massively impact the go/no go decision of an off shore field but one could expect it to significantly impact the LNG terminal developers decision on whether they enter the market.</p>
Transparent and Practical Regime	Mixed	<p>Moving to a postalised regime in Ireland and Northern Ireland should provide an easy to understand tariff for shippers on the system. This would not work for the Isle of Man though and a separate tariff would be needed there. Also, the move to a fully postalised methodology would offer the least legislative change to Northern</p>



		<p>Ireland.</p> <p>From a practical perspective, the calculation of the postalised tariff is, in theory, quite simple. Complicating this, however, would be the implementation of a revenue transfer mechanism between jurisdictions.</p> <p>The level of transparency and cost reflectivity is questionable with a postalised regime. For example, in a postalised regime the shipper paying a tariff at any Entry point will not know exactly what costs their payment correspond to. The same argument would be made by producers with a low cost Entry point where a higher tariff is charged on their gas than if it were a stand alone Entry. This implies a cross subsidisation of other assets.</p> <p>The adoption of Postalisation may not align to future European practice under current Third Package proposals. It would not be practical to revisit setting a tariff methodology again in the near future.</p>
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We further develop the arguments below:

#### 4.1.1. Advantages of a fully postalised regime

- Least legislative change

As a postalised tariff is the current structure in Northern Ireland, the move to an all-island postalised tariff would minimise the amount of legislative work required. A “common tariff<sup>7</sup>” i.e. postalised tariff is embedded in primary legislation in Northern Ireland. Any move away from this would require significant legislative change while the extension of a postalised tariff from Northern Ireland to the whole of Ireland would require significantly less legislative change than moving to Entry Exit. In reality though there will be other areas of CAG that will more than likely require some legislative change so the process would be taking place anyway.

- Average cost pricing

Employing a postalised regime will result in an average pricing system where users pay the average price of all the Entry and Exit points rather than paying for all gas at the price of the most expensive Entry point. Adopting an average cost pricing approach through full postalisation addresses the issue of lower IC utilisation. As was noted in the Consultation Paper

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<sup>7</sup> The Energy (Northern Ireland) Order 2003 reference to postalised tariff

this results in massive savings (€6,610m) for the two jurisdictions over the “do nothing” scenario. In reality the “do nothing” scenario is an extreme worst case situation but we would expect the savings from this regime to be significant.

- Reduced financial risk

An all-island postalised tariff would increase the size of the overall postalised combined pot and spread the risk across more customers. This ought to be welcomed by financiers as the exposure to risk would be reduced by this larger customer base and the lower risk could be passed onto to customers.

Furthermore, there are two obvious advantages to both jurisdictions operating one postalised tariff; specifically a simplified tariff structure and less volatile prices for consumers. This would on initial examination meet the Transparent and Practical Regime and Protection of Consumers criteria respectively. The transparency and practicality may then be lost in the implementation of any revenue transfer. Northern Ireland currently benefits from these advantages; expanding to an all-island postalised tariff would extend the benefits to Ireland.

#### **4.1.2. Disadvantages of a postalised regime**

- Price increases to Northern Ireland

An all-island postalised tariff would lead to a significant increase in transmission tariffs for Northern Ireland consumers. This was shown in the scenarios modelled for the Consultation Paper. Such a resultant situation would be deemed unacceptable and contravene the Protecting Consumers criterion. Therefore, any unwarranted increase in tariffs would need to be offset through a revenue transfer mechanism so that gas consumers in Northern Ireland are no worse off than in the absence of CAG.

Using a single postalised tariff makes revenue transfer more difficult compared to having two Exit tariffs. Therefore with a single postalised tariff, some explicit mechanism would need to be developed which would be external to the set tariff structure. This would be difficult to design and administer as it would be difficult to collect at the distribution level (circa 60% of gas does not enter the distribution system since it is used for electricity generation). Although a realistic counterfactual needs to be established, the increase and consequent revenue transfer may be very difficult to deal with and implement. The design of the counterfactual and implementation of

a revenue transfer mechanism would test the Transparent and Practical Regime criterion. Possible means of transferring revenue that could be considered are:

- Governmental transfer, either through a specific grant or via a tax framework. This would require political agreement. Ideally however, the impact should be handled within a tariff structure.
- A reduction to the Northern Ireland distribution network tariff through an increase to the Irish distribution network. However passing transmission costs through to distribution networks may not be an appropriate solution. Also, this approach leaves out power stations as they only pay the transmission element. An additional power station cost would need to be identified.
- Reduced balancing charges for Northern Ireland. Isolating Northern Ireland charges would be difficult to implement within a single balancing zone. Also, balancing charges are relatively small; a significant number of transactions would be required for this to work.
- Reduced connection charges for Northern Ireland (which could act as an incentive to extend the gas network). However the smaller scale of future connection charges would not reflect the sums associated with revenue transfer and would also be unfair to existing customers.
- Rebate to listed Exit points within the Northern Ireland transmission network. This approach would not be available within a postalised regime.
- Rebate applied directly to the bills of customers in Northern Ireland. This approach would bypass the problem of applying the discount through a specific network tariff but could involve numerous entities and intermediate transfers if applied to the final retail tariff.

An all-island postalised tariff would require an administrator function so as to collect and apportion the revenues. This would be similar to the Northern Ireland PSA (Postalised System Administrator) function with the addition of handling currency differences. This is foreseen as a manageable issue. This function could be delivered by the Single TSO or Single Service Provider structures which are being discussed in the operations workstream.

- Potential reduced investment

The implementation of a fully postalised regime in the two jurisdictions does not allow for any producer incentive at a lower cost Entry point. Shannon for example will have a low cost Entry point due to their short length of connecting pipeline. Their lower cost (than the IC for example)

Entry point allows them to recoup the difference between their Entry tariff and the higher cost Entry point tariff in the current Irish marginal cost system. This would be especially important to LNG as they may rely on this extra margin since they have to buy in the gas to sell on. The absence of this margin may deter potentially efficient entry.

The introduction of a fully postalised regime may hamper future investment and would therefore challenge the Development of the Gas Industry and Security of Supply criteria from the supply side.

- At odds with perceived best practice

The move to a fully postalised regime at a European Union level may not constitute perceived best practice. While at present this may make little difference it could have an impact if the Third Package is adopted. As part of the third package it is possible that an Entry Exit tariff may be made mandatory. The latest Third Package drafts<sup>8</sup> seem to be proposing this and consequently it may be prudent to future proof any regime implemented through CAG.

- Potential for inefficient investment

As previously noted, if investment is undertaken, determined by Government policy, or determined by the regulator, there is the risk that over investment will occur, since the market test is missing. This could then push prices up in the medium to long-term.

#### **4.1.3. Initial Conclusion on Postalisation**

The move to a fully postalised regime, while offering a number of advantages poses a fundamental problem in relation to unwarranted tariff increases in one jurisdiction. Initial analysis in the Consultation Paper suggests a significant increase in Northern Ireland tariffs were a fully postalised tariff employed. This would not be acceptable as there would essentially be cross subsidisation of customers in Ireland by those in Northern Ireland. An unnecessary rise in prices for Northern Ireland consumers under a fully postalised regime would therefore fail the Protecting Consumers criterion. The implementation of a revenue transfer mechanism is very difficult and is hard to see working in practice while retaining just one tariff. There are a number of potential solutions put forward above but they would all be difficult to implement especially

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<sup>8</sup> Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks  
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0532:FIN:EN:PDF>

when manipulating distribution tariffs. The implementation of a revenue transfer mechanism would challenge the intention to implement a Transparent and Practical Regime. The move to a postalised regime may also be at odds with the Third Package if adopted which may force a review in a few years. Further to this and as mentioned above the potential reduced investment as a result of postalisation would challenge the Development of the Gas Industry and Security of Supply criteria and would therefore not offer a desirable outcome.

Therefore, given the above reasoning, the proposed position is to discount a fully postalised tariff as a viable option.

## 4.2. Entry Exit

Ireland currently employs a separate Entry/postalised Exit regime. At present there are just two Entry points namely the ICs and Inch. Corrib is expected to come onshore in late 2009 with Shannon scheduled to arrive in 2012.

The implementation of an Entry Exit regime in the two jurisdictions would essentially involve Ireland continuing with a regime similar to that in place at present while in Northern Ireland the Entry (SNIP) and the Exit (onshore) would be separated out into different tariffs. Table 2 below assess Entry Exit under the assessment criteria.

Criteria	Assessment	Comment
Development of the gas industry	Positive	<p>On the supply side it would send signals for new indigenous gas production as well as for any LNG and/or storage facility. Whether the incentives are appropriate depends on the form of Entry Exit regime and whether any IC costs are mitigated.</p> <p>For shippers and suppliers the implementation of Entry Exit would create a single notional balancing point for gas trading. This should create liquidity in the market.</p> <p>Furthermore Entry Exit may provide the least impact to the current market and as such provide stability for future investments.</p>
Protection of consumers	Mixed	<p>In the short run Entry Exit would lead to less stable prices than postalisation.</p> <p>In the long run however, consumers would benefit through its transparent and cost reflective nature and in sending investment signals.</p> <p>An Entry Exit regime does provide a mechanism for revenue transfers should the need arise. This could protect Northern Ireland consumers from any unnecessary increases through tariff harmonisation.</p>
Security of supply	Positive	<p>Through providing the signals for investment an Entry Exit regime should have a positive effect on the security of supply in the two jurisdictions. There is a risk, however, that too much investment is encouraged.</p>
Transparent and Practical Regime	Positive	<p>An Entry Exit regime in Ireland and Northern Ireland would constitute a transparent and practical regime for users of the system and stakeholders alike. The separating of Entry and Exit would also be a practical solution for the Isle of Man as their exit charges are</p>

	<p>dealt with separately.</p> <p>An Entry Exit Regime may be the preferred tariff approach under recommendations within the proposed Third Package legislation. It may be practical to align to the proposed approach now rather than revisit again in the near future. This would also give more surety and clarity to the market.</p> <p>A continuation of the Entry Exit regime for Ireland would provide stability and ease implementation issues.</p>
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We further develop the arguments below.

#### **4.2.1. Advantages of both jurisdictions employing an Entry Exit regime**

There are a number of obvious advantages to both jurisdictions operating an Entry Exit tariff.

- Provides investment signals for new investment

The implementation of an Entry Exit regime in Ireland and Northern Ireland should create incentives for new investment where a new producer can build a cheaper Entry point and deliver gas cheaper than the marginal Entry point (the issue of IC utilisation may still need to be addressed). As detailed in the table above, this would provide a positive signal under the Development of the Gas Industry and Security of Supply criteria.

- Alignment to Europe

The introduction of the 3<sup>rd</sup> Package would appear to consider Entry Exit as the required European tariff methodology. Establishing an Entry Exit tariff regime within CAG could align the single all-island market to future European directives.

- Least market impact

Assuming the issues surrounding IC utilisation and revenue transfer can be resolved; the implementation of Entry Exit may well cause the least impact on the market. In Ireland the move away from Entry Exit may cause some major investments not to go ahead. In reality in Northern Ireland, the structural move from Postalisation to Entry Exit should not have any particularly adverse impact on the market in terms of new investment or development of the industry. Also, it is unlikely to have any effect on the storage model. This would align positively to the Development of the Gas Industry criterion.

- Allows a route for revenue transfer

If revenue transfer is required, an Exit point in each jurisdiction provides a natural transfer mechanism. Currency differences could also be treated via the exit tariff. This is a significant advantage of this model and would offer a means of protecting Northern Ireland consumers from any unwarranted tariff increases.

#### **4.2.2. Disadvantages of both jurisdictions employing an Entry Exit regime**

- Potential price increases

In almost all cases the implementation of Entry Exit leads to a marginal source of gas pricing structure (Single Entry would be the exception). Marginal pricing can be expected to lead to higher prices than an average pricing structure in the short term at least.

- Regulated Marginal Entry Point

In the event of a move to an Entry Exit (marginal pricing) regime in the two jurisdictions, the marginal Entry point will be the regulated BGN IC. One could question whether an Entry Exit regime could work as intended where the marginal Entry point is guaranteed cost recovery at that point. If the market were truly functioning as a market, then to maintain revenues, the marginal Entry point would need to drop its price to compete when a new source comes on stream. This is a fundamental issue and depending on the specific treatment would have an impact across all the proposed criteria.

- Tariff methodology change for Northern Ireland

The move from Postalisation to Entry Exit would constitute a major change to tariff structures in Northern Ireland and as mentioned above would require an amendment to primary legislation. This would most likely require considerable work and resources in Northern Ireland, especially since the regime has operated successfully to date. However within a future all-island market with cross jurisdictional flows, the continued use of postalisation in Northern Ireland could lead to tariff pancaking where shippers in Northern Ireland wish to purchase gas from Corrib or Shannon. Conversely, as Ireland currently operates an Entry Exit tariff, the addition of SNIP and a Northern Ireland Exit point to such a regime would be easier from an implementation perspective.



### **4.2.3. Initial Conclusion on Entry Exit**

Following initial analysis and consideration it would seem that some form of Entry/Exit regime would be most suitable for a harmonised tariff methodology. One of the main advantages of the Entry Exit regime is the ability to retain two Exit tariffs. This has twofold benefits; to avoid the need for Exit related revenue transfer between the jurisdictions and also to allow a route for any necessary Entry related revenue transfer, should the need arise. This is a particular advantage under the Protecting Consumers criterion. There are further benefits under Security of Supply and the Development of the Gas Industry criteria that we feel make Entry Exit a suitable methodology. Another advantage of Entry Exit is compliance at the European Union level. While this may not make a material difference at this stage it may become more important if the Third Package is adopted as there are indications of making Entry Exit mandatory. It is acknowledged (depending on the Entry Exit configuration selected) that a potentially complex counterfactual and subsequent revenue transfer mechanism may be required under this methodology.

Therefore, given the above reasoning, an Entry Exit tariff methodology is considered to be a viable option.

## **5. Specific Asset Configuration**

### **5.1. Entry**

Further assessment of Entry Exit suggests that there are a number of viable options available. They are detailed below with their respective advantages and disadvantages.

- i. Combined Moffat with all other Entry points separate.
- ii. Separate SNIP, Combined IC1 and IC2 with all other points separate; and
- iii. Single Entry,

There were a number of other options put forward in the Consultation Paper such as combining the non IC Entry points into one Entry point. On further consideration, analysis in the Consultation Paper and in light of comments received we have decided to exclude these options from further analysis.

#### **5.1.1. Combined Moffat Interconnectors (with all other points separate)**

One potential option is to combine all the Moffat interconnectors (IC1, IC2 and SNIP) into one asset. This would reflect the fact that they are all connected to the GB market at one point (Moffat) and provide a common service.

#### **Advantages of a Combined Moffat**

- Operational Efficiency

With the Combined Moffat configuration it is perceived that operational benefits can be achieved by flowing gas efficiently without any operational overhead or contractual impediment. Modelling of this scenario is ongoing with results expected in late October.

- Reduced IBP and reduced producer incentives

The combining of the Moffat interconnectors will result in a lower tariff on the interconnectors (lower than leaving separate SNIP and ICs) for customers in Ireland due to the averaging effect. This should lead to a lower balancing point and ultimately lower prices for all customers.

Compared to postalisation, there would remain a price differential for producers to take advantage of but not as much as the separate SNIP option. For producers, a combined Moffat

would be better than postalisation but would be less preferable to the separate SNIP, combined ICs option which keeps the southern ICs as the highest Entry point.

As a secondary benefit, combining Moffat provisionally addresses low levels of utilisation on the ICs; however it does not remove the IC problem completely. For example, the discovery of a new gas field or the introduction of LNG facilities would raise such issues again. Ideally IC mitigation would be solved independently from a specific asset configuration so that a robust solution is set in place.

- Reduced volatility

There should be greater tariff stability as any change in costs or utilisation would be averaged over three assets.

### **Disadvantages of a Combined Moffat**

- Impact to Northern Ireland

Prices for Northern Ireland consumers would increase, therefore a form of revenue transfer would be required, although this could be addressed through the Exit tariff. However, although achievable, calculating the size of the revenue transfer could be difficult since determining the Northern Ireland base case would be somewhat subjective and the subsequent calculation of the counterfactual could be complex. Further analysis is required on this option.

- Security of Supply Aspects

The price differential (between entry points) would be lower than currently set thereby lowering the producer incentive. This could potentially be detrimental to security of supply. Similar arguments exist against postalisation but combined Moffat would not cause as significant an impact.

- Implementation Issues

There are a number of implementation issues within the Combined Moffat approach that require further investigation, For example, consideration of how the operational relationship between BGE and PTL would work or the design of the nomination and allocation process require further thought. Any proposed changes would need to be considered in line with the preferred operational regime put forward in the CAG Operations workstream.

### **5.1.2. Separate Entry Points**

#### **Advantages of Separate Entry Points**

- Northern Ireland transmission tariffs

Since any Entry Exit regime, given the existing assets and their utilisation, will increase transmission tariffs to Northern Ireland, considering SNIP separately may simplify the resulting revenue transfer problem. This is because the problem could be internalised in Northern Ireland and not require an inter-jurisdictional revenue transfer.

Capacity on SNIP could be auctioned towards the IC tariff cost or even just set at the IC tariff. The extra revenue generated could be redistributed to the Northern Ireland Exit tariff. This approach avoids the design of a counterfactual element which although achievable, could be complex and open to challenge. Alternatively, the SNIP charge could be set at the IC charge (as the marginal source of gas) and additional revenue generated accordingly.

- New Production Incentives

Maintaining the southern IC's as a separate Entry point keeps the Irish Balancing Point (IBP) higher than the combined Moffat. This allows producers to take advantage of their lower cost (than the marginal Entry) Entry point when selling their gas. This may be beneficial to security of supply.

#### **Disadvantages of Separate Entry Points**

- Operational limitation

A separate SNIP option may limit the operational options by impacting optimal flows between SNIP and the ICs. Further analysis is ongoing on this potential limitation. The transporters are currently carrying out analysis around this and will be reporting their initial findings soon (see section 8.2).

- Potential price increase in Northern Ireland

As noted above, under any form of Entry Exit pricing there would be an increase in prices in Northern Ireland if no adjustments were made. The development of a revenue transfer could be difficult since determining the Northern Ireland base case would be subjective and the subsequent calculation of the counterfactual could be complex.

- Retain higher marginal pricing

One indirect advantage of a combined Moffat configuration is that it provisionally addresses IC mitigation and thereby reduces the marginal price set by the ICs. Operating SNIP as a separate Entry point would not provide such an additional benefit. Since this approach does not reduce the cost of the ICs by combining with the higher utilised SNIP, producers can take advantage of their lower cost Entry point, thereby retaining high marginal pricing.

### **5.1.3. Single Entry Point**

The final option for consideration comprises a single Entry point where the required revenues for the ICs, SNIP and the Entry point related revenues for Inch, Corrib and potentially Shannon would be combined to form an Entry asset pot which would be divided by the sum of all Entry capacities and flows to form a single Entry tariff. While this could be classed as an Entry Exit regime it essentially sees all the Entry assets postalised into a single tariff. It differs from postalisation since the two separate Exit points could be retained.

#### **Advantages of a Single Entry**

The creation of a single Entry tariff would have a number of potential advantages due to the postalised effect.

- Average cost pricing

Employing a single Entry tariff should at least in the short term result, in an average pricing system where users pay the average price of all the Entry and Exit points rather than paying for all gas at the price of the most expensive point. This would have a positive impact in terms of protecting consumers.

- IC Mitigation

The averaging of the costs of the Entry assets would result in a lower tariff as set out above. This should reduce the effect of low levels of IC utilisation and negate the need for any complex solution.

- Could be perceived as Entry Exit

Implementing a single Entry point, although a postalised Entry tariff, would result in the jurisdictions having an Entry Exit regime by virtue of the fact that the Entry and Exit tariffs are separate. In this situation the Entry and Exits would be postalised but separately.

### **Disadvantages of a Single Entry**

- Potential reduced investment

The implementation of a single Entry point could have an adverse effect on new indigenous production as it does not allow for any producer margin at a lower cost Entry point. Shannon for example may have a low cost Entry point due to their short length of connecting pipeline. Their lower cost (than the IC for example) Entry point could allow them to benefit from the difference between their entry tariff and the higher cost Entry point tariff in the current Irish marginal cost system. This would be lost in the single Entry model which may have a negative impact on security of supply and potentially developing the indigenous gas industry.

- Potential inefficient investment signals

In addition to reduced investment signals there is a danger that a single Entry point could result in inefficient investment being carried out which in the longer term may have an impact on the protection of consumers. Due to the averaging effect of postalising the Entry points there is a possibility that investment could occur that may not necessarily be needed. This would create a need for more regulatory intervention and less of the market functioning by itself. One solution would be to develop some sort of a Network Investment Test (as mentioned by one respondent) which should establish whether the investment was efficient.

## **5.2. Exit**

There are a number of potential options available as set out in the Consultation Paper. These options are discussed below.

### **5.2.1. Separate Exits**

With this approach the Exit systems in Ireland and Northern Ireland would remain separate with separate jurisdictional Exit tariffs. There are a number of advantages in adopting this approach in terms of the protection of consumers as there would be no unnecessary rise in Northern Ireland Exit tariffs due to the combining of tariffs with Ireland. This is a very important factor in itself. It also allows greater discretion for the two jurisdictions in relation to the connection of new towns. If the Exit zones were combined the two jurisdictions would require identical connections policies. This may not be acceptable as one jurisdiction may have different criteria for connections than the other. This could have negative impact on the Developing the Industry criterion in one or both jurisdictions. This is not to say that there should not be significant commonalities between connections policies, especially in relation to charging regimes.

### **5.2.2. Single Exit**

The move to a single Exit tariff would involve the postalisation of the onshore assets in both jurisdictions to a common asset and common tariff. This approach would allow greater flexibility (than separate Exits) for shippers as they would be able to trade secondary capacity as they wish. It would create the issue of an unnecessary tariff increase for Northern Ireland and not allow a straight forward route for revenue transfer. Finally the issues in relation to connections policies (mentioned above) would be considerable and may in some cases compromise the protection of consumers. It is questionable whether the additional ability to trade Exit capacity is a strong enough argument to create a single Exit and deal with potentially significant tariff increases for Northern Ireland.

### **5.2.3. Multiple Exits**

The development of multiple Exit zones would involve subdividing the existing Exit zones into a number of smaller zones. This would be somewhat similar to the Local Distribution Zones employed in GB. This approach would create a high degree of cost reflectivity for the different Exit zones but would be a dramatic move away from the models currently employed by the two jurisdictions. In Ireland for example, customers in the west of the country could find themselves

paying much higher transmission charges than customers in Dublin which could have significant implications for the development of the overall gas industry. It would also seriously challenge the economics of the recently connected towns in Ireland. In the GB system there are multiple Exit zones but considering the size of the entire market it is plausible that each zone is as big if not bigger than each jurisdiction here.

### **5.3. Initial preferred asset configuration**

The RAs have not formed a definite opinion on asset configuration at the Entry. We are currently minded to discount the single Entry point due to the impacts on developing the industry and the protection of consumers in the longer term . This is primarily due to the effects that postalisation could have on new efficient or indeed inefficient investment. It may also require more regulatory intervention in the market and could cause the general gas customer to underwrite more future Entry investment than would otherwise be the case.

In light of the above we are drawn to keeping all non interconnector (Inch, Corrib, Shannon, Larne) Entry points separate. The remaining issue surrounds whether or not to combine the Moffat interconnectors (SNIP and the ICs).

The transporters are currently carrying out modelling on the combined system (Ireland and Northern Ireland) to look at optimum flows. We therefore feel that it is too early to firm up our views on whether to combine Moffat or not. We will examine the results of the modelling to see what operational benefits can be gained from operating Moffat as one and how tariffing arrangements might work. This modelling work is due back in late October.

For Exit we are minded to adopt a regime with two Exit systems. This has advantages for the reasons set out previously and also in its ability to cater for any inter jurisdictional revenue transfer, should the need arise. Keeping the Exits separate also allows the two jurisdictions to pursue different strategies for the connection of new towns and development of the industry which should protect consumers in each jurisdiction. In a single Exit regime both jurisdictions would have to approve the other's connection strategies which may not be an appropriate situation.



## **6. Mitigating the effect of low IC utilisation**

Although not a part of CAG or a consequence or a result of CAG, there is an issue with regard to the potentially low level of utilisation on the ICs once new sources of gas arrive. If left unchecked it would result in a volatile (and high) tariff on the ICs. Although to date this has been a problem just facing Ireland<sup>9</sup>, the fact that SNIP will be fully booked soon means that Northern Ireland will be subject to potential tariff volatility also. The same can be said of the Isle of Man which is in the unique position of being 100% reliant on the ICs. Further to this, Northern Ireland relies on the ICs for security of supply in the event that anything happens to the SNIP. In this case all the Northern Ireland gas would need to come across the ICs and up the South North pipeline.

### **6.1. The need for mitigation**

Whether or not a complex solution for the treatment of the ICs is needed depends greatly on how the market develops and in particular, the impact on IC utilisation. For example, if Corrib were the only further source of gas to come onstream, the IC flows would dip for a few years and then ramp up again, therefore negating the need for any specific mitigation strategy. The arrival of the Corrib field combined with additional indigenous sources, the Shannon LNG facility or storage would, however, significantly exacerbate the issue and strengthen the need for a mitigation strategy in the short term. Separately, we are currently considering the efficacy of combining the Moffat interconnectors (ie, SNIP and the ICs) on the grounds of operational efficiencies. Should we go down this route it is likely to provide some mitigation for the potential IC utilisation issue (due to the impact of averaging across SNIP and the ICs). We do not see IC mitigation as the primary reason for combining the Moffat Entry points and, in any event, it would provide only a partial solution should both an LNG and a storage facility be developed.

### **6.2. Consultation Paper Proposals**

The Consultation Paper put forward a number of potential mitigation options. These options can broadly be described under the following headings;

- Partial stranding of the asset
- Reprofiting of asset revenues
- Moving part of the asset revenues; and

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<sup>9</sup> CER/07/110 BGN Transmission Revenue Review Decision Paper (August 2007)

- Setting a minimum booking level

Since the consultation the CER has examined further the case for stranding the IC investment costs as a means of mitigating the effects of lower utilisation and has concluded that such a course would not be acceptable. The reasoning is set out in **Annex 1**.

### **6.3. Specific industry response and proposals**

The proposals put forward by the RAs in the Consultation were not intended to be exhaustive and as such we welcomed further proposals from respondents. Most respondents made no specific comment on the IC mitigation approach (see Section 7) but there were four proposals made by interested parties. All these proposals involved the reprofiling of revenues and capping the interconnector tariffs.

#### **6.3.1. Long Run Marginal Cost pricing**

In its response BGN advocated what it described as a Long Run Marginal Cost (LRMC) approach to setting tariffs on the ICs. Under their approach transmission tariffs would be set based on the forward looking incremental costs of the “optimal response” to a sustained increment of demand for the transmission service. In their modelling they assume a combined Entry point of the ICs and SNIP and that the optimal response to meet additional demand is to increase capacity on the ICs. Based on these assumptions BGN estimate the indicative equilibrium LRMC of transporting gas over the interconnector to be around €107/peak day MWh. They suggest capping the interconnector charge at this level and that the resulting likely shortfall in allowed revenue being recouped through Exit tariffs split proportionately between both jurisdictions.

#### **General comments on marginal cost pricing**

Whilst describing their proposal as an LRMC pricing approach in our view it more closely resembles Long Run Incremental Cost (LRIC) pricing with the tariff being set on the basis of the incremental cost for a unit increment in demand over a time horizon that allows capital inputs to vary. Whilst very similar to LRMC the two are not, however, exactly the same. LRIC considers the marginal cost of increased demand where capacity is given whilst LRMC assumes current capacity has been determined as part of an optimal path.

LRIC is a well established pricing methodology in the field of regulated telecoms. There are significantly fewer examples, however, of its application in other regulated network industries<sup>10</sup>. The main benefits of LRIC relate to the investment signals it sends, that is when to invest and where to invest. As such it is reliant on the assumption that from time to time demand for the service is such that demand growth will result in demand exceeding capacity and that the investment signals contained within prices are the primary objective of tariff setting. Where demand is not expected to exceed capacity in the foreseeable future and there is permanent and significant excess capacity such that cost recovery is the primary aim of the regulatory prices setting mechanism then backward looking approaches (such as average cost pricing) are likely to be more appropriate.

### **Comments on the BGN proposal**

In addition to the points made above in relation to the appropriateness of marginal cost pricing in this context we have identified a number of issues with the BGN proposal that we believe would require further work for it become a viable proposal.

#### *What is the incremental point of Entry?*

The BGN proposal suggests the LRIC calculation should only be carried out on the IC's without explaining why this is the case. Whilst the ICs are the marginal source of gas it is not clear that they are also the long run marginal source of gas into the island.

#### *How effectively does this address IC utilisation?*

In itself LRIC pricing does not address the issue of cost recovery on the ICs. Indeed, as BGN note there will need to be a mechanism to recover the shortfall in revenue that will arise from LRIC. BGN propose meeting this shortfall through Exit charges. This is effectively shifting a significant proportion of the investment costs associated with the ICs to the onshore system (the Exit tariff).

Effectively it is this shifting of costs that "mitigates" the IC utilisation issue in BGN's proposal.

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<sup>10</sup> We note that LRIC is used by National Grid for setting reserve prices for entry capacity into the UK transmission system.

### **6.3.2. Long Run Average Remaining Costs**

BGES and Shannon LNG have both put forward approaches where tariffs are set on the basis that a unit of production depreciation methodology is applied when calculating the IC tariff. For example, under this approach the remaining recoverable capital cost of the ICs is divided by the projected flows across the pipeline to give an average capex cost element for each unit that flows. We refer to this approach as Long Run Average Remaining Cost (LRARC). BGES suggest that the unrecovered revenue (projected revenue compared to allowed revenue) should be recovered from the Exit tariff while the Shannon approach would see a regulatory asset created for the unrecovered part.

LRARC is effectively a method for reprofiling revenues across price control periods to give stable tariffs (albeit not revenues) on the IC regardless of flows. Given the role of projected future flows it is clear that full cost recovery is reliant on the accuracy of the forecasting. If there is a backending of depreciation on the basis of expected increased future utilisation that does not materialise, then there is a risk of merely having put off the stranded asset problem that the ICs present.

### **6.3.3. Setting of notional IC utilisation**

AES have put forward a nominally straightforward approach to the setting of the IC tariff. They propose that a notional utilisation level on the ICs is assumed and cap the IC at the corresponding tariff. Inevitably, this will yield an under recovery in years of low utilisation and they suggest that this is either recovered through a PSO levy or a re-profiling of revenues.

Whilst this approach is ostensibly simple to implement with only the appropriate utilisation needing to be decided upon, it is likely to be more involved than it first appears. Setting an appropriate cap will be a non-trivial exercise and developing the PSO mechanism (if that were preferred to re-profiling) is likely to attract considerable debate.

One clear benefit of this approach is that it would result in a stable tariff and consequently a stable IBP, albeit through creating issues elsewhere in the regulatory framework.

## 6.4. Summary of the RA's view on stakeholder proposals

In this section we considered the proposals put forward by industry participants to address the issues created by potentially enduring low utilisation levels on the ICs. The proposals broadly came under three headings:

- marginal cost pricing (requiring the shifting of costs onto the onshore system);
- reprofiling of revenues; and/or
- a PSO.

In relation to BGN's LRMC/ LRIC proposal; effectively it is the shifting of costs onto the onshore system that mitigates the potential IC issue. Such LRMC/LRIC pricing would essentially be a new approach to tariffing grounded in allocative and dynamic efficiency (ie, where, how much and when to invest in response to consumer demand). We do not rule out LRMC/LRIC pricing at this stage, but note that it would represent a significant change in direction for the RAs on this particular issue of gas transmission pricing and we invite further views on its merits.

The other options of: revenue re-profiling (with the question of whether doing this beyond the standard five year price control period is appropriate and the best way to achieve this); shifting costs onto the onshore system; and the viability of a PSO all remain under active consideration.

In part their applicability depends on:

- expectations of new gas fields, LNG and storage development and their appropriate time frames since this drives the likely need to shift costs away from the ICs; and
- the form of Entry Exit asset configuration chosen.

As such we will continue to consider the various options and need to determine their robustness as our positions on these two issues develop. In passing, we would note that going the PSO route would require a decision by the Minister/Government in Ireland and prior notification and approval by the European Commission.

## **6.5. Alternative View**

There is a view which could be taken on this issue which looks at security of supply in the jurisdictions. This matter is raised in the context of security of supply and how explicitly recognising the security of supply that the three interconnectors, along with the other existing and potential supplies, bring to the island which could reduce the need for any mitigation.

The defacto design standard for the market is to have sufficient separate supply available, e.g. in Ireland the second gas interconnector with Scotland was built while Northern Ireland made a second connection via the South North pipeline. For security of supply reasons it could be made mandatory that all shippers book a set number of days back-up capacity on a separate physical connection (than where their firm capacity is) that can be reasonably expected to have the ability to deliver gas. This could apply to all Entry points including interconnector Entry. The choice of back-up Entry point could be made by the shipper (once the backup Entry point meets certain criteria).

In the same manner that combining the interconnectors for operational reasons might reduce the need for mitigation; similarly explicitly recognising security of supply benefits might also reduce the need for mitigation, although neither action would have this as their primary objective.

## **6.6. Current Thinking**

As stated earlier, the transporters are currently carrying out modelling of the single gas system and initial results are due in late October. Part of the intention of this modelling is to verify potential operational savings of combining Moffat. A consequence of combining Moffat may be that IC mitigation is provisionally addressed; however we do not see IC mitigation as the primary reason for combining the Moffat Entry points. Also, the security of supply aspects, mentioned above, are important and may be examined further in other workstreams. This could also have an impact on the future IC bookings.

As stated previously, the need for and the precise level of mitigation is unclear and will depend on future market developments. For the avoidance of doubt though:

- The extreme “do nothing” scenario mentioned in the Consultation Paper is not an option the RAs would consider or allow to occur
- The aim is to design a suitably robust tariff regime at this time that will handle short term troughs in IC utilisation without being overly interventionist

- The RAs will intervene to make some adjustment to the manner in which the IC revenues are recovered if we believe the utilisation will fall below a level that would have a significant detrimental effect on the market
- Any intervention in the treatment of the ICs will involve a solution where BGN will recover their required revenues from the market and so stranding will not be considered as an option (see Annex 1).

In light of this we intend to examine the modelling results before proposing any preferred solution. We invite comment on the proposals put forward above and following this consultation we will undertake a more detailed analysis.

## **7. Responses to Consultation**

### **7.1. Comments received**

The RA's received 15 responses to the consultation from interested stakeholders. The feedback received has been useful in forming this Draft Conclusions Paper. Responses were received from the following stakeholders.

- AES
- Airtricity
- Bord Gáis Energy Supply
- Bord Gáis Networks
- Gaslink
- Irish Offshore Operators Association
- Marathon
- Manx Electricity Authority (MEA)
- Phoenix Natural Gas
- PTL
- Shannon LNG
- Shell
- Statoil
- Viridian Power and Energy (VP&E)
- Confidential Response

One respondent has requested that their response to the Consultation be dealt with in confidence and not be published. All of the other responses are published with this paper on the websites.



In the next sections we address the comments received from the Consultation. The responses are dealt with under the broad headings set out in the Consultation Paper. It should be noted that not all of the responses addressed all of the issues as some parties may not have been directly interested in some aspects of the paper.

## **7.2. Substantive issues and RA's responses**

### **7.2.1. Existing transmission tariffs**

Most of the respondents agreed with our description of the current systems and tariff structures in place in Ireland and Northern Ireland. MEA did point out that there are more than two jurisdictions involved as the Isle of Man are significantly involved and impacted as they are in the process of accession to the Code of Operations in Ireland. They have stated that we should be mindful of the impact any changes to current structures may have on them.

*The Regulatory Authorities are mindful of the impact any changes may have on the Isle of Man, although this may not have been explicitly stated in the Consultation Paper. In the development of the final solution the impact on the Isle of Man will be assessed and considered.*

The confidential respondent, while in agreement with our assessment of current structures felt that a number of other issues should have been addressed. These relate to asset valuation and the treatment of "k" factors. They also believed that distribution tariffs should have been looked at.

*The above issues raised by the respondent are out of scope of this paper. Revenue reviews are carried out by each Regulatory Authority. Both jurisdictions are within price control periods and there are no plans for wholesale reopening of these at this time. It was never the intention of the Regulatory Authorities to review distribution tariffs as part of this process and may well be out of scope for the CAG project.*

### **7.2.2. Assessment criteria**

A number of the respondents made no specific comment on the criteria proposed by the RA's. There is no clear consensus to be drawn from the specific comments received with some proposing amendment to our proposal and some proposing alternative criteria. Gaslink, while in broad agreement with our criteria made some suggestions on how they could be clarified further. They also proposed two additional criteria namely ease of implementation and flexibility.

*The commentary provided by Gaslink is useful and outlines some of the limitations with our criteria. They show that the "Development of the Industry" criterion will have different effects on*

*different stakeholders within the industry. For example it will mean different things for producers and shippers and a balance should be struck. In relation to the two additional criteria, the RAs agree that both the Gaslink extra criteria are important and are reflected in our updated criteria.*

VP&E have stated that the absence of any environmental criterion poses a difficulty. They have pointed out that not only is natural gas the main electricity generation fuel, it can be reasonably assumed that natural gas will be used to meet the strategic back up requirements of renewable generation. VP&E also believe that using the RA's proposed criteria may result in the outputs being too narrowly defined. VP&E has also suggested that we should not apply specific weighting to the criteria as they may be subjective and open to challenge.

*The RAs recognise the absence of any specific environmental criteria in the Consultation Paper but is unclear what form any environmental criteria would take. Presumably any criteria would involve the incentivising of new gas plant over distillate. This will be looked at as part of the examination of short term products and possibly in the capacity commodity split. These products will be examined in later consultation papers.*

BGN has put forward a number of criteria which they believe may be more robust than those proposed by the RAs. They have proposed cost recovery, efficiency, equity, stability and practicality. BGES has also proposed cost recovery as important to provide investor confidence in the regulatory regime.

*The RAs note the alternative criteria put forward by BGN and BGES but are unconvinced that there is anything that is not already covered in the criteria put forward either explicitly or implicitly. We have however reviewed our criteria in light of all new proposals to ensure we have considered all proposals.*

### **7.2.3. Asset Configuration**

#### **Postalised**

The majority of respondents were not in favour of postalisation. Many respondents declined to comment but those who did were of the opinion that a postalised tariff across both jurisdictions would not work, VP&E believe that it will cause the effective collapse of the IBP. Phoenix sought clarity on what assets would be included in the revenue pot, and how new assets will be dealt with when they come on-stream. BGN considered that full postalisation is unlikely to be acceptable because of the implied cross subsidy between jurisdictions. PTL are in favour of postalisation believing that the Northern Ireland concept could be easily transferred across both jurisdictions and that a revenue transfer mechanism could be developed. AES suggested the

option of having a Network Investment Test (NIT) for new infrastructure. This test might, for example, consider the incremental capital costs and the resulting reduction in overall unit costs to all consumers. BGES are seeking more clarity on what we actually mean by postalisation. This was raised at the workshop in Belfast also.

*The comments received from respondents have been helpful and have aided the further analysis of postalisation. In our assumptions to date we have taken postalisation to be the combining of all onshore assets, the interconnectors and Entry point assets divided by the projected system flows. No allowance has been made for any upstream installations. The specific analysis and assessment of postalisation is contained in Section 4. The concept of the NIT put forward by AES is very interesting and may be a useful tool to employ for new pipelines in the future, especially if there are concerns over inefficient investment. New connections and network investment will be considered under the relevant policies addressed within the separate CAG Connection Policy workstream. Finally, the issue of intra jurisdictional revenue transfer combined with potential future different connection policy strategies potentially makes postalisation a less suitable tariff solution in the future.*

### **Entry/Exit**

The majority of respondents favour the Entry Exit option. The MEA felt that separate entries were not viable under current circumstances and a single Entry model is worth further analysis believing that a single Entry would have advantages in that it is easy to regulate and it sets sufficient price signals for development of more gas import capacity. Other options backed by some respondents were a combined Moffat, with all other entries separate, with new entrants being added separately as they come along. Entry/Exit was considered by Gaslink to be most aligned to European legislation and regulation.

*The Entry Exit option has been analysed in Section 4 and we are at this stage minded to adopt this approach. The specific entry configuration needs to be assessed further and this paper seeks further comment in this area. We are not convinced of the MEA argument in relation to the single entry option and feel that this approach may not be optimum at this time.*

### **Moffat**

The combined Moffat option yielded differing responses. BGES, BGN and VP&E (potentially) were in favour of combining Moffat, as they provide a common service of entry from the GB

market. The other benefits noted were that it provides all Moffat shippers from both jurisdictions a transparent and easily understood tariff. A combined tariff would also ensure that the three interconnectors would be operated efficiently and different tariffs would not dictate the way the pipelines are operated. Phoenix are not in favour of combining Moffat. They believe that it would have implications for the current NTS exit reform proposals. One respondent would consider a combined Moffat but preferred the status quo with NI adopting Entry/Exit (separate Moffat). Many respondents gave no opinion on this issue.

*As stated earlier, the issue of combining Moffat and its appropriateness is still under review and further comment is sought on this. It is our understanding that from an operational point of view the existence of a single tariff at Moffat allows the operator to flow gas in the most efficient way as they are not constrained by contractual flows. The remaining arguments against the proposal centres around any revenue transfer from north to south and what any counterfactual would be. We do not feel that the issues raised by Phoenix in relation to NTS reforms are a significant barrier to the combining of the Moffat interconnectors as the two RAs are currently pursuing a combined approach to the issue.*

## **Exit**

BGN, VP&E, Phoenix and Airtricity were in favour of dual exit points, one in each jurisdiction. It was considered the most suitable option both on social grounds and because it offers the possibility of reducing the need for financial transfers across the jurisdictions. Only BGEN favoured a single Exit point saying it would allow capacity trading without jurisdictional restriction providing for efficient use of the overall network both Ireland and Northern Ireland and encouraging competition between all suppliers on the island. Airtricity also suggested that a special exit tariff should be implemented for gas fired electricity generation. Nine other respondents gave no comment.

*In light of the comments above and further discussion and analysis the RAs are minded, at this stage, to implement two separate Exit tariffs in the two jurisdictions. We do note the BGEN preference for a single Exit zone to allow for capacity trading. There are a number of factors (mentioned above) which weigh against the single exit approach. We do not believe that the need for secondary capacity trading is great enough to outweigh the arguments against. For example, in the GB market not only is secondary capacity trading prohibited between LDZs but it is entirely prohibited.*

#### **7.2.4. Mitigating the effect of declining interconnector utilisation**

As a general response to dealing with mitigating the effect of declining interconnector utilisation, a majority of respondents felt that the issue should be dealt with in a separate consultation. Phoenix and PTL felt that the IC mitigation issue is something that should be dealt with by the CER, as the decision to construct IC2 was taken prior to any discussions in respect of CAG and therefore any revenue recovery issues in respect of IC2 should be addressed by Ireland. Similarly they state that when the decision was taken to construct the South North pipeline, the increase in cost would be borne by the Northern Ireland consumer and apart from any future usage by ROI Shippers, is not anticipated to be spread across Ireland consumers.

*While the overall regulatory treatment of the BGN interconnectors may be an issue for the CER, the mechanism for dealing with the mitigation should be dealt with as part of this CAG tariffs workstream. Further to this, the second BGN interconnector provides a service to Ireland, Northern Ireland and the Isle of Man. Northern Ireland is set to start using IC2 once the SNIP becomes full around 2011.*

AES stated that the networks in the ground are a sunk cost and have to be paid for. In a follow up meeting they have stated that a sunk cost asset should not be allowed to distort the market because of its cost recovery requirements and result in higher prices for all. The IOOA has stated that it is the current regulatory treatment of the interconnectors that is to blame for any such increase in the cost of gas in Ireland and not the new gas production facilities. They also stated that they may accept profiling of IC revenues over a period longer than five years and moving some of the revenues to the exit (as long as it is taken account of later or an export facility is developed at Moffat).

*The RAs agree that the regulatory treatment of the IC should not be allowed to distort the market unnecessarily and send perverse signals. We therefore feel that some measures should be put in place to stop this from happening, as set out in the Consultation Paper. We also note the producers statement that the new indigenous sources are not the problem, but is more to do with the full cost recovery of the regulated marginal entry point at that point.*

VP&E, MEA and AES did agree there is merit in some mechanisms put forward in the consultation paper. Aside from mechanisms proposed by the RAs, there were a number of alternative approaches put forward. BGN suggests that the IC should be capped at the

equilibrium level of the LRMC to provide a stable and practical charge regime, thereby giving appropriate price signals. In subsequent discussions we have established that the BGN proposal involves a forward looking LRMC. BGEN proposed that we would look at the historic costs. They say it would also recognise and reward the long term contributions of the IC's as an asset. Shannon LNG was of the opinion that the ICs could be depreciated per unit charge over 30 years. AES had the view that existing networks are sunk costs and have to be paid for irrespective of utilisation, therefore the tariff should be based on a notional level of utilization e.g. 80%, and the rest of the revenue should be recovered from a PSO.

*The various forms of mitigation for low IC utilisation have been assessed and discussed in section 6.*

#### **7.2.5. Capacity/Commodity split**

The general response to capacity and commodity charges was in favour of supporting harmonization, and believed there was merit to it. Phoenix would discourage a move towards 90:10 split and would favour a 50:50 approach. AES was in favour of the highest commodity possible (100% in both jurisdictions), PTL took the opposite view that the highest capacity possible is best as coming from a transporter viewpoint highest capacity is best, although it was also appreciated that some level of commodity is required to assist the development of the gas industry. PTL intend to comment further on harmonisation once a clearer picture of the tariff methodology is developed. Several respondents believe that a compromise between the two current splits of 90:10 and 75:25 should be moved either on one hand to the lower end (65:35 like GB) or to the upper end (90:10). VP&E feel that the split is important and may have a major effect on the development of the industry. They also feel that natural gas should be promoted as it the lowest carbon fossil fuel. New plant should not be promoted to run on distillate due to the gas market framework in place.

*We welcome the comment from respondents in relation to the Capacity Commodity split. We now propose to deal with this issue as part of a subsequent consultation as essentially it is not a first order issue. For this paper we are focusing on the overall tariff structure. We will however consider the responses received when looking at the issue in subsequent papers.*

### **7.2.6. Smoothing**

The responses were generally in favour of tariff smoothing. BGN, Phoenix and BGES feel that smoothing within a price control is very important. Phoenix did though understand that there may be constraints on such in NI due to certain assets being mutualised. VP&E and Shannon LNG recommend that it is deferred for future review and examination, subject to progress to being made on the core issues covered in the consultation paper. Most respondents had no comment.

*We welcome the comment from respondents in relation to the smoothing of revenues. We now propose to deal with this issue as part of a subsequent consultation as essentially it is not a first order issue. For this paper we are focusing on the overall tariff structure. We will however consider the responses received when looking at the issue in subsequent papers. In this section we are referring to within price control smoothing. Smoothing between price controls is a different issue and is addressed in Section 6.*

### **7.2.7. Other Comments**

Aside from the comments made on the above points, one Northern Ireland party said that access to Corrib and Shannon should not be at the expense of gains made already through mutualisation. They believe that CAG should build on the success of mutualisation to reduce the cost of transportation to Northern Ireland consumers. They also believe it is possible to develop a common tariff methodology that does not require jurisdictional tariffs to be identical. BGN indicated that any major structural change to the tariff charge structure should not be implemented until the next price control period to avoid adverse impact on investment. The IOOA found that CAG paper dwelt on issues that have been consulted on before without giving any recommendation for moving forward. The MEA would like any consideration made in relation to future tariff arrangements under CAG to take into account the Isle of Man's unique situation, so that the use of natural gas on the Isle of Man remains economically viable. Finally one respondent has asked for the regulators to publish costs associated with implementing options presented in the Consultation Paper, both from a transporters and shippers view point.

## **8. Next Steps**

### **8.1. Request for Comment**

The RAs invite comment from interested parties on all aspects of this Draft Conclusions Paper. In particular we seek comment on the following:

- The preferred approach of implementing an Entry Exit regime
- The draft conclusions on a fully postalised regime
- Entry asset configuration
  - Combined Moffat and all others separate
  - Separate Moffat and all others separate
- Exit asset configuration
  - Two Exit zones
  - The draft conclusion on single Exit and multiple (more than two) Exit zones
- IC Mitigation proposals
  - The need for mitigation
  - Long Run Marginal Cost
  - Long Run Average Remaining Cost
  - The use of back-up capacity

Comment is sought by close of business on 14<sup>th</sup> November 2008 (see Section 1.4).

### **8.2. Industry Workshop**

The RAs will hold a Combined Workshop to discuss this paper and the Operations Paper in Dublin on 7<sup>th</sup> November. It is also anticipated that the initial results of the transporter modelling will be available at the workshop and we propose to discuss this on the day, especially in light of the impact it may have on our asset configuration decision.



## **Annex 1. CER Position on Regulatory Treatment of IC2 Investment Costs.**

### **Introduction**

The CER sets out below its position on the case for “stranding” IC2 investments costs, as mooted as a possible option in the joint CER/NIAUR CAG Consultation Paper on Transmission Tariff Methodology of 27 June 2008. This issue arises in view of the prospective decline in gas throughput as Corrib, and potentially Shannon LNG in due course, comes on stream. By “stranding” in this particular context we mean, in broad terms, that IC2 would no longer be underpinned financially by the network tariff regime and that BGN would in future only be remunerated to the extent that IC2 is actually used.

### **Background**

Ireland has two subsea interconnectors connecting the Irish market to Scotland. The first interconnector (IC1) was built in the 1990s while the second (IC2) was commissioned in 2003. The two pipelines connect to a single pipeline at Brighthouse Bay in Scotland. In addition the Scotland to Northern Ireland Pipeline was built in the late 1990s which connects to the BGN interconnectors at Twynholm in Scotland and lands in Northern Ireland at Ballylumford.

At present around 92.5% of the gas used in Ireland is transported across the interconnectors (ICs). The tariffs on the ICs are calculated by taking the BGN allowable annual capital revenues and dividing by the projected flow for the year; this gives a capacity and commodity tariff<sup>11</sup>. These allowable revenues are set by the CER as part of the general multiannual transmission tariff revenue reviews carried out by CER (to date covering 2003-2007 and 2007-2012). These reviews have not differentiated between the interconnectors and the onshore system for the purpose of determining the regulatory *status* of the asset base (the “RAB”) or the weighted average cost of capital (WACC) to be allowed on this RAB. In other words, the ICs were treated as no different to the onshore system for the purpose of determining aggregate allowable revenues. [The fact that tariffs are subsequently set on a separate entry/exit is a different question].

The arrival of new indigenous and diverse gas sources in the future is expected to result in a lower utilisation of the ICs. The first impact is expected in late 2009 with the arrival of the Corrib field. Under current regulatory practices, once IC utilisation decreases the per-unit tariff would increase as the allowed revenues remain the same, but will be divided by a smaller flow volume.

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<sup>11</sup> This process is documented in the recent Annual BGN Transmission Allowed revenues and Tariffs Decision Paper CER/08/151

This was recognised as an issue previously in the last CER BGN Price Control in 2007. Since then, it has been suggested by some market participants that the CER should no longer require the general transmission customer to effectively underwrite IC2. Either the original investment was a bad decision, the argument runs, or BGN should in any event have to live with the risk of it becoming stranded at some stage in the future just in the same way as, say, offshore gas developers have to live with the risks associated with their investments in gas production facilities.

The CER has considered this issue by reference primarily to two considerations:

- the background facts
- the regulatory principles arising

### **The Background Facts**

The CER has corresponded with the Department of Communications, Energy and Natural Resources on the background to the original 2001 Government decision to invest in IC2 which, of course, predated the extension of the CER's regulatory remit to the gas sector<sup>12</sup>. The CER has also carried out its own research on the matter. A copy of a DECNR letter to the CER of 12th August 2008 is appended to this memorandum.

From this correspondence and our research the following essential facts emerge:

- The decision to invest in IC2 was made with the approval of the Government of 20 February 2001
- The background information and the lead up to the decision to construct was documented in the Gas 2025 Project Close Out Report and Review (available on the DCENR website)
- The decision and the Government approval were expressly grounded on security of gas supply considerations, and short term security of supply in particular
- The conditions attaching to the Government decisions have either been met or have been overtaken by events
- The decision to invest was made following quite extensive research and input by a number of advisory bodies and (e.g. ESRI, Forfas)
- The discovery of the Corrib field was known at the time, though there was a uncertainty over its size, extraction rate and likely timing of coming on shore

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<sup>12</sup> The CER's regulatory remit in the gas sector was established with the enactment of the Gas (Interim) (Regulation) Act 2002.

- One firm of advisors to the then Minister did carry out a risk analysis, or “what if” study of the project. It acknowledged the risk of stranded asset and advised that any major capital investment in IC2 be “delayed pending clarification of the position concerning the Enterprise gas discovery”. To our knowledge, however, it did not go so far as to recommend *against* the project.

The decision to invest in IC2 predated the current Directive 2003/54/EC which, among other things, introduced the concept of a “designated TSO” with the corollary responsibilities of operating and developing etc. a transmission system in a Member State or part thereof. The then prevailing EU rules were set out in Directive 98/30/EC which mainly confined itself to setting out certain duties (non-discrimination etc.) on the part of “gas undertakings” such as storage or network operators, or suppliers etc. The 1998 Directive did not really go into *positive* duties of individual “designated” operators etc. It is worth noting here in passing that the EU regime on market liberalisation does not differ between gas and electricity in terms of recognising the natural monopoly characteristics of system operation and the right and duty of Member States to “designate one or more transmission system operators...” in their territory.

For practical purposes, however, it is reasonable to see BGN’s 2001 decision to invest in IC2 as that of a *de facto* TSO. There was no other entity in existence at the time with either the capacity or the statutory remit to plan for how to meet Ireland’s future gas requirements. BGE was acting within its domestic statutory remit. It was charged by the Gas Act, 1976 “to develop and maintain a system for the supply of natural gas being a system which is both economical and efficient”. In Ministerial Order, S.I. 283/1987, it was granted the express power “to supply, transmit, distribute and sell gas within a given area”.

In summary, the CER has inherited a Government approved decision for the *de facto* Irish gas TSO to invest in IC2 on the express grounds of national security of gas supply.

### **Regulatory Principles**

As a general principle, an economic regulator should not allow major regulated infrastructural investments that have received prior approval to be subsequently stranded unless there are very special circumstances or compelling reasons for doing so. Apart from any question of fairness, this creates considerable uncertainty and sends a bad message to potential investors. The fact that the investment in the present case was approved, or even mandated, by Government on the grounds of security of supply would add further to the case that the CER

should be wary of stranding IC2 simply on the grounds that its contribution to national security of supply will now become less significant by virtue of Corrib coming on stream.

There is also an issue of consistency in regulatory treatment of IC2 arising here. CER has to date treated BGE as a *de facto* monopoly operator in the two multiannual price controls to date - akin to ESB Networks as networks asset owner in the electricity sector. This is reflected in the allowed cost of capital (WACC) and, in particular, in the setting of the risk premia. The WACC assumed there was little or no regulatory risk of the assets (onshore or ICs) being stranded. Were it now to emerge that, contrary to this assumption, there is the clear prospect of unused IC capacity now being stranded by the regulator, then at the very least there would be an onus on CER to revisit the earlier WACC calculations and retrospectively "correct" them upwards, with obvious tariff repercussions for end customers

Even if CER were to base its regulatory treatment of IC2 on the benefit of hindsight - which it is not proposing to do - it is by no means clear that this would strengthen the case for stranding IC2. IC2 has been in use now for a number of years and provides a number of key benefits to both gas and electricity customers in Ireland. One of the reasons why the building of IC2 was criticised by some was the fact that Corrib was due to arrive and the second IC would not be needed. At the time of the decision Corrib was expected to be operational from 2003. The latest projected operational date for Corrib is now late 2009 - some six years later than expected. During this time the capacity provided by IC2 has allowed the gas industry to develop without constraint. On the electricity generation side, there have been a number of substantial sized gas fired power stations commissioned since IC2 was built. There are currently two 400MW CCGT plants in construction and several other gas fuelled generation projects either under active development or at an advanced planning stage. It is hard to see that all these projects would be where they are today without IC2.

In passing, these security of supply benefits from IC2 are not confined to customers in the Republic of Ireland. Customers in Northern Ireland also benefit. Their security of gas supply is enhanced by the recently completed South North pipeline which, in turn, could not have been contemplated without IC2.

Lastly, regarding a possible argument that underwriting IC2 would discriminate unfairly against offshore gas developers or Shannon LNG, it is important to bear in mind that BGN was not, and still is not, a gas producer. It is a network operator and it was in that *de facto* capacity that it invested in IC2. This differentiates the IC2 project from, say, the Corrib or Shannon LNG projects. The IC2 project is relying exclusively on a regulated tariff revenue stream to remunerate the investment. Corrib/Shannon LNG are commercial ventures whose remuneration

will depend on gas sales alone. Moreover, as TSO, BGN has a statutory duty to develop the gas transmission system to cater for future demand, which the developers of the other projects do not.

All of this is not to suggest that a gas developer such as Corrib is in any way “responsible” for the prospective reduced IC2 utilisation. It is not. The Corrib project is very welcome. There should be no question, for example, of discriminating against customers who offtake gas from Corrib (or Shannon LNG) as opposed to the ICs or attempting to discourage them from doing so through the network tariff regime. These tariff design questions are being considered separately under the Common Arrangements for Gas (CAG) consultation exercise being conducted jointly by CER and NIAUR.

### **Conclusion**

For the reasons set out above, the CER does not see stranding IC2 investments costs as an acceptable means of mitigating any tariff implications of expected reduced IC2 throughput in the coming years, whatever those implications may turn out to be. Any mitigation measures taken must, however, be efficient, fair and proportionate. This issue is being addressed within the CAG forum.



An Roinn Cumarsáide,  
Fuinnimh agus Acmhainní Nádurtha  
Baile Átha Cliath 2.

Department of Communications,  
Energy and Natural Resources,  
Dublin 2.

12 August 2008

Mr. Denis Cagney,  
Commission for Energy Regulation,  
The Exchange,  
Belgard Square North,  
Tallaght  
Dublin 24.

DIN NO. 37043

FILE NO. 071-01-152

ACTIONED BY: DC

DATE RECEIVED: 13 Aug 08

**Re: Construction Decision IC2**

Dear Denis,

I have carried out a trawl through the files that relate to the Government approval for the construction of a second Scotland-Ireland subsea interconnector. In the following paragraphs, I set out the basis for the decision for IC2 which was made at the Government meeting of 20<sup>th</sup> February 2001.

- (a) The Government approved, in principle, the construction of a second Scotland-Ireland subsea interconnector to proceed immediately in order to ensure continuity of gas supply in Winter 2002/2003, on the basis that the pipeline will be commenced by Bord Gais Eireann (BGE), and that ownership of the project will be subject to private sector participation at a level yet to be determined, in a transparent public process;
- (b) The Government agreed that the approval, at (a) will be subject to-
  - proceeding directly to liberalisation of the market for gas supply
  - fulfilling statutory requirements
  - Department of Finance approval for BGE's capital expenditure and
  - examination of the necessity for non-exchequer funding to reflect the security of supply value of the interconnector
- (c) The Government approved, in principle, the construction of spur pipelines to the North, North West and North East;
- (d) The Government agreed that, subject to the agreement of the Attorney General, gas transmission tariffs will be based on the principle of postalised (geographically uniform) tariffs for gas transmission on-shore and that there should be separate tariffs for supply/import pipelines; and

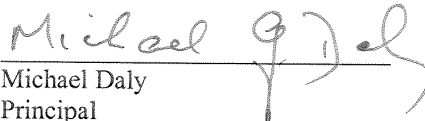
- (e) The Government agreed that the question of the efficient application of postalised tariffs to all gas consumers should be considered by the interdepartmental group chaired by the Secretary General to the Government, which had examined the interconnector proposals.

As you will be aware the proposal to involve private sector participation did not proceed as preliminary studies indicated that the proposal was not feasible.

As mentioned to you there is also the Agreement between the Government of Scotland and the United Kingdom of Great Britain and Northern Ireland relating to the transmission of Natural Gas by a second pipeline between Ireland and United Kingdom of Great Britain and Northern Ireland and through a connection to the Isle of Man. A few of the Articles of the Agreement also impact on the determination of interconnector charges for the provision of this facility.

Please feel free to contact me should you require any further clarification or elaboration.

Yours sincerely,

  
Michael Daly  
Principal  
Electricity and Gas Regulation Division