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19 August 2008

Dear Clive,

CAG – TRANSMISSION TARIFF METHODOLOGY AND REGULATION IN IRELAND AND NORTHERN IRELAND

Thank you for this opportunity to contribute to the above consultation. Please note a copy of our response (see attached) has also been passed to Richard Hume (NIAUR), and this includes a summary comment against each of the consultation's questions within Annex A.

By way of background, Viridian Power & Energy Ltd, under its independent energy supply arm 'Energia', is Ireland's largest independent energy supplier with over 35,000 customers. We own two natural gas power stations at Huntstown capable of supplying 747MW of power into the Irish grid (about 20% of the total demand for Ireland). Our growing renewable business unit, with interests in Northern Ireland (NI) and the Republic of Ireland (RoI), has an extensive pipeline of projects at various stages of development. As such, we have a strong vested interest in developing a pro-competition tariff methodology that is capable of providing a platform for change and thereby capitalise on the all-island reform opportunities.

The challenges for Ireland and Northern Ireland, particularly securing investment and the security of supply issue, are common to both jurisdictions. The continuing dependency on Great Britain's (GB) wholesale gas market, and exposure to high wholesale energy costs, as well as dealing with environmental change, make it essential for closer collaboration between the two. We therefore welcome this consultation.

The subject matter is complex, requiring very careful consideration, and we are therefore making our submission in two parts. The first part deals with our high-level view and perspective on an all island framework for transmission tariffs, as such it sets the markers for change. The second submission will underscore these change markers with research being undertaken by POYRY Energy Consulting, focusing on the particular issues faced by Shippers, Suppliers and their customers. As such, this will provide further insight to the core issues, dealing in particular with:

- Capacity/commodity split: what should be the appropriate balance?
- Entry/Exit: what is the right framework?
- Interconnector utilisation: what are the market issues, and how they should be addressed?

We therefore anticipate drawing further from these key themes within the next three to four weeks. However, for this submission and as already mentioned above, we lay down the core markers for change. In doing so, we reserve the right to modify these views in the light of additional information made available by POYRY Energy Consulting.

Fragmented markets lead to additional costs, potential barriers to effective competition, and a market that becomes frustrated through an inability to innovate. Some change is therefore inevitable, but our thrust remains a pragmatic one.

The island of Ireland currently has a common gas commodity price, and inevitably this drives the gas markets to focus predominantly on more efficient transmission pricing. However, the benefits of integration must be demonstrated to outweigh the costs of implementing any integrated pricing regime.

Gas fired electricity generation remains one of the largest consumers of gas on the island, with around 45% driving the island's generation requirements in 2007[1]. Natural gas has the lowest carbon intensity of any fossil fuels readily available in the market and, as such, provides not just the primary electricity generation needs for the island, but is the natural choice to meet the strategic back up generation requirements, especially with the prospect for much greater reliance on renewable energy on an all-island basis.

The market framework must therefore be geared to ensure that natural gas generation is promoted over other more carbon intensive fuels in developing a sustainable energy future across the island. In this context, VPE consider flexibility of gas tariff pricing to be a primary consideration if the right signals are to be sent to promote a sustainable competitive energy market on the island.

However, the recent trend from power plant developers has been to eschew gas as a fuel for new flexible generation plant, and to choose distillate fuel instead. The primary reason for this development has been the inflexible pricing of gas transportation capacity and the inability to

[1] In Great Britain this is around 35%

recover fixed gas transportation costs under the new Single Electricity Market (SEM) rules. Continuation of this trend will have a significant impact on the future projected gas demand on the island of Ireland.

Whilst a 'one market' philosophy and operational regime is the ideal, we must accept also the challenges that lay ahead when dealing with two quite distinct jurisdictions. It is against this backdrop we make the following initial submission.

Yours sincerely

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COMMON ARRANGEMENTS FOR GAS

TRANSMISSION TARIFF METHODOLOGY AND REGULATION IN IRELAND AND NORTHERN IRELAND

An Initial response from Viridian Power and Energy Ltd (19 August 2008)

1. INTRODUCTION

We start from a position that a cost reflective tariff methodology provides the right signals and incentives for the efficient development and management of networks, and that flexible gas tariffs will promote a more efficient energy market on the island of Ireland. Security of supply, sustainability through diversity, and effective competition requires targeted and timely investment. We therefore welcome the RAs commitment to ensure 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*"[2].

The Island of Ireland is, and will remain, heavily dependent upon Great Britain (GB) for its Natural Gas supply (in 2007 imports represented 93% for Ireland and 100% for Northern Ireland). In turn, the island of Ireland is increasingly exposed as GB becomes ever more dependent upon imports from Europe (UKCS is now at 85%).

Corrib will provide a rest bite for a few years, and perhaps LNG at Shannon and the proposed salt cavity storage at Larne, may also provide a hedge. However, the physical delivery of LNG at Shannon will depend on prices and global market dynamics.

Gas storage on an all-island basis is an important factor, and securing the right sort of commercial incentives and signals will be important in helping to drive investment where it is most needed. This has been successful in Great Britain (e.g. Rough), which is helping it to achieve its 13 days of gas storage.

The electricity system in Ireland is highly dependent on gas as an input fuel (for example, in 2006/07 Ireland's power generation was responsible for 65% of total gas consumption[3]) and the policy in both jurisdictions to promote a high level of renewable electricity generation on the island is the only reasonable prospect to reduce this dependency[4]. Also, the variable nature of renewable energy resources (primarily wind as the cheapest source) will have a significant effect on existing gas fired generators and their gas consumption.

The future all-island gas pricing will therefore need to factor in these important new all-island market dynamics, and it is against this backdrop that we first consider the consultation's four assessment criteria against which the reform options are considered, namely:

- Development of the gas industry
- Protection of consumers

[2] Common Arrangements for Gas Project, Preliminary Cost Benefit Analysis – 30 July 2008.

[3] See Report on Ireland's Security of Supply in Electricity (dated July 2008)

[4] Ireland's Government target for power generation is 50% BY 2020

- Security of Supply; and
- Promotion of competition

Our analysis suggests the above criteria are problematic in two key respects: the absence of any environmental criteria, and the outputs against these four criteria are, in some cases, too narrowly defined.

Environmental considerations serve to highlight the increasing interdependency between gas, electricity and renewables. We note, natural gas has the lowest carbon intensity of any fossil fuel readily available in the market and as such it provides not just the primary electricity generation needs for the island, but is the natural choice to meet the strategic back up requirement for renewable generation.

With regard to the outputs (following the criteria assessments), we note in particular the consultation's assessment that Postalisation provides 'significant' protection, predicated on the basis that it would produce the lowest tariffs and lowest price variability. However, taking a wider perspective on customer protection, i.e. acknowledging the risk of supply shocks through underinvestment, and we arrive at a more moderate assessment on protection. The consultation further argues that Postalisation leads to simplified tariff structures for customers. However, we find it hard to translate a single transmission tariff for Shippers/Suppliers into a more simplified end result for customers. The reality will be somewhat different.

We conclude, Postalisation is not the answer, particular in view of the significant complexity involved should it be adopted on an all-island basis and the resultant effective collapse of the IBP. Ultimately, customers will have to pay for the absence of market based signals that affect investment decisions and efficiency, leading to an increased risk to security of supply.

For these reasons, we believe an Entry/Exit model is much preferred, underpinned by a marginal cost philosophy it results in a more market responsive and network efficient outcome. However, we do not disregard the obvious political and jurisdictional issues that exist, and we accept the need for pragmatism.

We face significant challenges in the years ahead. Securing the delivery of sustainable and flexible energy networks will be critical in meeting the increasing energy demands[5] and in a manner that delivers the Security of Supply and environmental objectives to meet the longer term aspirations of an all-island market.

Whatever short-term fluctuations occur, and whatever regulatory action is taken, the era of cheap energy is surely over, and cost reflective pricing at least provides important market signals that help support the key energy policy drivers.

[5] For example, Ireland electricity network projections indicate an annual increase of up to 3.6% for the period to 2014., and electricity generation in 2007 came from over 62% using natural gas (see report on Ireland's Security of Supply of Electricity.)

2. ENTRY & EXIT REFORM

As we outlined above, we strongly believe that a cost based market decision model is by far the better outcome for the island of Ireland. Consequently, we see strong benefits flowing from an entry/exit model, and are not in favour of a postalised model per se.

The consultation argues that postalisation would have a positive impact on the development of the gas industry. A view we would largely refute. Network growth will inevitably continue to be strongly regulated under a price control. As such, growth will be delivered by creating the right investment incentives for both Bord Gais Networks (BGN) and Phoenix Natural Gas Networks (PNGN). We see this continuing.

We also believe the consultation overstates the benefits that Postalisation brings in terms of protecting customers. This perspective takes a very narrow view on customer protection, and in so doing understates the 'protection' that customers will require from a sustainable energy policy. It is fortunate that Ireland and Northern Ireland have not faced any serious supply shocks, unlike the authorities in the western Indian state of Maharashtra which have recently announced tough measures to deal with a power crisis. The state's 250,000 industries will now get power only five days a week and malls and government offices have been told to reduce energy consumption.

These are the harsh realities of underinvestment, and it takes political will and foresight to drive through change to ensure that customers across the island of Ireland are able to continue to rely upon an energy policy that strikes an effective balance between prices and efficient investment to safeguard their future.

We agree with the RAs view, moving towards a fully postalised system on an all-island basis would be complex to manage, with particular difficulties arising from the harmonisation and sharing of revenues across the two jurisdictions. Notwithstanding the obvious currency issues that are solvable, but will nonetheless require management. There are several disadvantages of Postalisation – it provides no price signals and it destroys the ability for a market to generate efficient practices. This is not advisable in the longer term interests of an all-island market.

However, an Entry/Exit model has two main advantages: it enables shippers to book capacity in a more flexible manner and at less risk, and second the formation of a balancing point offers more choice for sourcing gas. It will also support a sustainable energy policy through:

- **Security of Supply:** by encouraging further producer investment
- **Competition:** by supporting improved market liquidity, and stimulating new entrant, and increasing market liquidity.

- **Efficient networks:** transmission access will depend on the cost associated with that entry point and appropriate allocation of risk.
- **Focused and timely delivery:** developing networks in an economic and coordinated manner.

These are the measures that will best serve customers longer term interests.

There is a downside, namely the amounts of capacity could in theory be reduced and potentially there is greater administrative difficulty in scheduling the system. However, these downside effects are significantly mitigated in that ROI is already based on entry/exit principles with an entry tariff that distinguishes between entry points, and for NI, the legislative preparation could be undertaken to prepare for the future.

An Entry/Exit Regime on an all-island basis is certainly possible, providing we are pragmatic, and build upon the foundations that already exist. Our approach is thus evolutionary, not revolutionary.

For these reasons, we advise against unnecessarily and arbitrarily increasing the number of entry and exit points - the formation of new entry points must be based upon whether the extra transparency and therefore cost reflectivity is justified. For example, Corrib, Shannon and Larne could quite credibly be nominated as additional entry points.

With regard to Exit points, we are persuaded to maintain the two existing exit points, one in the North and one in the South. Our view is this would allow charges to reflect the different regulatory policies and assets in the two jurisdictions. For example, some protection to customers in the North could be provided by adjusting the exit prices in that jurisdiction. Equally, separate jurisdictional exit prices might reflect the sharing effects from the improved security of supply measures that flow from an all-island market. Noting in particular that, tariff price increases are inevitable in the NI market as SNIP reaches full capacity and the marginal price of gas then flows from interconnectors and the North-South pipeline.

We therefore make the following recommendations:

- **a separate entry point:** this represents the no change position, but allows for new entry points as each new gas source arrives; and
- **two exit points**: this will help alleviate the risks to Northern Ireland in having to bear some of the costs, e.g. IC under utilisation in the South.

We also submit that amalgamating SNIP and the southern ICs into a single Moffat Entry Point should not be ruled out and warrants further analysis. This may help alleviate some of the short term under utilisation difficulties that are anticipated with the Southern ICs - by smearing the effects.

This approach aligns the all-island market with the strong steer being given by the European Commission towards entry/exit models. It avoids the retrograde step of Postalisation and brings us a step closer to a harmonised European market place, and the transparency benefits that will flow by adopting a transmission tariff methodology that is in common with the more competitive European markets.

We understand that in the short term, some customers may be impacted through increased prices, and whilst we argue these measures are in the longer term interests of all customers (present and future), there are steps that can be taken to ease the pressure on these customers, such as a dual jurisdictional exit model. We also comment below on how a more flexible transmission tariff model will help.

3. CAPACITY AND COMMODITY CHARGES

The consultation considers the appropriate split, citing the differences between the North and South and poses the question on the appropriate split including whether a harmonised 80/20 split might be a way forward.

We argue that, setting the correct flexible gas market framework, i.e. the appropriate balance between capacity and commodity, is of fundamental importance on two counts: security of supply and environmental grounds.

As we have already noted in this response, gas fired electricity generation remains one of the largest consumers of gas on the island (e.g. meeting around 65% of Ireland's generation needs in 2006/07). Natural gas has the lowest carbon intensity of any fossil fuels readily available in the market and, as such, it provides not just the primary electricity generation needs for the island, but is the natural choice to meet the strategic back up for renewable generation requirements.

With the prospect for much greater reliance on renewable energy on an all-island basis, it is important the market framework is geared to ensure that natural gas generation is promoted over other more carbon intensive fuels in developing a sustainable energy future across the island.

Unless steps are taken, the prospects do not look good. We note a recent trend from power plant developers has been to eschew gas as a fuel for new flexible generation plant, and to choose distillate fuel instead. The primary reason for this recent development has been the inflexible pricing of gas transportation capacity and the inability to recover fixed gas transportation costs under the new Single Electricity Market (SEM) rules. Continuation of this trend will have a significant impact on the future projected gas demand on the island of Ireland.

The all-island market thus represents a set of unique challenges. This requires a flexible gas transmission charging model with the right capacity to commodity split to ensure that market signals are properly focused. Settling on an 80/20 split may not be the right answer, for example, the consultation notes the capacity to commodity range varies across Member States, and we observe that in GB, a 65/35 capacity to commodity split has been adopted.

VPE therefore concludes there is a strong case for adopting, on an all-island basis, the NI split (75/25), or even the GB split of 65/35. We note this will provide stronger market signals to gas fired electricity generators, and also better equip the market in targeting future investment. The distributional customer effects will also provide some additional protection to smaller usage customers during what inevitably will be a very difficult and volatile global energy backdrop.

Following analysis by POYRY Energy Consulting, we anticipate responding further on this subject in our second submission, including whether the 80/20 split would be an effective compromise. In the meantime, we have no doubt that a shift towards a greater commodity component will improve market and investment signals.

4. INTERCONNECTOR UTILISATION

We are concerned that by linking the under utilisation of the interconnector with the other CAG reform issues, may lead to a public perception of the increased costs being a consequence of the all-island reform measures. This is not only misleading, but reduces transparency on costs and benefits. We therefore recommend this matter be dealt with and consulted upon outside of the Transmission Tariff Methodology review. In the meantime, we make the following observations on this critical issue.

The consultation argues for mitigating action to counter the effects on the marginal cost pricing system of under utilisation of the Interconnector. A range of options are then set out, including:

- Establishing a PSO levy to defray some of the costs.
- Buying down some of the costs through changing the Regulatory Asset Base (RAB) by moving or suspending some of the asset value during the trough in consumption.
- Cutting the allowed rate of return.
- Reprofiling (averaging out the trough in consumption).
- Setting a minimum booking level (filling in the trough).
- Reducing the depreciation level during the trough in consumption.

We have two key concerns with the above intervention measures. First, this interference may well have unintended consequences the impact of which may not materialise for months or even years. Second, regulatory intervention in this manner introduces additional regulatory uncertainty and therefore risk into the market, and this will affect future investment decisions.

Moreover, to intervene in this manner would run counter to the CAG objective, namely: *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"*[6] It therefore seems perverse to forward an interventionist policy.

However, whilst a non interventionist policy is better market orientated, i.e. it may give producers an incentive to deliver gas to the market and to invest in new opportunities (noting the effect expires in 2018), we accept that producer gains cannot be totally unfettered to the significant detriment of customers - a balance must be struck. But, to artificially massage the marginal cost pricing system by adopting any of the above measures without refinement would simply be wrong.

We have asked POYRY Energy Consulting to review this aspect of the review in more detail and hope to respond further in due course. In the meantime, we strongly recommend this matter be dealt with outside of CAG.

5. TARIFF SMOOTHING

Whether to adopt the accounting based approach as in Northern Ireland, or the smoothing approach in Ireland, is of second order importance to the main issues for CAG. We recommend this be deferred for future review, subject to progress being made on the core issues.

6. NON - ANNUAL GAS CAPACITY PRODUCTS

The consultation sets out as a minimum a range of potential non-annual gas capacity products, noting that not all are available in both jurisdictions; these are:

- Short term Products
- Inventory Products
- Interruptible Products
- Storage Tariffs
- Reverse Flow/Backhaul Tariffs

This review represents an ideal opportunity to fully implement Regulation EC 1775 with regard to non-annual gas products.

The availability of all the above products on an all-island basis would be a good start. We therefore encourage CAG to develop and implement a range of 'within day' and 'day ahead'

[6] Common Arrangements for Gas Project, Preliminary Cost Benefit Analysis – 30 July 2008.

products. However, they should be sensibly priced such that Shippers are not deterred from using these products.

7. ENTRY AUCTIONS

Adopting Entry Capacity Auctions on an all-island basis would seem to be of little benefit. Rather, it introduces unnecessary market complexity and cost. In the case of Northern Ireland, in the interests of harmonisation and a coherent all-island gas transmission tariff methodology, we question why the consultation should even ‘propose’ to allow Northern Ireland to introduce entry capacity auctions at SNIP.

Given the present state of capacity under utilisation at SNIP and IC1/IC2, there appears to be no rationale for doing so, especially if a single Moffat entry point proves to be of benefit. We therefore recommend this be deferred pending a clear direction on the overall transmission tariff methodology.

ANNEX A – Consultation Questions

Please note, we have provided just summary comments to the questions set out below. Referral back to the main document is therefore necessary to understand the full basis for our recommendations.

1. **Have we adequately described the differences/commonalities between the two markets?**

   Response: *Yes*

<u>**Chapter 3 – Assessment Criteria**</u>

2. **Do you feel that all the relevant criteria have been covered in this document and are there other criteria you feel should be included?**

   Response: *our analysis suggests the above criteria are problematic in two key respects: the absence of any environmental criteria, and the outputs against these four criteria are, in some cases, too narrowly defined.*

   We note that natural gas provides not just the primary electricity generation needs for the island, but is the natural choice to meet the strategic back up requirements for renewable generation.

   With regard to the outputs (following the criteria assessments), we disagree with the Postalisation assessment that it provides 'significant' protection.

3. **Do you have a view in relation to the priority of the criteria and whether some criteria should be considered more important than others?**

   Response: *we advise against defining any particular weighting, since this would require significant analysis in order to arrive at a balanced outcome. At best, it would be subjective and open to challenge.*

<u>**Chapter 4 – Reform Options**</u>

4. **Do you feel we have adequately represented the appropriate reform options at Entry and Exit? What further reform options do you feel warrant further investigation?**

   Response: *we believe the main reform options have been identified*.

5. **In relation to mitigating the effect of declining interconnector utilisation, have all the viable options been set out? What option do you feel is missing? What level of price incentive, if any, do you feel is an adequate signal to incentivise indigenous gas production/storage?**

   Response: *we believe the 'do nothing' option has not been fully explored in terms of its effects on competition, markets and on investment. We advise against regulatory intervention, but accept that a form of cap should be introduced in the event IBP prices significantly exceed a rational market value. We are undertaking further analysis and hope to provide further information in our second response.*

6. **Do you think we should harmonise the capacity/commodity split?**

   Response: *setting the correct flexible gas market framework, i.e. the appropriate balance between capacity and commodity, is of fundamental importance on two counts: security of supply and environmental grounds.*

   Natural gas has the lowest carbon intensity of any fossil fuels readily available in the market and, as such, it provides not just the primary electricity generation needs for the island, but is the natural choice to meet the strategic back up for renewable generation requirements.

   With the prospect for much greater reliance on renewable energy on an all-island basis, it is important the market framework is geared to ensure that natural gas generation is promoted over other more carbon intensive fuels in developing a sustainable energy future across the island.

   We note a recent trend from power plant developers has been to eschew gas as a fuel for new flexible generation plant, and to choose distillate fuel instead. This does not bode well for the future.

   VPE therefore concludes there is a strong case for adopting, on an all-island basis, the NI split (75/25), or even the GB split of 65/35. We note this will provide stronger market signals to gas fired electricity generators, and also better equip the market to target future investment.

   We will respond further on this issue in our second response.

7. **Do you think we should aim to harmonise non annual gas capacity products? What products do you feel should be available?**

   Response: *we do not argue for harmonisation for its own sake, but for increased product flexibility. In this regard, we are seeking appropriately priced 'within day' and 'day ahead' products on an all island basis.*

Chapter 5 – Assessment

8. **Do you feel we have adequately described Postalisation under the selected criteria?**

   Response: *in part yes, however we believe the consultation overstates the benefits that Postalisation brings in terms of protecting customers. This perspective takes a very narrow view on customer protection, and in so doing understates the 'protection' that customers will require from a sustainable energy policy.*

9. **Do you feel that Postalisation is a viable option for the harmonisation of transmission tariffs in the two jurisdictions?**

   Response: *absolutely not. Postalisation is not the answer, noting in particular the significant complexity involved should it be adopted on an all-island basis and the effective collapse of the IBP. Ultimately, customers will have to pay for the absence of market based signals that affect investment decisions, efficiency, and lead to an increased risk to security of supply.*

10. **How should we deal with revenue transfer between the two jurisdictions under postalisation?**

    Response: *we do not support a Postalisation model, but intuitively we would expect this to be complex and very time consuming to get right. If taken forward, it should be managed under the auspices of the price control mechanisms. However, the market consequence of potentially getting it wrong could be significant.*

11. **How should we deal with the currency risk arising from the Postalisation option?**

    Response: *we do not support the Postalisation option. However, the SEM provides a model for dealing with currency risks.*

12. **Do you feel that we have adequately described the entry options under the selected criteria?**

    Response: *yes, we support the 'no change' entry/exit model across the two jurisdictions, adding new entry points as they arise. As such, Northern Ireland would adopt a single Entry model.*

13. **How should we deal with the revenue transfer between the two jurisdictions under the relevant options?**

    Response: *adopting a dual exit point (North and South) should help alleviate the need for significant revenue transfer between the two jurisdictions. Otherwise, it should be dealt with under the price control mechanism*.

14. **How should we deal with currency risk arising from the above options?**

    Response: *further analysis would be required, but we suspect that under our chosen entry/exit option (see main response), the dual exit approach will help alleviate these risks.*

15. **Do you feel that we have adequately described the exit options under the selected criteria?**

    Response: *yes*

16. **How should we deal with revenue transfer between the two jurisdictions under the single exit option?**

    Response: *further analysis would be required, but we suspect that, under our chosen entry/exit option (see main response), the dual exit approach would allow exit prices to reflect jurisdictional differences and allow for revenue transfer balancing.*

17. **How should we deal with currency risk arising under the existing exit option?**

    Response: *further analysis would be required, but we suspect that under our chosen entry/exit option (see main response), this should be mitigated. Otherwise, the SEM provides a model to manage the risk.*

18. **Should there be any attempt to mitigate the effect of declining utilisation of the interconnectors?**

    Response: *in principle 'no'. We have two key concerns with any intervention. First, this interference may well have unintended consequences the impact of which may not materialise for months or even years. Second, regulatory intervention in this manner introduces additional regulatory uncertainty and therefore risk into the market, and this will affect future investment decisions.*

    Moreover, to intervene in this manner would run counter to the CAG objective, namely: "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"*[7] *It therefore seems perverse to forward an interventionist policy.*

However, we accept that producer gains cannot be totally unfettered to the significant detriment of customers - a balance must be struck, and we have therefore asked POYRY Energy Consulting to provide further insight on this matter and we hope to respond further in due course.

In the meantime, we strongly recommend this matter be dealt with outside of CAG to allow for a fuller consideration of all the issues.

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19. Do you feel that we have adequately described the relevant options under the selected criteria?

Response: *we would prefer for the interconnector utilisation to be dealt with outside of CAG. We are undertaking further analysis and will respond further on this issue.*

20. Do you feel that we have adequately described the option of harmonising capacity & commodity charges under the selected criteria?

Response: *we had hoped for a more detailed critique. We have set out our views that improved market signals and investment would arise from a greater commodity component. However, we are undertaking further analysis and will respond further on this issue*.

21. What is an appropriate level at which to harmonise?

Response: *we argue that, setting the correct flexible gas market framework, i.e. the appropriate balance between capacity and commodity, is of fundamental importance on two counts: security of supply and environmental grounds.*

Natural gas has the lowest carbon intensity of any fossil fuels readily available in the market and, as such, it provides not just the primary electricity generation needs for the island, but is the natural choice to meet the strategic back up renewable generation requirements.

With the prospect for much greater reliance on renewable energy on an all-island basis, it is important the market framework is geared to ensure that natural gas generation is promoted over other more carbon intensive fuels in developing a sustainable energy future across the island.

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[7] Common Arrangements for Gas Project, Preliminary Cost Benefit Analysis – 30 July 2008.

We note a recent trend from power plant developers has been to eschew gas as a fuel for new flexible generation plant, and to choose distillate fuel instead. This does not bode well for the future.

VPE therefore concludes there is a strong case for adopting, on an all-island basis, the NI split (75/25), or even the GB split of 65/35. We note this will provide stronger market signals to gas fired electricity generators, and also better equip the market to target future investment.

We will respond further on this issue in our second response.

22. Do you agree with our analysis of the applicability of auctions?

Response: *broadly yes, we do not believe an entry capacity auction is necessary, and certainly not solely for Northern Ireland.*

<u>Chapter 6 – Next Steps</u>

23. Do you agree with our selection of viable options for further analysis?

a. What additional options should be included for further analysis and why?
b. What options should be excluded from further analysis and why?

Response: *it is important to narrow the field of analysis in order to focus effort on the critical issues. We therefore recommend discounting Postalisation (does not support a competitive market and of questionable protection to customers), and a single entry and exit model which would lead to a reduced market transparency, and have significant jurisdictional issues to contend with – not achievable by 2010) .*

24. Which is your preferred option for entry/exit?

Response: *please see main body of response. We recommend adopting the Entry and Exit model that is already in place for both Ireland, and adopting a similar basis for Northern Ireland. This will grow as new sources come on stream. For example, Corrib in the South, Shannon to the West, and Larne in the North.*

25. Which is your preferred option for mitigating the effect of declining interconnector utilisation?

Response: *we have two key concerns with any intervention. First, this interference may well have unintended consequences the impact of which may not materialise for months or even years. Second, regulatory intervention in this manner introduces additional regulatory uncertainty and therefore risk into the market, and this will affect future investment decisions.*

Moreover, to intervene in this manner would run counter to the CAG objective, namely: "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"[8] It therefore seems perverse to forward an interventionist policy.

However, we accept that producer gains cannot be totally unfettered to the significant detriment of customers - a balance must be struck, and we have therefore asked POYRY Energy Consulting to review this aspect of the review in more detail and hope to respond further in due course.

In the meantime, we strongly recommend this matter be dealt with outside of CAG to allow for a more considered and detailed consultation to take place.

8 Common Arrangements for Gas Project, Preliminary Cost Benefit Analysis – 30 July 2008.