Common Arrangements for Gas

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

AES Response

21st November 2008

Introduction

1. AES welcomes the opportunity to respond to the Draft Conclusions Paper on Gas Transmission Tariff Harmonisation in Ireland and Northern Ireland.

2. This is a complex area requiring a clear "roadmap" for evaluating the options. We agree with Shannon LNG that "*a robust set of principles for entry tariff design should first be established by the regulatory authorities……before evaluating the various tariff options*", although we would extent this to include exit tariffs.

3. In this draft conclusion paper the RAs have helpfully put their proposed roadmap on the table by establishing "*assessment criteria*" to compare the various options; Development of the Industry, Protecting Customers, Security of Supply, and Transparent and Practical Regime.

4. We have approached this issue (perhaps from a slightly different angle) by thinking about *what* the high level objectives for tariff design should be, and then by considering *how* these objectives might best be advanced. For guidance we have looked to energy policy and to statutory duties and come up with the following two high level objectives:

    - Protection of Gas Consumers, and

    - Economic Development of the Gas Industry.

5. These are similar to two aspects of the assessment criteria in the consultation paper although there is one notable difference; we have included the word "*economic*" to development of the gas industry to emphasis that development for the sake of development should not be the objective (avoidance of "*white elephants*").

6. Before setting out *how* we think these objectives might best be advanced, it is perhaps worth explaining what we understand by "*protection of consumers*". In our view, two things matter to gas and electricity customers; (i) "fair" and competitive prices and (ii) security of supply. If these aspects are properly addressed, customers are protected. Therefore, whilst the "*assessment criteria*" identifies security of supply separately from protection of consumers in the consultation paper, we consider the former to be a subset of the latter.

7. Now turning to the "*how*": In our view, both of the high level objectives identified above are best advanced if regulated gas transmission tariffs meet the following criteria ("*the how criteria*"):

    - Ensure "fairness" in the recovery and allocation of fixed network investment costs,

- Ensure static economic efficiency in the allocation of network investment costs and fixed operational costs (within each jurisdiction),

- Ensure dynamic economic efficiency for variable operational costs, and

- Facilitate effective competition in the upstream and downstream gas and electricity markets for the benefit of consumers.

8. There are off course other aspects of gas transmission policy and regulation which will influence the achievement of the high level objectives identified above. Examples would include connection policy and the tariff charging basis (the fixed and variable split) and required booking periods. These aspects are however not the subject of this particular consultation. The assessment criteria proposed by the RAs also includes "*transparent and practical*". We agree that this is important but in our view this too is second order at this stage.

9. The economic development of the gas industry and the protection of consumers will also be influenced by other government decisions; e.g. investment tax incentives or grants, public service obligations (PSOs) or international agreements regarding fuel supply or infrastructure investments. Again however, these factors are largely outside the scope of this consultation.

10. The rest of this paper considers each of the "*how criteria"* in turn with reference to particular proposed tariff structures.

Fair Recovery and Allocation of Investment Costs.

11. The investment costs for all existing gas transmission entry and exit pipelines for Ireland and Northern Ireland are sunk costs. These investment decisions, whilst taken by the pipeline owners, were finally approved by either governments and/or regulators. In these circumstances it is fair that pipeline owners continue to earn a regulated rate of return on their investments commensurate with the associated risk.

12. Although "fairness" is a subjective term, most people would likely accept that it is fair that decision makers (or whoever they represent) should bear the costs (and enjoy the benefits) of their decisions. Regulators and/or governments have statutory duties in regard to the gas industry and this will invariably lead to the requirement to approve regulated network investment decisions. These decisions are made on behalf of gas consumers and result in consumers becoming the underwriters because they must pay for the investment, on an on-going basis, irrespective of overall utilisation.

13. Network investments have already been made in both jurisdictions and these are being separately underwritten by gas consumers in each jurisdiction. In the

interests of fairness, this needs to continue; annualised investments costs should be clearly separated on a jurisdictional basis and charged accordingly[1]. This consideration, when taken alone, may point to the separation of both entry and exit tariffs on a jurisdictional basis, i.e. no combining of assets across jurisdictions into a single tariff, e.g. a SNIP/ICs combined tariff and/or a single all-island exit tariff.

14. It may also be the case that each jurisdiction wishes to retain the flexibility to independently develop their respective networks (both off shore and on shore). This too may point to the separation of both entry and exit tariffs on a jurisdictional basis.

15. However assets are physically connected across the two jurisdictions, both onshore and offshore via the SN and SNIP/IC pipelines respectively. Consumers in each jurisdiction will therefore enjoy the trade and security of supply benefits which flow from these interconnections. This fact should be taken into consideration when allocating the sunk investment costs of these interconnections. The consultation paper appears to consider this point for SNIP/ICs (by proposing a combined tariff as an option) but may have overlooked this for SN because a single combined exit tariff does not appear to be a "*minded to option*".

16. It should be possible to cater for this cross-jurisdictional utilisation on either an ex-ante or ex-post basis. Combining ex-ante (as least for SNIP/ICs) would clearly result in an unfair allocation of costs to Northern Ireland (NI) consumers, at least in the short to medium term. This could be addressed however by allocating an ex-ante correction via the NI exit tariff. Alternatively the assets and tariffs could be left separate with an ex-post correction via the RoI exit tariff. Although our understanding is likely to benefit from further analysis, we are presently minded to favor separate jurisdictional tariffs with an ex-post correction, for a number of reasons. Firstly, the correction would be based on actual flows and there would be no need to construe a notional and ex-ante "counterfactual". Secondly, dynamic economic efficiency can still be achieved from optimising flows after gate closure (see later).

Static Economic Efficiency.

17. We have made the argument thus far that gas consumers in each jurisdiction should bear the sunk investment costs for that jurisdiction and that there should be no cross-jurisdictional subsidisation (notwithstanding interconnector flows). We are minded, thus far, to favor separate jurisdictional entry and exit tariffs, because we think that this best ensures fairness in the allocation of sunk investment costs.

[1] This assumes the absence of a political and/or regulatory agreement to "merge" these obligations. At least theoretically, this should be possible and fairness could be ensured by a transfer payment to reflect the difference in valuations.

We now wish to address the issue of recovery of these fixed sunk costs and fixed operating costs *within* each jurisdiction.

18. Investment costs and fixed operating costs for gas networks do not vary with utilisation. They are fixed costs. These costs are spread across all gas consumers (based on demand) in the jurisdiction irrespective of which parts of the network they utilise[2]. Frontier Economics examined the issue of tariff design to recover sunk investment costs efficiently for the New Zealand electricity transmission network[3]. Their views below would also apply to gas transmission networks:

> *"With respect to existing network, increased usage involves little additional cost, as most cost is sunk. Therefore, static efficiency requires that prices for the existing network should seek to recover regulated revenue in a way that does not discourage network use"*, and
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> *"Hence, from a strategic efficiency perspective, the transmission pricing methodology should not create incentives for participants to reduce their use of the existing grid, because this would imply that transmission customers were changing their behavior in response to prices that did not reflect the incremental cost of using the network"*

We concur with these views. Consumers should only change their behavior (i.e. choice of gas producer or supplier) in response to prices that only reflect only differences in incremental costs. The allocation of fixed (and sunk) network costs should not cause consumers to change their behavior.

19. Static economic efficiency is very relevant for the recovery of IC costs. If there are separate entry tariffs for Inch, Corrib and perhaps Shannon LNG, this is likely to further discourage the use of the IC network. However gas consumers in the jurisdiction still cannot avoid the IC costs because the shortfall in recovery is likely to be included in a single exit tariff. Static economic efficiency would suggest that there should only be one combined entry tariff in each jurisdiction and one combined exit tariff. Differentiating entry tariffs will likely result in higher costs overall for consumers (after combining gas commodity and transmission costs) than would otherwise be the case, with the distortion resulting in value flowing to gas producers and/or suppliers rather than to consumers.

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[2] The consultation paper suggests that any under recovery from entry tariffs will be transferred to the exit tariff in the relevant jurisdiction.

[3] http://www.electricitycommission.govt.nz/pdfs/infopapers/infopdfs/pdfstr
ansmission/frontier-transmission-pricing-advisory-groups.pdf

20. There are also fixed operating costs for operating gas transmission networks. These costs do not vary with utilisation. Therefore the same arguments outlined above apply.

Dynamic Economic Efficiency.

21. We have thus far considered how best to allocate fixed costs from the standpoint of ensuring static economic efficiency. We will now consider variable transmission operating costs. We understand that these costs are gas pressure dependent and that they vary depending on which part of the network is used. For example, the ICs operate at a higher pressure that SNIP. This suggests that, where there is choice, e.g. between using SNIP and the ICs, then variable operating costs should be optimised.

22. We are not convinced however that dynamic economic efficiency can only be achieved by combining SNIP and IC into a single tariff. In our view the transmission system operator should be incentivised to optimise these variable operating costs and should have the authority to decide actual flows after gate closure. This would be similar to the role of the electricity TSO in optimising transmission constraint costs.

Facilitating Competition in Adjacent Markets.

23. It is widely recognised that gas (and electricity) transmission networks are usually natural monopolies that should be regulated. When they are regulated (which is the case here) there should not be competition between different parts of the regulated network. Instead, networks should facilitate competition in the adjacent upstream and downstream markets. This is achieved by having transparent and non-discriminatory tariffs with no barriers to entry (e.g. via the connection process).

24. The consultation paper focuses quite a bit on increasing competition by attracting new entry, particularly in production. New production facilities should enter the market if their production costs are competitive. We would note that the decision to invest in Corrib was made when the NBP was in the order of 15 p/therm.

25. The competitive benchmark for Corrib, Shannon LNG or any other production facility should be the UK NBP excluding the existing IC transmission entry tariff. Including the IC tariff (or rather the differential with other entry tariffs) in the benchmark is likely to distort competition rather than facilitate it. In our view most of the tariff differential will flow to producers and/or suppliers rather than to consumers. Therefore, whilst we might end up with more "competitors" in the market, this may not result in increased benefits for consumers.

26. It should also be noted that the UK NBP already includes offshore infrastructure costs, and entry/exit costs to and from other transmission networks.

27. It may also be interesting to compare the treatment of the Moyle interconnector in the SEM. This capacity is auctioned and any shortfall in receipts is postalised across the onshore transmission tariff. We also understand that suppliers who use Moyle do not pay this onshore tariff. We are not suggesting that the treatment of Moyle is fair or economically efficient, but would suggest that this should be compared and debated in the context of CAG development.

28. Clearly other production facilities and/or storage facilities will provide an additional security of supply benefit. However we should avoid trying to secure this benefit by differentiating transmission tariffs. If there is to be support for a project because of the security of supply benefit, then this support must be transparent and competed for. The two governments need to decide what, if any, additional security of supply measures are required beyond what the market is likely to deliver. If a transparent competition was held other options may well come to light. Furthermore it may well be the case that the least cost solution will be in an all-island context.

Conclusions:

29. Economic efficiency (both static and dynamic) and fair cost allocation may best be achieved by having single entry and exit tariffs in both jurisdictions.

30. Any support mechanisms for ensuring security of supply should be transparent and competed for.