



Commission for Energy Regulation

An Coimisiún um Rialáil Fuinnimh

## The Regulatory Treatment of the BGÉ Interconnectors

DOCUMENT TYPE:	<b>Consultation Paper</b>
REFERENCE:	<b>CER/11/112</b>
DATE PUBLISHED:	1 <sup>st</sup> July 2011
CLOSING DATE:	10 <sup>th</sup> August 2011
RESPONSES TO:	Stuart Coleman <a href="mailto:scoleman@cer.ie">scoleman@cer.ie</a>



Commission for Energy Regulation

An Coimisiún um Rialáil Fuinnimh

*The CER for Energy Regulation,  
The Exchange,  
Belgard Square North,  
Tallaght,  
Dublin 24.*

[www.cer.ie](http://www.cer.ie)

## CER – Information Page

**Abstract:**

In this Consultation Paper the Commission for Energy Regulation ('the CER') seeks the views of interested parties on updating the regulatory treatment of the subsea interconnectors.

**Target Audience:**

Gas Customers, Suppliers, Shippers and Producers

Responses are requested from interested parties on the matters raised in this Consultation Paper. Comments should be submitted by 5.00pm on the 10<sup>th</sup> of August 2011.

A workshop relating to this consultation will be held on Wednesday the 3<sup>rd</sup> August. Details will be announced on the CER website in due course.

These should be submitted to:

Stuart Coleman,

Commission for Energy Regulation,

The Exchange, Belgard Square North, Tallaght, Dublin 24

Tel: + 353 1 4000 800

Fax: + 353 1 4000 850

Email: [scoleman@cer.ie](mailto:scoleman@cer.ie)

**The CER intends to publish all submissions received.**

Should respondents wish to have part of their responses remain unpublished they should include the confidential parts only in a separate Annex.

## Executive Summary

In January 2011 the CER published CER/11/002 a pre consultation paper which provided information on the security of supply benefits provided by the two Bord Gáis Eireann subsea interconnectors and set out the rationale for updating the current regulatory regime.

While the issue itself is not new, the case for reviewing the current arrangements is triggered by the following forthcoming changes:

- I. New sources of gas in the near future
- II. A new 5 year revenue review for Bord Gáis Networks covering 2012 – 2017 and
- III. Progress on the all island Common Arrangements for Gas (CAG)

The interconnectors (IC1 & IC2) provide two separate physical sub-sea connections to the GB gas market. The interconnectors are owned by Bord Gáis Eireann and operated by Gaslink. The first interconnector (IC1) was built in 1993 and the second interconnector (IC2) was built in 2002/03. IC1 has a capacity of 17mcm/d with IC2 having a capacity of 23mcm/d<sup>1</sup>. The two subsea interconnectors provide the supply of most of the gas onto the island. At current gas demand levels the interconnectors can withstand the unavailability of one of the two pipes without disrupting gas flows to customers under most circumstances.

At the current time, the Interconnectors are paid for directly by shippers booking interconnector capacity, where circa 94% of gas consumed in Ireland comes across the Interconnectors. This situation is expected to change significantly as new sources of gas are introduced. The interconnectors provide the marginal source of gas to Ireland and therefore set the price of gas on the island and may well continue to do so even after new sources of gas are introduced (e.g. Corrib, possibly Shannon LNG).

While the consultation CER/11/002 focused on security of supply, a number of respondents to that consultation raised broader issues such as the effect of volatile interconnector tariffs setting a high price for gas on the island, thereby allowing indigenous gas producers to achieve a higher price for their gas than would occur under a different tariffing regime. In response to these comments the CER sets out a broader examination of the issues in this paper.

---

<sup>1</sup> These capacities depend on a number of factors in particular, the prevailing pressure in GB and Ireland. The capacities are given for indicative purposes only

This broader examination focuses on what is termed the “diversity premium”. As the ICs are a set of underwritten assets a consequence of making a decision not to strand<sup>2</sup> them and also allowing freedom to book other entry points, has effectively created this so called “diversity premium”. This essentially boils down to the fact that as the (underwritten) marginal source of gas, the ICs set the transportation price. Other entry points each having their own transportation price, are commercially free to price up to the ICs and thereby collect this premium. If the ICs recover their full revenue (given that they are underwritten) and other entry points have collected the full premium then this premium in effect is paid twice. The price of gas in Ireland rises by the amount of premium paid.

In considering the appropriate course of action, the CER’s primary duty is to protect the interests of consumers, both current and future. Generally this means ensuring that the cost of gas to consumers is at the lowest possible level that is commensurate with secure supplies. It would seem strange if new sources of gas resulted in an increase in the price of gas to consumers. As such, it seems impossible for the CER not to act to prevent negative effects to consumers but it would note that diversity of gas supplies may confer a genuine benefit to consumers, both now and in the future.

Background information and the regulatory policy dealing with the treatment of the ICs thus far is set out in the paper. The paper discusses investor incentives, diversity premium, tariff volatility and the role CAG may play in any decision.

Finally the CER sets out two options that it considers to be the most sensible as a mechanism for going forward for dealing with the regulatory treatment of the ICs. Those options being:

- Retaining a premium for diversity of gas supply and capping it;
- Removing the diversity premium altogether

These options can be implemented through design of regulated tariffs, or alternatively through an auction process that may, or may not, have a reserve price. The CER considers that it does not have the legal power to “strand” the interconnectors, i.e. to remove some or all of the future payments promised to BGE in order to recover the costs of building them. Such an option could be exercised only by BGE’s shareholder. The CER would note that any such action

---

<sup>2</sup> Annex 1 CER/08/207 : Draft Conclusions on Transmission Tariff Harmonisation in Ireland and Northern Ireland

could have negative consequences on regulatory certainty and the prospects of future investments.

The CER calls for comments on the proposed options. A workshop relating to this consultation will be held on Wednesday the 3<sup>rd</sup> August. Details will be announced on the CER website in due course.

## Table of Contents

1.0 Introduction .....	7
1.1 Purpose of this paper.....	7
1.2 Legislative Background.....	7
1.3 Comments Received .....	8
2.0 Interconnectors .....	9
2.1 Background .....	9
3.0 Comments Received.....	11
4.0 Policy and Background Context .....	15
4.1 Background context.....	15
4.2 Historical Dimension to the debate .....	16
4.3 Revenue Reviews.....	17
4.4 CAG Decision 2008 .....	18
5.0 IC Volatility .....	20
6.0 Regulatory Approach .....	23
6.1 Investor Incentive.....	23
6.2 Diversity Premium.....	23
6.3 All Island Dimension .....	24
7.0 Preferred Methodology .....	26
8.0 Next Steps .....	29

## 1.0 Introduction

### **1.1 Purpose of this paper**

The purpose of this paper is to seek the view of interested parties on guiding principles for updating the regulatory treatment of the Bord Gáis Éireann (BGÉ) subsea gas interconnectors.

### **1.2 Legislative Background**

Under the Gas (Interim) (Regulation) Act, 2002, the CER is responsible for regulating network charges in the natural gas market. Under Section 14 of that Act the CER may set the basis for charges for connecting to the transmission and distribution systems.

(b) The Commission may—

- (i) give directions to a pipeline operator from time to time in respect of the basis for charges for the transportation of natural gas through, or connection to, the pipeline of the pipeline operator, and

Under Section 9 (1B) of the Electricity Regulation Act 1999, as inserted by S.I. No. 452 of 2004, the Commission is responsible for ensuring non-discrimination, effective competition and the efficient functioning of the natural gas market.

### **1.3 Comments Received**

The CER received fourteen submissions to the initial consultation CER/11/002. Submissions were received from the following individuals/organisations.

<b>Respondents</b>	
Bord Gáis Networks	Irish Offshore Operators Association (PSE Kinsale, Shell E&P Ireland, Statoil, Vermillion)
Endesa Ireland	Manx Electricity
ESB Energy International	Paul Hunt
Gazprom Marketing& Trading Retail	Shannon Development
Harper Energy	Shannon LNG

Responses are published in conjunction with this consultation paper.



## 2.0 Interconnectors

### 2.1 Background

On 4<sup>th</sup> January 2011 the CER published a consultation paper which provided information on security of supply benefits provided by the two Bord Gáis Eireann subsea interconnectors. The paper discussed and gave background on the interconnectors, the benefits accorded by the interconnectors, and the interconnector's relationship with security of supply. Guiding principles (listed below) were proposed for any modification of their role and regulatory treatment.

Any modified approach to the regulatory treatment of the Interconnectors should be based on:

#### 1. Efficiency

- ensure the integrity of the market and not allow regulatory treatment to challenge the competitive position of natural gas versus competing fuels;
- promote efficient development and operation of the gas transmission system;
- ensure that those who benefit from the security of supply associated with the Interconnectors (whether indirectly or directly) pay accordingly for that benefit;
- ensure that the security of supply benefit of the Interconnectors is supported whether the Interconnectors are utilised or not;
- avoid creating windfall winners and losers from any future change in the current arrangements (as this will impact on investment incentives and, in the end, on final costs to customers of ensuring security of supply);

#### 2. Equity

- avoid unfair discrimination against end-users through an excessive Interconnector charge;
- avoid unfair discrimination between customers in different jurisdictions and between different customer types.
- avoid unfair discrimination against other entry points and/or storage;
- ensure that those who benefit from an investment in the Interconnectors (whether indirectly or directly) contribute toward paying for the investment;

### 3. Practicality

- be based on principles with a clear and transparent methodology employed; and
- avoid arrangements which are overly complex or create additional transaction costs.

CER/11/002 also went on to suggest three alternative high level methodologies for ensuring that the security of supply value of the existing interconnector assets is recovered. The methodologies proposed were:

- RAB Movement to Onshore Network
- Back-Up Booking Requirement
- Levy at all Entry Points.

Any options for modifying the treatment of the interconnectors is expected to be considered in the context of the forthcoming 5 year (2012 – 2017) revenue review for Bord Gáis Networks (PC3). It will also be considered in the context of the all island Common Arrangements for Gas and specifically within the context of the CAG tariffs workstream.

### 3.0 Comments Received

The respondents commented on various aspects of the CER proposals in CER/11/002. This section summarises some of their high level comments.

**Endesa Ireland** agrees that the security of supply associated with the interconnectors should be fairly supported by all who benefit from it. Endesa Ireland supports Option 3 of a Levy at all points. Shippers should not have a competitive benefit depending on where they source gas. A levy in the context of a move to an all Ireland market should be payable by Northern customers otherwise it would give a benefit to certain generators and thus distort the gas and electricity markets.

**ESB Energy International** (ESB EI) agrees with the CER that the burden of investments costs in the gas interconnectors should be borne by all who benefit from it. ESB EI agrees that the cost of security of supply benefits should be shared by all users. ESB EI agrees that the asset value (of IC2) can be split into the services that it provides namely security and supply.

**Bord Gáis Networks** consider the interconnector system to be a critical asset of the Irish gas system, which is critical to operation, support and development of the Irish gas system. The ICs provide essential security of supply to the island, access to the liquid UK market among other benefits associated with this link. BGN believe there is merit to each of the three options proposed by the CER for the recovery of the security of supply value of the ICs and any change must consider the overall financial impact on gas customers to ensure they have access to competitively priced and are paying efficient and fair gas transportation costs.

**Gazprom Marketing & Trading Retail** (Gazprom MTR) believe that the costs and benefits associated with the security of supply provided by the subsea interconnectors should be shared by all market participants. Gazprom MTR agree that the interconnectors currently provide the best form of security of supply. Gazprom MTR support RAB movement onshore subject to further in-depth analysis. They believe that by allocating a security of supply charge against the onshore system all users will bear a fair share of the cost of ensuring appropriate security of supply arrangements are in place.

**Harper Energy** believes that the interconnectors provide a considerable level of security of supply. However, other sources of gas also contribute in proportion so

it does not seem logical to make alternative sources of gas bear additional unnecessary costs. It is not the utilised interconnector capacity that will contribute to future security of supply but the unutilised capacity that will be there to provide additional capacity in an emergency. Option 1 (RAB movement on shore) is seen as the least bad solution. Harper Energy believes the aim should be to recover the security of supply premium that is inherent with the existence of the interconnectors at the lowest cost to end users.

**Irish Offshore Operators Association (IOOA)** appreciates the challenges facing the regulatory authorities in setting tariffs for the use of Moffat infrastructure but it does not believe it appropriate to try to address these challenges by overstating the security of supply benefits of the interconnectors. As such the IOOA remains committed to working with the CER on developing a tariff regime based on the twin objectives of:

- a) Consistency and compliance with national and European legislation; and
- b) Enhancing the diversity and security of supply for Irish customers.

The IOOA considers that none of the proposed high level principles (outlined in the CER consultation paper) are anything but discriminatory, in that they would all result to a greater or lesser extent in discrimination in favour of the owner of the interconnectors to the disadvantage of other sources that offer security of supply benefits in addition to gas users in Ireland.

**Kinsale Energy** believes that the security of supply to any market is best assured by supplying that market from several diverse supply sources and also by ensuring that as much physical commodity as possible is located within the state, particularly during times of peak demand. Kinsale Energy does not agree that the two interconnectors provide the best form of security of gas supply for consumers in Ireland. They believe that only indigenous production and storage, coupled with the interconnector infrastructure, can provide comprehensive security of supply.

**Manx Electricity Authority (MEA)** is in full agreement with the stated high level principles. MEA believe that the principles set out are proportionate and sufficiently robust.

**Paul Hunt** believes that rather than seeking to impose some of the future IC investment recovery costs on new suppliers at new entry points, the CER should commit to taking steps to minimise the gap between wholesale the wholesale price of gas in Ireland and that in Britain. Mr. Hunt believes that CER should set

appropriate security of supply standards (in line with the relevant EU regulation) and require owners/operators to present the binding arrangements they would employ in the event of a failure of their supply infrastructure to provide service. This may include long term commitments to reserve capacity on the IC assets, but it should be a choice made by owners/operators of other supply infrastructure; it should not be imposed on them. Mr. Hunt also believes that the regulatory value of the ICs should be written down to a value that would generate the annual capital charge plus opex equal to any revenue that may be secured from capacity reservations for normal use and for security of supply purposes.

**Shannon Development** made comments regarding the Shannon LNG project. Shannon developments made reference to benefits of the Shannon LNG project going ahead such as:

1. A regional solution to the National energy issue: significant improvement in national diversity and security of energy supply.
2. Private sector investment in Ireland's energy infrastructure (including strategic gas reserve), which otherwise might require State funding in the future.

Shannon Development stated their view that the above benefits to the Irish economy far outweigh any benefits to be achieved in adjusting the regulatory treatment of the interconnectors.

**Shannon LNG** does not support the changes being proposed by the CER because they create an overlay on ongoing regulatory uncertainty, they appear to be arbitrary, they are fundamentally anti-competitive, unjustified and possibly unlawful. Additionally, and critically they are not in the best interest of Irish consumers. SLNG seeks a comprehensive, long term solution that brings stability and certainty to the interconnector tariff and gas market. SLNG suggest a unit tariff design that is essentially flat in real terms. The result should be a tariff where the unit IC tariff rate does not vary with interconnector throughput.

**Shell E&P Ireland** believe that the proposed way forward, whichever option is developed, would run contrary to the long term interest of the Irish market as it would:

- a) Reduce the commercial incentives to increase Irish diversity of supply
- b) Effectively seek to gold plate interconnector revenue or at least retrospectively remove any legitimate investment risk;

- c) Distort gas flows between the GB and Irish market, potentially resulting in a reduction of security of supply due to an increasing dependence on a single source of supply.

**Statoil** and **Vermillion** both endorsed the response from the IOOA.

## 4.0 Policy and Background Context

### 4.1 Background context

Before delving into proposed solutions or methodologies it is worthwhile looking at the issue and the policy framing it.

The issue at hand relates to the fact that interconnectors provide the marginal source of gas to Ireland and therefore set the tariff. Gas is a homogenous product that is traded internationally and there is no reason to doubt that Ireland will effectively remain a price taker for the foreseeable future.

The interconnectors (IC1 & IC2) provide two separate physical sub-sea connections to the GB gas market. They are owned by Bord Gáis Eireann and operated by Gaslink. The first interconnector (IC1) was built in 1993 and the second interconnector (IC2) was built in 2002/03. IC1 has a capacity of 17mcm/d with IC2 having a capacity of 23mcm/d<sup>3</sup>.

IC2 serves to replicate the maximum of 17mcm/d made available from IC1 and also serves to provide an additional 6mcm/d of capacity to the Irish market (and the Isle of Man which can take 1mcm/d<sup>4</sup>). The combined interconnectors lie in the BGN Regulated Asset Base (RAB) and form a standalone regulated interconnector tariff. The annual revenue allowed to the interconnectors is circa €50m (for gas year 10/11) with 90% recovered through capacity charges and 10% recovered through commodity charges.

While a combined maximum capacity of 23mcm/d is available from the interconnectors, customers in Ireland are currently paying for 40mcm/d worth of assets<sup>5</sup>. As 40mcm/d is being paid for currently it could be said that 17mcm/d in of the availability is being paid for as insurance policy in case of a supply interruption. The question arises, is a tariff which reflects a security of supply element efficient? The answer is not simple.

While requiring customers to pay for security of supply may seem sensible it is only fair if all customers can be reasonably assumed to receive the same benefit and therefore pay the same price. As there are currently two entry points in

---

<sup>3</sup> These capacities depend on a number of factors in particular, the prevailing pressure in GB and Ireland. The capacities are given for indicative purposes only

<sup>4</sup> Capacity shown for indicative purposes only

<sup>5</sup> 17mcm/d + 23mcm/d

Ireland (ICs and Inch) the majority of customers pay the IC tariff. With the advent of Corrib coming on-stream and potential other new supply sources such as Shannon LNG it is expected that the bookings on the ICs will move away to cheaper entry points.

Those shippers who book non IC entry capacity will still benefit from the availability of the ICs. This benefit would essentially accrue to shippers and customers. A further issue arises with regard to tariff volatility. With large movement of capacity bookings away from the interconnectors comes significant tariff volatility. This has a knock on effect to the entire gas market (not just interconnector users) as interconnector gas effectively/arguably sets the wholesale price of gas in Ireland (NBP plus carriage from NBP through the marginal entry point known as IBP). An increase in the IC tariff due to lower utilisation would increase IBP and this would allow producers to price up to an even higher IBP even where producers have no underlying increase in costs.

It is worth noting that new supply sources can also provide security of supply and perhaps even more importantly diversity of supply. In recognition of these facts the question was asked by some respondents what is so special about the ICs? One answer could be that they are an uncongested link to a liquid market through two subsea pipes with regulated third party access. These pipes were built by the then de facto TSO (BGE) under Government direction; in effect the ICs are already there and are underwritten by the customers. In other words the ICs are different because they are already there and they are there by historical mandate. The CER cannot ignore these facts, quite apart from what one might think of the relative security of supply benefits of the interconnectors versus other sources of gas supply.

#### ***4.2 Historical Dimension to the debate***

While the debate on the regulatory treatment of the ICs and the associated security of supply considerations has become more urgent, it is not new. It is worthwhile looking back briefly at the historical dimension to the debate.

The Brattle report<sup>6</sup> which was commissioned in 2001 by the Department of Public Enterprise made a series of recommendations concerning new pipeline

---

<sup>6</sup><http://www.dcenr.gov.ie/NR/exeres/4722B54B-70B0-44B5-A215-3B23075F1F4D.htm>



authorisation and third-party access tariffs. These recommendations were made on the grounds that ‘cost reflectivity should be a basic principle for setting entry tariffs’. With this in mind Brattle recommended that the two interconnectors should have separate tariffs. Brattle also recommended that the Government should authorise the construction of any pipeline that could show long term contractual commitments for a specific amount of capacity.

Brattle also considered competition between entry points and stated that under the “Irish Entry/Postalised Exit” a difference in transportation prices would emerge, and Corrib’s gas could command a premium. The premium at that time was calculated to be in the order of 1.2p/therm on a wholesale price of around 10p/therm to 15p/therm. In euro that amounts to 1.52c/therm. At that time Brattle considered that the absence of this premium may have been sufficient to prevent Corrib from becoming commercially viable. However, gas prices are no longer 10 to 15p/therm with current spot prices averages between 58 to 60p/therm therefore the absence of this premium is less likely to deter or make new projects commercially unviable. The order of magnitude of the premium has significantly diminished primarily due the rise in wholesale gas prices.

In summary the Brattle report essentially advocated separate tariffs for each entry point where this can lead to pipe on pipe competition.

### **4.3 Revenue Reviews**

The issue of the regulatory treatment of the IC’s is not new. It has been discussed since 2003. It has been raised as part of previous CAG consultations in 2008 and more specifically as part of issues addressed in the Bord Gáis Networks Revenue Review for Price Control period 1 (PC1) and Price Control Period 2 (PC2)

In the PC1 consultation document (CER/03/060) section 8 examined options for recovering the spare IC2 capacity costs. Options considered included:

- Current Moffat shippers pay for all the IC2 capacity
- Current Moffat Shippers pay only for IC2 booked capacity and spare capacity costs are deferred
- All Irish shippers pay for IC2 through a Public Service Obligation
- Storage (a proportion of spare capacity to be sold as storage)
- Dividing the costs of latent capacity at IC2/Backup

- Use a lower rate of return for IC2
- Profile costs and demand over a period
- Cap Moffat tariff

Ultimately the CER chose (CER/03/172 section 3.7.2) to apply a different depreciation profile to IC2.

In the PC2 consultation and decision papers (CER/07/080 & CER/07/110) the CER noted that the current transmission tariff '*creates strong incentives for the development of indigenous gas sources*' and questioned 'whether this incentive is too great'. The CER noted that it would '*undertake a more fundamental assessment of the underlying issue*' and would 'undertake a separate consultation to determine the best way forward.

#### **4.4 CAG Decision 2008**

In 2008 as part of the CAG work programme a paper was published (CER/08/207 Draft Conclusions on Transmission Tariff Harmonisation in Ireland and Northern Ireland section 6.2) which examined mitigating the effect of low IC utilisation. The paper looked at options to offset this issue using mechanisms such as:

- Partial stranding of the asset
- Reprofiling of asset revenues
- Moving part of the asset revenues; and
- Setting a minimum booking level

Stranding or partially stranding the ICs was ruled out. It was noted in the paper that '*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*'. '*Any mitigation measures taken must, however, be efficient, fair and proportionate*'.

In the decision paper CER/08/263 section 6 (Conclusion on High Level Transmission Tariff Structure in Ireland and Northern Ireland) it was recognised by both RA's that the treatment of IC mitigation has a significant impact on both jurisdictions under an Entry Exit regime and cannot remain unanswered indefinitely. The RA's stated they would consider further the issues arising around the mitigation solution but believed that the implementation of any mitigation measures are unlikely as long as IC tariffs are broadly in line with the

current level. It was also stated at that time that further work was planned to consider what levels of IC utilisation might require intervention and the process by which mitigation could be implemented.

## 5.0 IC Volatility

One of the fundamental issues which relate to the treatment of the interconnectors and which needs some considered discussion is the issue of tariff volatility. This issue was raised by a number of respondents to the January consultation.

At present there are significant peak day bookings on the interconnectors. This can be expected to decrease upon the addition of new supply sources such as Corrib. When a new supply comes on-stream there will be a large diversion of capacity bookings away from the interconnectors to the new supply source as it is fully expected that the new supply source will be marginally cheaper. Assuming the interconnector tariff revenue will continue to be underwritten, required revenue must be paid to the asset owner each year. Decreasing interconnector booking will have a significant effect on the interconnector tariff, as the lower the bookings go, the higher the tariff goes in return. A knock on effect of this will be the increase of gas to the final customer as the interconnector gas notionally sets the wholesale price of gas at IBP. Any increase in the IBP would allow producers to price up to the IBP and gain further margin thus putting an even bigger burden on the final customers.

If the current IC tariff structure is not altered then it is very likely that all consumers (gas and, indirectly, electricity) will be impacted by higher gas costs. Higher tariffs may also incorrectly incentivise new infrastructure to be built without any economic reason for it. Equally so, setting the tariff too low may deter potential investors. Striking a balance between the need for new investment and not burdening consumers with undue increase in costs for diversity of supply is a key requirement.

Taking as an example the current interconnect tariff with a customer of 365 MWh annual consumption and a load factor of 1.3<sup>7</sup>.

---

<sup>7</sup> Customer example is taken from section 2 of CER/10/149

Customer of 365 MWh annual consumption and a load factor of 1.3		Moffat Shipper
Capacity Charge	€ per peak day	
	MWh	215.8333
	Load Factor	1.3
	Total in €	280.58329
Commodity Charge	€ per MWh	0.09
	Consumption	365
	Total in €	32.85
Total Cost for 365MWh annual consumption		313.43329
Total Cost in € per MWh		0.858721342
1 Therm	in kWh	29.3071
Total in cents per MWh		85.87213425
Total in cents per kWh		0.085872134
Total in cents per Therm		2.52

This could be viewed as an average cost for transport over the interconnector. If the ICs or part of the ICs were moved onshore this cost of transport would be lower, i.e. moving 17/40 of the ICs onshore will lower the current assumed cost of 2.5cent/therm to 1.06cent/therm. This should not be seen as an indication of what the price might be it is merely used for demonstration purposes. One consideration with the cost of transport is that it might be appropriate to associate operating costs of the ICs with the supply as opposed to the security of supply. Therefore the opex costs for the ICs could be associated with the ICs rather than with any security of supply charge.

### HUB Concept

As part of the CAG process the concept of pricing entry for delivery to a hub is being examined. The term ‘Transportation Hub’ is intended to refer to the notional transportation of all gas entering Ireland and Northern Ireland (from any Entry Point) to a specific geographic point on the island’s transmission network. Entry tariffs would be calculated on the basis of transportation to this Hub. For the purposes of discussion, Gormanston is taken as a potential focal point.

The implementation of a Hub approach would allow gas to flow seamlessly around the island of Ireland whilst preserving the key tariff principles of cost

reflectivity, equity, non discrimination and fairness. The principles of the CAG Hub would also meet the requirements of Regulation 715.

In the Hub approach the total of required entry and exit revenues is not altered. All assets continue to be paid for by those who utilise them. The relative amount of these costs that apply at the various entries and the relevant exits would change but the sum would remain the same. It is important to note that in the event that the hub concept is progressed under CAG this would have an impact on the tariff for each entry point. In this case the entry charge would include the (calculated) cost of transportation to Gormanston. This would clearly narrow the differential in costs between indigenous gas in Ireland and the interconnectors.

## 6.0 Regulatory Approach

### 6.1 Investor Incentive

It is important that any future decision on the treatment of the IC's does not harm or potentially undermine any new infrastructure projects that will efficiently add to security and diversity of supply, provided, of course, that any associated costs to the general gas/electricity customers are proportionate to the resulting benefits. This was echoed in the Brattle report "*Efficient indigenous production should be encouraged. Tax revenues, greater diversity and hence greater security of supply would all benefit from the development of the Corrib field, and other economically viable offshore fields.*"

While promoting security and diversity of supply it is equally important to ensure that customers do not overpay for their supply. This will be reflected by ensuring the tariff structures reflect the marginal cost of gas for transmission. Sending the correct signals to investors may seem straightforward; however, any signals or incentives offered to new investors must be reasonable, well structured, clear and defined. Setting these correctly will allow for efficient investment in new infrastructure. Equally so setting them incorrectly could lead to a lack of proper infrastructure investment which may ultimately lead to an environment where gas network growth may not keep pace with service requirements.

The CER is fully committed to ensuring that the correct signals are sent to the market, while fulfilling its statutory duty to ensure non-discrimination, effective competition and the efficient functioning of the natural gas market.

### 6.2 Diversity Premium

The ICs are a set of underwritten assets. A consequence of making a decision not to strand<sup>8</sup> them and also allowing freedom to book other entry points, has effectively created a so called "diversity premium". This essentially boils down to the fact that as the (underwritten) marginal source of gas, the ICs set the transportation price. Other entry points each having their own transportation price, are commercially free to price up to the ICs and thereby collect this premium. If the ICs recover their full revenue (given that they are underwritten)

---

<sup>8</sup> Annex 1 CER/08/207 : Draft Conclusions on Transmission Tariff Harmonisation in Ireland and Northern Ireland

and other entry points have collected the full premium then this premium in effect is paid twice. The price of gas in Ireland rises by the amount of premium paid.

The magnitude of the potential premium has been increased following the decision to combine both ICs into one tariff. The question arises now should it be allowed to continue? Considering this premium has been around since 2003 it may have been expected that it would remain. The issue of the treatment of the IC's has been known since PC1 however, and with the advent of Corrib coming on-stream always in the foreground, any prospect of this premium continuing has been under constant consideration.

If the premium is to continue, how much is it worth and how should it be collected? Should there be a premium of this form, which new entrants can get for promoting diversity and security of supply? If the diversity premium is allowed to continue it could raise the total gas bill in Ireland by as much 2.9% per annum.<sup>9</sup>

These are not simple questions, even more so now with the advent of an all island gas market an added complexity arises. It could be argued that having a diversity premium is inefficient and unnecessarily raises gas prices in Ireland. It could equally be argued that a diversity premium is needed to encourage new investment in infrastructure. The options relating to a diversity premium are discussed further in section 7.

### **6.3 All Island Dimension**

The CAG project has recently relaunched and with the advent of a single gas market across the island the issue of a diversity premium poses potential problems.

As it stands there are currently differing policy and regulatory approaches to a diversity premium. The current regime in RoI allows a diversity premium to be paid. NI on the other hand does not pay for a diversity premium. NI has recently published a paper<sup>10</sup> consulting on a number of items regarding moving SNIP to

---

<sup>9</sup> Taking 2bn therms of gas coming into Ireland @ 60pence/therm divided by exchange rate of 0.88. Add on T&D (€357.78m in 10/11) and an estimated cost to serve, giving total estimated gas bill of €1.74bn. Cost of IC's is approx €50m,

<sup>10</sup> [http://www.uregni.gov.uk/uploads/publications/SNIP\\_Moving\\_to\\_an\\_Entry\\_Exit\\_regime.pdf](http://www.uregni.gov.uk/uploads/publications/SNIP_Moving_to_an_Entry_Exit_regime.pdf)



an Entry/Exit regime. One of the considerations the Utility Regulator (UR) has raised is what, if any, security of supply/diversity incentive should be considered by reference to the following:

- What security of supply is required?
- What does (will) the market provide?
- How can additional supply (if required) be efficiently incentivised?

UR's initial view is that this (diversity incentive) is a very blunt tool to incentivise security of supply and diversity and could be ineffective in the NI context. UR also questions whether it has a significant incentive on indigenous gas (which could be more dependent on geology, tax regimes etc) and would offer no incentive to storage. The UR believes that security of supply/diversity incentives is a high level question that will have to be considered along with DETI. The UR called for comments on whether respondents believe there is merit in incentivising new entry points and possibly improving diversity of supply through increased prices for all customers.

Given the situation in both jurisdictions, it is necessary to consider whether it is reasonable for one side within CAG to be paying a diversity premium which promotes having spare capacity with the aim of avoiding an emergency while the other side does not pay. In the event that new entry occurred and the premium was paid in RoI, if NI then had an emergency affecting SNIP, would RoI call an emergency? Even if it did not call an emergency there would be spare capacity available because RoI have paid a premium. This leads to the question as to whether RoI should then give this spare capacity which it has paid for to NI.

All other things being equal the transmission tariff in RoI will be higher than NI because of the premium being paid in RoI. This could well impact future investment decisions. It could be considered rational for a new customer (e.g. Power Station) to choose to locate to NI where charges are lower. This could distort the market and potentially frustrate the goals of the CAG project. Thus the CER is currently of the view that the presence of CAG strengthens the argument for no diversity premium. However, it is looking for consultation responses on this issue. While CAG feeds into this issue of dealing with the regulatory treatment of the ICs, it is ultimately an ROI issue to be decided by the authorities in Ireland.

## 7.0 Preferred Methodology

In this section the CER set out the options available to deal with the ICs issue. Table 7.1 below set out options, their effects and potential methods.

Options	Effect on Producers	Effect on BGE	Effect on Consumer	Method
<b>1. Do Nothing</b>	Very high Premium arises	No change	Price of indigenous gas rises by uncapped amount	No change
<b>2.Strand IC's (Strand unused part)</b>	Capped premium arises	Lost revenue, Potential WACC issues	No change as premium paid to producers is offset by the stranding of the IC's	Cap tariff, unrecovered revenues are lost to BGE
<b>3. Keep Premium but Cap</b>	Capped premium arises	No change	Price of indigenous gas rises by capped amount	Cap tariff, unrecovered revenues are recovered at Exit
<b>4.Remove Premium</b>	No premium	No change	No change as no premium paid	Double booking, Auction with zero reserve price, Postalize entry

Table 7.1 Methodology and Options

Considering the four options presented above, there only really two options that can be considered, with those being option 3 and 4. Option 1 and 2 have already been ruled out for the reasons listed below. They are included to give context to the debate rather than being advanced with a view to seriously reopening earlier CER decisions.

**Option 1:** 'Do nothing' is not feasible as it will result in increased tariff volatility, probable higher costs to consumers, larger diversity premiums for producers for

no extra cost input on their part and a highly unstable regulatory tariff environment which will not attract efficient investment in new infrastructure.

**Option 2:** ‘Stand IC’s’ is another option that has been ruled out, as far as the CER is concerned. This was ruled out in 2008 when as part of CER/08/207 the CER noted that *‘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’*.

The ICs construction and costs were approved by the State and the CER does not consider that it has the power to change this. Thus, any consideration of stranding the ICs would not be a matter for the CER. It would ultimately be a matter for the shareholder. The CER corresponded in 2008 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 CER’s regulatory remit to the gas sector. Ultimately the Government approved the decision for the then *de facto* TSO to invest in IC2 on the express grounds of national security of supply. Stranding IC2 is therefore only an option the Government as shareholder can consider.

As a general regulatory principle it would be considered bad practice for an economic regulator to allow major infrastructural investments that have received prior approval to be subsequently stranded. Apart from the message of fairness, this would send a bad message to potential investors and create uncertainty. The level of the WACC for BGN might have to be reopened as stranding part of the RAB could create financeability issues.

**Option 3:** ‘Keep Premium but Cap’;

Arguably this option strikes a reasonable balance to contain consumer costs in the short term while providing a signal to encourage indigenous gas production. On the other hand it could be argued that such encouragement for indigenous production should be implemented through Government policy i.e. through licencing, tax regimes and other avenues open to Government. Keeping the premium and capping the tariff will create an investor incentive to build new infrastructure thereby increasing diversity and security of supply, while capping the tariff will remove the volatility. It could, however, be said that keeping a diversity premium will keep the price of gas higher than it should be. The CAG dimension also poses several questions about how appropriate it is for Rol customers to continue paying a diversity premium to promote security of supply while NI customers who have access to Irish entry points as a backup make no such payment. Keeping a premium of any size will allow this to continue.

**Option 4: 'Remove Premium';**

Removing the premium has no effect on consumers and may even bring gas prices down in the short term. However, it could be argued that this amounts to a significant reduction in the revenues available to sources of gas competing with the interconnectors, e.g. indigenous gas or LNG. The CER must consider protection of consumers in all decisions it takes, and balance the strong preference for new entrants, increased competition and improved security of supply with the cost implications for customers.

An advantage of removing the premium is that it would also mirror the likely approach to be taken by NI.

A mechanism for removing the premium could be through auctions. The premium could be removed by auctioning capacity and setting a reserve price of zero, with any unrecovered monies being passed onto the onshore. It could be argued that such an auction is likely to set a zero price for interconnector capacity and therefore serve no meaningful price signalling purpose given that supply is always likely to exceed demand.

Another mechanism would be to make double booking obligatory, where shippers would be required to book a certain amount of capacity at more than one entry point. Another option would be to postalize the entries, where monies unrecovered from the ICs could be recovered at other entry points.

The CER are calling for comments on option 3 and 4 proposed above. The CER is seeking comments on the proposed options in light of principles of efficiency, equity, practicality and stability. Analysis of the exact mechanics of how either option 3 or 4 would work will be carried out in time but for the moment a clear process for moving forward needs to be defined.

## 8.0 Next Steps

The CER has put forward the two options that it considers to be the most sensible as a mechanism for going forward for dealing with the regulatory treatment of the ICs. Those options being:

- Keep the diversity premium and cap it;
- Remove the diversity premium altogether

If there are other options that respondents wish to present the CER will consider them all before reaching a decision in due course.

Responses are requested from interested parties on the matters raised in this Consultation Paper. Comments should be submitted by 5.00pm on the 10<sup>th</sup> of August 2011.

A workshop relating to this consultation will be held on Wednesday the 3<sup>rd</sup> August. Details will be announced on the CER website in due course.

These should be submitted to:

Stuart Coleman,

Commission for Energy Regulation,

The Exchange, Belgard Square North, Tallaght, Dublin 24

Tel: + 353 1 4000 800

Fax: + 353 1 4000 850

Email: [scoleman@cer.ie](mailto:scoleman@cer.ie)

**The CER intends to publish all submissions received.**

Should respondents wish to have part of their responses remain unpublished they should include the confidential parts only in a separate Annex.