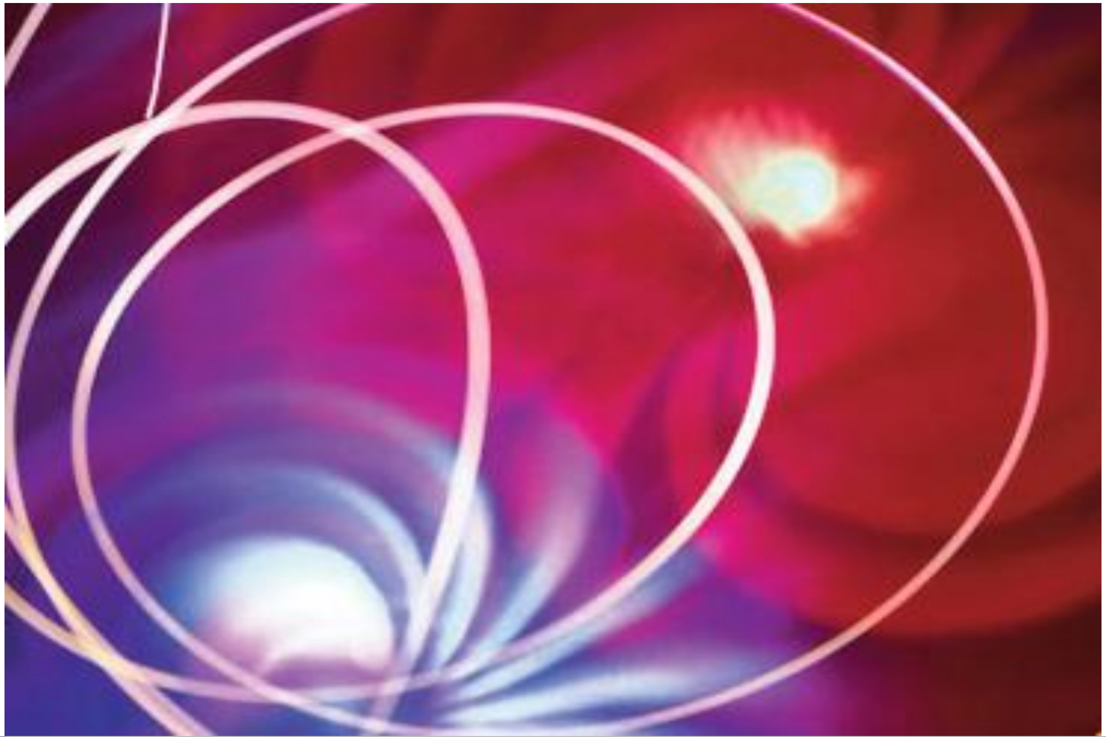

Treatment of Gas Transportation Capacity Costs

A response to SEM-12-089

16 November 2012

Table of Contents:

1. Introduction

This document is VAYU's response to SEM-12-089, which consults industry on the treatment of gas transportation capacity costs in relation to the Single Electricity Market ("SEM").

The issue of whether generators should be allowed to bid in the cost of short term gas capacity has been an issue since the launch of the SEM. A day-ahead gas capacity product was introduced in October 2007; whereas the rules to disallow the bidding in of capacity pre-dates this with the July 2007 SEM decision paper AIP-SEM-07-430. This paper noted that future developments in gas capacity trading and booking may be done in "such a way that allows them to be reflected in bids".

Recent years have witnessed significant changes in the generation portfolio on the island. From a position where renewables comprised 11% of generation in 2007, the figure is now over 17% and rising. The renewable generation target of 40% by 2020 will drive further changes in market structures. This is also against the backdrop of the development of the EU's target model for energy by 2014. Given the substantive structural change required in Ireland's electricity market to comply with the target model Ireland has been given a two year derogation to restructure the market.

Representations by a number of parties regarding the inclusion of these costs were made and this has forced the RA's to address this issue. These vested interest parties may argue that these costs must be bid in to the market due to the Irish Supreme Court decision on the treatment of the Carbon Revenue Levy.

Rather than coming to a preliminary position in the consultation paper, the RA's outline the key drivers of what needs to be considered before making a decision. They are looking for responses to a series of questions on key aspects of the issue. These range from, asking if there has been sufficient development of the gas capacity to allow these costs to be now included in bids, to seeing if the capacity payments structure of the market should be recalculated.

2. Executive Summary

2.1 Summary

The RA's are in a dilemma. They know that this issue should have been addressed before now and are mindful of the recent Supreme Court decision on the Carbon Revenue Levy. They are also fully aware that if short term gas capacity costs are included in commercial offers this will result in a significant increase of wholesale electricity prices.

Vayu is strongly opposed to any proposal that would see the cost of short term gas capacity increasing the cost of electricity because:

- If implemented, including short term capacity costs in commercial offers would be a retrograde step for the market. We are surprised that the RAs have deliberately chosen to remain muted in their response to this issue and have made no comment on the potential financial impact for end-users.

- End-users already pay high electricity charges, without being forced to absorb these costs. We feel it necessary to recall here a duty of care to consumers: - more must be done to protect these end-users. As a supplier with a very strong focus on the retail sector in the all-island energy market, we do not want to see our Customers paying more for their electricity on a like-for-like basis, but getting nothing in return.

- As with other issues in the Irish energy market this, more than many others, demonstrates the interconnectedness and dependencies between the electricity and gas markets. A workshop to discuss these issues in finer detail should be arranged before a final decision is made.

- It exacerbates the already appalling imbalance of power and control that the generation sector enjoys over the retail sector. In their Customer protection role the RAs should have given their initial position on the paper or have noted a number of possible alternatives to the use of short term capacity products.

- Vayu believes that industry should exhaust all other possible measures or develop / amend existing ones before opting for the most expensive product in the market to satisfy capacity requirements.

- If short term gas capacity costs are included in bids to the SEM, the higher wholesale electricity prices will be fed back to all generators, resulting in higher revenues and margins for a number of these generators, especially generators with a mix of fuel types in their portfolio, that do not have any gas fired generation. They will benefit despite little or no contribution to the market.

- In discussions with the Commission for Energy Regulation ("CER") on this issue we have made clear that we believe that the CER has not considered the domino effect and the long term damage to the energy sector from a proposal to include the cost of short term capacity in commercial offers.

- Vayu's responses to specific questions are made in Section 4 below.

2.2 Consequences of the change in treatment

The RA's must not consider any treatment in isolation. The domino effect from this has far reaching consequences.

We were surprised and disappointed that no regulatory impact assessment was included as part of the consultation. This is simply good regulatory practice; the RA's should address if this exercise was carried out and if so, issue the results.

If implemented, the consequences of the decision will be very serious for business. Such a decision would result in a significant increase in electricity prices. Unfortunately, the consultation paper does not disclose the financial impact on SEM prices.

Informed industry estimates vary as to the magnitude of the increase. However, the hike in prices at certain times could be as much as €10/MWh, which would represent an increase of up to 9% in electricity costs. The average increase in annual electricity prices is estimated to be between 4-5%

Those end-users who pay for electricity on the basis of wholesale market prices, typically larger companies with heavy energy usage (and often greater employment), will immediately incur higher costs. Those on fixed tariffs would pay higher prices at the next contract renewal date or whenever the utility is able to raise prices, which in an unregulated market is whenever they like.

This current consultation has a direct adverse impact on the cost of doing business in Ireland. Business Customers have been hit hard enough this year with increases in transportation tariffs and the PSO and the cessation of the LEU Rebates. This proposal would only add to this suffering and further erode the competitiveness of Irish businesses, putting jobs at risk.

This change would also result in significant variability in annual transmission tariff revenues for Bord Gáis Networks ("BGN") due to a profound change in the profile of capacity bookings causing knock-on effects for consumers. Industry is still waiting on a response on submissions to the Price Control 3 consultation process in which BGN's regulated revenues are profiled over the 5 year period 2012-17.

The domino effect is that if BGN revenues are not in line with those expected, any under-recovery is loaded onto gas transportation tariffs in the following gas year. This would result in a) electricity Customers paying more in the initial periods and b) gas Customers paying artificially higher transmission tariffs in subsequent periods.

2.3 Recommendation

In the short to medium term the ultimate result of any proposal that would allow short term capacity costs to be bid into the SEM will be an increase in wholesale electricity prices.

This is very damaging to Ireland's business community and "Ireland Inc.'s" image as a destination of low regulatory risk.

The RA's have not sought to comprehensively explore credible alternatives to the use of short term capacity products in bids.

The paper notes that, assuming there is no recognised and accessible trading market for primary capacity, replacement cost is the most suitable "opportunity cost" for bidding purposes. It further states that this would appear to be the regulated price for regulated capacity i.e. a short term capacity product.

However, there is a much cheaper alternative. Secondary trading of transmission capacity has been available in the RoI gas market for a number of years. The data in the paper SEM-12-101, Overview of Secondary Gas Transportation Capacity Trades, demonstrates that there is a reasonably high level of secondary capacity trades. We would argue that this market is a recognised and generally accessible market.

The CER deferred its decision to restrict exit capacity trading until October 2013. We strongly believe that this SEM issue demonstrates the need to maintain the current regime of allow unrestricted and full transferability of spare exit capacity. Although pricing is done on a bi-lateral basis the Market Monitoring Unit ("MMU") is empowered to investigate data on capacity trades.

It could result in additional work for the MMU; however, it would also mean that SEM price increases should be minimised. We agree with the pricing alternatives for bids of secondary capacity suggested in the paper, which are either a) the sales price where that price can be justified by referencing prices at which secondary sales have recently taken place; or b) the CER regulated prices of Bord Gáis Energy sales of secondary capacity. On an annual basis both of these options are far cheaper than short term capacity products.

This will also ensure that there is scope for competitive market behaviour between generators and the MMU will need to maintain a close watching brief on the capacity trading activity in the market.

For the vast majority of the year there is spare exit capacity in the market. This is driven by the requirement to book exit capacity for non-daily metered sites at the same level as the Supply Point Capacity ("SPC") which is based on a 1 in 50 winter.

Equally, if a non-baseload plant is dispatched at short notice (either day ahead or within day) it should be incentivised to look for spare entry and exit capacity first before immediately looking to book short term capacity.

3. Questions for Stakeholders

3.1 Has there been sufficient development in the trading of gas transportation capacity since the publication of the Bidding Code of Practice to allow the cost of such to be included in Commercial Offer Data? If so, why? Is this situation different between Northern Ireland and RoI?

We were disappointed that the RA's chose not to initially publish data that would allow respondents make a reasoned submission to this question. Following representations from a number of stakeholders, the RA's issued a paper subsequent to the initial consultation (SEM-12-101) which detailed secondary gas capacity trades between RoI shippers from Q3 2010 to Q2 2012.

It would have more useful to have had the same data since the publication of the bidding code of practice. Although the data only covers a two year period it is clear from this analysis that shippers are becoming more active in trading entry gas capacity and that exit capacity trading has been steady over the period under review.

The situation is different between RoI and Northern Ireland as transmission capacity is booked on behalf of shippers and charged on a commodity basis. Trading of this capacity is difficult.

3.2 Should the cost of gas transportation capacity be included in the Commercial Offer Data of units in Northern Ireland?

In our view the transmission capacity booking regime in NI should be radically overhauled to bring it into line with a proper entry exit based system with full trading of entry and all levels of exit capacity.

3.3 Should the cost of gas transportation capacity be included in the Commercial Offer Data of units in the Republic of Ireland? Is there any good cause why the principles within paragraphs 8(i) and 8(ii) of the Bidding Code of Practice should not be applied?

Paragraph 8 of the Bidding Code of Practice permits the RA's not to use the principles where it can be demonstrated to their satisfaction that there is good cause for the principles not to be applied. Before there is any possibility of the RA's disregarding these principles for this consultation they must have very strong reasons for doing so.

We believe that the capacity payments mechanism structure and the price of the BNE should be reviewed in conjunction with this consultation. The two issues are inextricable linked. In our view the cost of short term capacity should not be included in the commercial offer data. If the cost of capacity was included in commercial offers it could be argued that generators would recover transmission capacity costs twice.

3.4 If the cost of gas transportation capacity is to be included in the Commercial Offer Data (of units in the Republic of Ireland) is there a recognised and generally accessible trading market in short-term gas transportation capacity? Is this recognised and generally accessible trading market in secondary capacity or regulated daily capacity?

The paper notes the views of the SEM committee with respect to the trading of firm or regulated capacity. It does not consider there to be a traded market on the basis that this capacity can only be bought, not sold. If it is sold, it is done so as a secondary product. We therefore agree with the SEM committee's views.

Secondary capacity is mostly sold on an interruptible basis. We would interpret any interruption of sold capacity as a virtual purchase back of the original capacity sold.

However, as we noted in the body of our submission, the traded market in secondary capacity should be developed further by allowing full trading of both entry and exit capacity. All shippers should be motivated by trying to source the cheapest priced capacity before resorting the higher priced short term rates. We reiterate our point though that capacity costs should not be included in the commercial offers.

3.5 If the cost of gas transportation capacity is to be included in the Commercial Offer Data (of units in the Republic of Ireland) and there is no recognised and generally accessible trading market in short-term gas transportation capacity, what is the replacement cost?

Generators should be incentivised to look for the most cost efficient products to keep wholesale prices under control. Transportation costs incurred by a generator to replace this cost-item can be a controlled cost.

This will also ensure that competitive markets forces prevail and will encourage shippers to go to the market and look for this capacity on a secondary basis.

3.6 If the cost of gas transportation capacity is included in the Commercial Offer Data (of units in the Republic of Ireland), should the price of the BNE be recalculated?

Given that the price of the BNE and the issue now being consulted upon are so closely linked, we believe that a re-calculation is carried out.

3.7 Which of the methods outlined in Section 3 is the most appropriate for accounting for the cost of short term gas transportation capacity?

We do not agree that short term capacity should be used in commercial offer data and therefore singled out in this question. The question is irrelevant in the context of the methods proposed.

3.8 Are there any other methods for valuing gas transportation capacity which have not been included in Section 3 (Considerations)?

As we mentioned previously the RA's must be acutely aware of and remain conscious of the wider market developments at EU level. The structures must be future proofed and in line with the target model. There may be merit therefore in looking more closely at the auction based platforms for capacity products.

We believe this could be considered for secondary capacity trades, which would necessitate full trading of secondary capacity across all sectors of the market, be it LDM, DM or NDM and also require onward sale of secondary capacity to third parties.

4. Conclusion

The RA's are in a quandary. It is an issue that clearly demonstrates the closeness of the gas and electricity markets, but also the requirement to have full trading of gas transmission capacity to avoid an artificial increase in wholesale electricity prices.

The bidding code of practice seeks to ensure there is an efficient market by not allowing any interested party to wield market power. We support this and would encourage the RA's to consider all options before making a decision for the good of the market and all end-users who are already under severe economic pressure.

We would welcome the opportunity to meet and discuss these points in more detail with you in the near future.