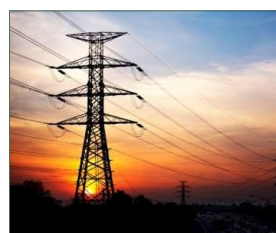


Gas to the West Licence Consultation

18 December 2014



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference

Act with integrity.

Abstract

In order to facilitate the extension of the Northern Ireland natural gas network to towns in the west of Northern Ireland, new licences must be granted by the Northern Ireland Authority for Utility Regulation. The Authority launched the application process for the licences on 6 February 2014 and eight applications were received.

The Authority has carried out an assessment of these applications against the criteria which the Department of Enterprise Trade and Investment have determined. This process resulted in the Authority identifying both a preferred applicant and a reserve applicant for each licence.

The next step is to consult on the conditions of the high pressure licence and the low pressure licence and to this end a notice was published on the Utility Regulator website on 18th December 2014. This document accompanies the notice and presents an overview of the conditions of each licence. The proposed text of the conditions within each licence is also published in full alongside this paper.

Audience

The preferred and reserve applicants for the conveyance licences in the west of Northern Ireland, potential investors in Northern Ireland gas network assets, regulated companies in the energy industry, government and other statutory bodies and consumer groups with an interest in the energy industry.

Consumer impact

Research conducted on behalf of the Department of Enterprise Trade & Investment (DETI) indicates that potentially 40,000 domestic and commercial customers will connect to the new gas network in Tyrone and Fermanagh. These customers will benefit from lower energy costs and society as a whole will benefit from lower carbon and other emissions.

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1.0 Introduction

1.1. Introduction

1.1.1 In January 2013 the Northern Ireland Executive agreed to provide grant funding of up to £32.5m to facilitate the extension of the Northern Ireland natural gas network to the following towns:

- Dungannon including Coalisland;
- Cookstown including Magherafelt;
- Enniskillen including Derrylin;
- Omagh;
- Strabane.

1.1.2 In order to convey gas to these towns, new or extended gas networks will need to be constructed. The owners of these networks will require licences to be granted to them by the Northern Ireland Authority for Utility Regulation (**the Authority**) under Article 8 of the Gas (Northern Ireland) Order 1996 (**the Gas Order**).

1.1.3 Both the Authority and DETI have consulted with stakeholders for over three years on the project to extend the Northern Ireland natural gas network – colloquially known as the Gas to the West (or **G2W**) project¹. The Authority has published all of the key materials on a special project page set up on its website², and there are further important materials published by DETI.

1.1.4 The Authority issued its consultation on Provisional Decisions on the 12th October 2014 with the Final Decisions issued on the 18th November 2014. As per the decision paper the Authority proposes to grant two gas conveyance licences in respect of the networks:

¹ The acronyms 'GTTW' and 'GTW' are also sometimes used in documents that are referred to or quoted in this document; all are descriptors of the same thing.

² http://www.uregni.gov.uk/gas/projects/gas_to_the_west_initiative/

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- a. one licence relating to the high pressure assets needed for the distribution of gas to the designated towns.
 - b. the other licence relating to low pressure assets in the designated towns that are required for the distribution of gas to individually connected supply points.
- 1.1.5 Each licence will be 'exclusive'. This means that, once it has been granted, no new gas conveyance licence can be granted in relation to the area covered by that licence for a specified period.
- 1.1.6 The Authority intends the exclusivity period to be five years in the case of the high pressure licence and twenty years in the case of the low pressure licence. For that reason, and since a number of companies expressed interest in obtaining the licences and developing the networks, the Authority has facilitated a competition to determine who should be granted the licences.
- 1.1.7 The Authority launched the application process for the licences on 6 February 2014. The period during which applications could be submitted closed at noon on 6 May 2014. Eight applications (**the applications**) were received from the companies (**the applicants**) set out in the table below.

High pressure licence applications	BGE (UK) Ltd – application connected to the firmus Energy Distribution Ltd low pressure application.
	BGE (UK) Ltd – unconnected application.
	Northern Ireland Energy Holdings Ltd – application connected to the Scotia Gas Networks (Northern Ireland) Ltd low pressure application.
	Phoenix Natural Gas Ltd – application connected to the Phoenix Natural Gas Ltd low pressure application.
Low pressure licence applications	firmus energy Distribution Ltd – application connected to the BGE (UK) Ltd high pressure application.

	firmus energy Distribution Ltd – unconnected application.
	Phoenix Natural Gas Ltd – application connected to the Phoenix Natural Gas Ltd high pressure application.
	Scotia Gas Networks (Northern Ireland) Ltd – application connected to the Northern Ireland Energy Holdings Ltd high pressure application.

1.1.8 The Authority has carried out an assessment of these applications against the criteria which the Department of Enterprise Trade and Investment (**DETI**) have determined and published for that purpose under Article 8(7B) of the Gas Order (**the Criteria**).

1.1.9 Following this assessment the Authority provisionally identified both a preferred applicant and a reserve applicant for each licence. The Authority’s provisional conclusions were published for consultation on 12 August 2014 and responses were sought by 7 October 2014. Five responses were received by the deadline and the Authority has carefully considered each of these responses.

1.1.10 Subsequently the Authority’s final decision, published on 18 November 2014, confirmed MEL³ and SGN as the preferred applicants for each licence.

	Gas Conveyance Licence Awarded	
	High Pressure	Low Pressure
Preferred Applicant	NIEH (Mutual Energy)	SGN (Scotia Gas)
Reserve Applicant	BGE UK	firmus

³ The name of the applicant is Northern Ireland Energy Holdings, in this document we refer to them as MEL.

1.2. Purpose of this document and next steps

1.2.1 The next step in the process is to consult on the conditions of each licence. The statutory process for granting the licences is set out in article 8(4) the Gas (Northern Ireland) Order 1996. This requires the Authority to publish notice of its intention to grant each of the licences and to provide a period of not less than 28 days for representations with respect to the proposed licences.

1.2.2 The Authority will then finalise the conditions in each of the licences following consideration of any responses which it has received.

1.2.3 We anticipate that the licences will be granted in February 2015.

1.2.4 The purpose of this document is to outline for consultation:

- a. the standard conditions which the Authority proposes to include in the High Pressure and Low Pressure licences;
- b. the special conditions to be included in the High Pressure licence;
- c. the special conditions to be included in the Low Pressure licence.

1.3. Structure of this Document

1.3.1 This document contains the following sections:

- Section 1: Introduction – This summarises the steps in the competition to date and sets out the purpose and structure of this document. It also clarifies how to respond to this consultation;
- Section 2: Standard Licence Conditions – This summarises the main changes we propose to the standard conditions from those published alongside the Applicant Information Pack;
- Section 3: High Pressure Licence special conditions - This summarises the special conditions we propose to include in the High Pressure Licence;
- Section 4: Low Pressure Licence special conditions - This summarises the special conditions we propose to include in the High Pressure Licence;

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- The draft conditions of the High Pressure Licence and the draft conditions of the Low Pressure Licence are published alongside this document on the Authority's website.

1.4. Responding to this Consultation

- 1.4.1 The Authority welcomes responses to the issues raised in this paper by 5pm on 22 January 2015. Responses should be sent to:

Graham Craig
Compliance and Network Operations
Utility Regulator
Queens House
14 Queens Street
Belfast BT1 6ER

gastothewest@uregni.gov.uk

- 1.4.2 The Authority's preference would be for responses to be submitted by e-mail.
- 1.4.3 Individual respondents may ask for their responses (in whole or in part) not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, the Authority will ask respondents to also supply the redacted version of the response that can be published.
- 1.4.4 As a public body and non-ministerial government department, the Authority is required to comply with the Freedom of Information Act (**FOIA**). The effect of FOIA may be that certain recorded information contained in consultation responses is required to be put into the public domain. Hence it is now possible that all responses made to consultations will be discoverable under FOIA, even if respondents ask us to treat responses as confidential. It is therefore important that respondents take account of this and in particular, if asking the Authority to treat responses as confidential, should specify why they consider the information in question should be treated as such.

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- 1.4.5 This paper is available in alternative formats such as audio, Braille etc. If an alternative format is required, please contact the office of the Authority, which will be happy to assist.

2.0 Standard Licence Conditions

2.1. Overview

2.1.1 The Applicant Information Pack (AIP) published in February 2014 included the standard licence conditions that the Authority proposed to include in the G2W conveyance licences (see annex 4 of the AIP).

2.1.2 The Authority asked Applicants to assume that these are the conditions that would apply to the licences when granted. However, the standard conditions may be modified by the Authority on grant if deemed appropriate in the light of our duties at Article 14 of the Energy Order. Therefore the AIP noted that in practice – in the light of submissions made by an applicant, representations received during consultation, or considerations identified by us during the application process – the Authority may consider it requisite in all the circumstances relating to an individual applicant to make certain changes to these conditions so that they are appropriate for that case.

2.1.3 The Part 2A conditions set out below will be included in the high pressure licence granted and will take effect once the Department has designated the high pressure assets as forming part of the Northern Ireland postalised system. Designation means that the allowed revenue derived from the licence will be collected by means of the Northern Ireland postalised tariff meaning that all gas consumers in Northern Ireland will be responsible for funding these assets.

2.1.4 We have set out here the main changes we propose to make to the standard conditions. These changes are generally proposed for one of following purposes:

- The change is a necessary update to the standard licence conditions of either HP, LP or both and we therefore propose to make this change in due course to all other relevant conveyance licences.
- Mirror conditions in the G2W licences to give effect to obligations reflecting the particular circumstances of G2W but which are not necessary to incorporate in conveyance licences more widely at this time.

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- 2.1.5 The Authority has otherwise made minor changes to the standard licence conditions, e.g. to update legislative references, include new definitions where necessary, or to ensure alignment between the two licences.
- 2.1.6 Before grant of licence the Authority may make further minor changes to the standard licences to ensure consistency, e.g. of numbering or formatting. In due course the Authority will consider whether these minor changes should also be made to the other conveyance licences.

Payment of fees to the Authority

- 2.1.7 This condition has been updated to reflect the fact that due to legislative change the costs of the Competition and Markets Authority (CMA) will not be collected by the Utility Regulator. In due course the Authority proposes to update all the conveyance licences with an equivalent modification.

Resolution of disputes

- 2.1.8 The Authority has updated the licence conditions pertaining to the resolution of disputes relating to conveyance services in order to incorporate a role for the Consumer Council in the resolution of disputes. See the process for the resolution of disputes (condition 2.2.6 in the LP licence and 2.2.7 in the HP licence condition 2.3.9 in the LP licence and 2.3.8 in the HP licence).
- 2.1.9 If this change is confirmed in the final licences granted the Authority will consider whether this should be made standard across all conveyance licences.

Trading with Associated Businesses

- 2.1.10 The proposed condition (Trading with Associated Businesses) is contained in both the HP and LP licences and prohibits cross subsidies to or from businesses operated by the licensee or any of its affiliates or related undertakings. This reflects our intention that the licensee shall not benefit from cross-subsidies arising from transactions with associated businesses, nor provide such benefits to associated businesses. There are in addition requirements to ensure that contracts entered into by the licensee comply with the prohibition on cross subsidy. See condition 2.29 in the HP licence and condition 2.30 in the LP licence.

- 2.1.11 It is our intention to include an equivalent licence condition in the licences of the other gas distribution network operators in Northern Ireland in due course.

Reasonable and prudent operator

- 2.1.12 In line with the AIP both licences contain obligations to act as an RPO and maintain the network for its economic engineering life. In the HP licence condition 1.1 of the draft licence includes a definition of a reasonable and prudent operator and condition 2.25 obliges the licensee to act as an RPO. These obligations are based on similar obligations in the existing high pressure conveyance licences, e.g. condition 3.3 of the PTL licence.

- 2.1.13 Similarly for LP the obligations to act as an RPO and maintain the network for its economic engineering life have been formalised in condition 2.27 of the LP licence.

- 2.1.14 It is our intention to include an equivalent licence condition in the licences of the other gas distribution network operators in Northern Ireland in due course.

Requirement for liaison and cooperation

- 2.1.15 We propose to include an obligation in both of the G2W conveyance licences to liaise and cooperate with each other for the purposes of designing and developing the new networks such that the network provides for the conveyance of gas to the towns in the most efficient and economic manner possible. See condition 2.28 in the HP licence and condition 2.29 in the LP licence.

Other changes proposed to HP standard licence conditions

- 2.1.16 In relation to the HP licence only, the AIP indicated that there will be licence obligations to ensure cooperation with the delivery of single system operation in line with the Authority's stated policy in this area. The proposed licence obligation is set out in 2.5.6 and the Authority propose to include a substantively similar licence obligation in the high pressure licences of BGE(UK), PTL and BGTL.

Other changes proposed to LP standard licence conditions

- 2.1.17 The proposed LP licence incorporates a number of new conditions designed to ensure cooperation between relevant licensees for the purposes of achieving a common approach to branding (condition 2.25), a common network tariff (condition 2.26), cost reporting (condition 1.21) and common network code requirements (condition 2.4).
- 2.1.18 It is our intention to include an equivalent licence condition in the licences of the other gas distribution network operators in Northern Ireland in due course.

Common Branding

- 2.1.19 The AIP indicated that there will be a licence condition obliging the licensee to co-operate in delivering a common branding approach in relation to promoting gas in NI. This has now been formalised in condition 2.25 of the licence.

Common Tariff

- 2.1.20 The AIP indicated that there will be a licence condition obliging the licensee to co-operate in delivering a common low pressure network tariff in NI. This has now been formalised in condition 2.26 of the licence.

Cost Reporting

- 2.1.21 The AIP indicated that there will be a condition to oblige the licensee to co-operate with cost reporting. It also stated that all business plan submissions for periodic price reviews will be required 18 months before the implementation date. The cost reporting conditions have been formalised in condition 1.21 of the licence.
- 2.1.22 The obligation to provide input data for periodic price reviews 18 months prior to the start of the new price control period is included in condition 4.4.7.

Network Code

- 2.1.23 The AIP indicated that there will be an obligation to work with other GDNs to produce a single low pressure network code for NI and a consistent switching system and processes. This has now been formalised in condition 2.4.5 of the

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licence.

Summary of applicable standard licence conditions

2.1.24 The table below summarises which standard conditions will apply in each licence to be granted.

Table 1: Summary of applicable standard licence conditions

Part 1: General Conditions Applicable to the Licence Holder	High Pressure Licence	Low Pressure Licence
Interpretation and Construction	✓	✓
Separate Accounts for Separate Businesses	✓	✓
Provision of Information to the Authority	✓	✓
Consultation with the General Consumer Council	✓	✓
Restriction on Use and Disclosure of Certain information	✓	✓
Powers of Entry	✓	✓
Authorisation of Persons	✓	✓
Exercise of Powers of Entry	✓	✓
Modifications	✓	✓
Assignment of Licences	✓	✓
Transfer of Business	✓	✓
Disposal of Relevant Assets	✓	✓
Payment of Fees to the Authority	✓	✓
Notices	✓	✓
Independence of the Licensee (HP)	✓	
Independence of the Licensee (LP)		✓
Business Separation Compliance Plan		✓
Systems to Facilitate Change of Supplier		✓
Prohibition of Discrimination in provision of services		✓
Provision of Information to Gas Suppliers		✓
Regulatory Instructions and Guidance		✓
Part 2: Conditions Applicable to the Conveyance of Gas by the Licence Holder	High Pressure Licence	Low Pressure Licence
Territorial Scope	✓	✓
Conveyance Charges, Other Terms for the Conveyance of Gas and the provision of Conveyance services	✓	✓
Connection Charges and Obligation to permit a Connection	✓	✓
Network Code	✓	✓
Compliance with System Operator Agreements	✓	✓
Conduct of Transportation Business	✓	✓
Provision of information to a relevant gas licence holder	✓	✓
Emergency Services and Obligations	✓	✓
Maintenance of Records	✓	✓
Powers of Licensee under Article 13 of the Order	✓	✓

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Network Forecasts	✓	✓
Provision and Return of Meters		✓
Distribution Marketing Code		✓
Complaints Handling Procedure		✓
Consumer Information Code		✓
Preparation, Revision of and Compliance with Codes of Practice		✓
Terms and Conditions of Gas Contracts with Domestic Consumers		✓
Standards of Performance		✓
Capacity Booking		✓
Provision and Return of Meters	✓	
Cross Border Capacity		
Regional Co-operation		
Competition and Effective Functioning of the Market		
Transmission System Operator		
Common Branding		✓
Common Network Tariff		✓
Reasonable and Prudent Operator	✓	✓
Designation as Distribution System Operator		✓
Gas to the West Conveyance Networks Liaison and Cooperation	✓	✓
Trading with Associated Businesses	✓	✓
Network Development Duties	✓	
Part 2A: Standard Conditions Applicable to the Conveyance of gas by Designated pipe-line operators	High Pressure Licence	Low Pressure Licence
Interpretation and Construction	✓	
Postalisation Charges	✓	
Recovery of PS Non-Payments	✓	
The Postalisation System Administrator	✓	
The Trustee	✓	
Distributions from the PoT Account and Designated Pipe-Line Operators Agreement None	✓	
New Licence Requirements relating to the Network Code	✓	

3.0 High Pressure Special Licence Conditions

3.1. Overview

- 3.1.1 As well as standard conditions there are a number of special conditions which will be included in the High Pressure licence. The Authority has set out our intentions in sections 3.9 to 3.36 of the AIP on the appropriate special conditions and the licence for consultation has been based on these.
- 3.1.2 This section focuses on the key areas within the High Pressure Licence which are likely to be of interest to applicants.

3.2. Outline of the High Pressure Licence Special Conditions

Capital Expenditure Licence Conditions

- 3.2.1 The capital expenditure licence conditions are set out in part 4 of the draft HP licence.
- 3.2.2 The Authority indicated in the AIP that the licence conditions applicable to capital expenditure will be based on providing an incentive to the licensee to outperform forecast capex allowances that are set in advance of construction and therefore that the licensee will be taking on an element of risk with respect to capex. The Authority also indicated in the AIP that the capital expenditure allowances will be determined by a process similar to that set out in condition 2.2.2 of the BGE (UK) licence. This process includes a pain/gain sharing mechanism, the fundamental concept being that if the licensee under spends on their forecast capital expenditure costs they will give some of this back to customers. Similarly if the company overspends on its forecast, customers will underwrite some of the overspend. The sharing factor will be 65% and symmetrical, i.e. if the licensee under spends they will give 65% of the under spend back, and customers will underwrite 65% of any overspend.
- 3.2.3 The VFCE process proposed for the HP licence is set out in condition 4.2.1 and

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is based on condition 2.2.2 of the BGE(UK) licence. In the revenue formulae it can be seen that the allowed capital expenditure includes the VFCE and pain gain components.⁴

3.2.4 In addition the AIP indicated that capital allowances for a number of activities will be treated as uncontrollable with the allowance equalling actual expenditure, so long as this is efficiently incurred. The Authority set out a number of activities which we will treat in this way based on the BGE(UK) licence: construction archaeology, planning conditions and stock up gas and any other categories the Authority may determine as appropriate for this treatment having regard to all of the circumstances. The licence holder will be required to demonstrate to the Authority that these costs have been incurred in an efficient and effective way and the Authority will reserve the right to disallow costs which it judges have not been so incurred. The relevant provisions in the draft HP licence are at condition 4.2.2.

3.2.5 The capex will be depreciated over 40 years from the date of completion.

3.2.6 In relation to the timing of the setting of capex allowances the Authority plans to do so after materials have been purchased and after the construction tender has been completed in line with previous high pressure pipelines projects. The draft HP licence therefore requires that the licensee submit a forecast of the amount of capital expenditure no later than 18 months after the date of grant.⁵

Treatment of assets/revenue before FOCD

3.2.7 As there will be no revenue recovery mechanism during the period when the pipeline is being constructed the AIP stated that costs allowed will be capitalised and included in the opening asset value. The interest rate used will be LIBOR+ 0.5%⁶. This was done in order to incentivise the licence holder to deliver the pipeline in a timely way and in line with the development plan.

3.2.8 This proposal was not intended to cover a circumstance where a part of the network pipeline is operational earlier than envisaged in the development plan.

⁴ See draft HP licence, condition 4.5.6.

⁵ See draft HP licence, condition 4.2.1(a).

⁶ The one year LIBOR rate will be used.

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3.2.9 The Authority is minded to include a provision in the licence which would allow an amount to be included in the opening assets value related to any operational sections of pipeline which have been completed early. We propose that this amount should include any operating costs approved by the Authority, any additional interest calculated by the Authority greater than LIBOR + 0.5%, minus any revenues the Authority determine are received before first operational commencement date. The interest rate will be based on the cost of capital revealed by the competitive process, i.e. 1.98%.

Fixed WACC Licence Conditions

3.2.10 The application pack indicated that the licence will facilitate both periodic reviews where the cost of capital is reset regularly (as in the BGE(UK) licence) and a facility to fix the cost of capital over a longer period of time (as was done through long term debt in the PTL and BGTL licences).

3.2.11 In line with the AIP therefore the HP licence includes a condition which allows the licensee to request that long term financing arrangements are put in place which would avoid the need for regular setting of the rate of return at reviews.⁷ NIEH has made clear in its application⁸ that it plans to request such arrangements and the Authority expects to engage with it on its detailed proposals in the coming months.

3.2.12 This process is likely to involve potential changes to licence conditions at a point in future. The Authority has previously allowed a number of licences to include licence conditions to facilitate long term financing and has carried out a number of consultations on this.⁹ The Authority would expect that these licence conditions are likely to be a starting point for discussions with NIEH. All changes will be fully consulted on.

3.2.13 The Authority made clear in setting out the G2W competition¹⁰ that there were different models in place in NI and the Authority were comfortable that both

⁷ See condition 3.5.3 (e) in the draft HP licence.

⁸ See section 10 of the Business Plan

http://www.uregni.gov.uk/uploads/publications/4_5_NIEH_HP_Operational_Business_Plan_Innovation_Technology.pdf

⁹ See for example in relation to PTL

http://www.uregni.gov.uk/uploads/publications/New_PTL_Licence_and_Grant_of_Licence_03-03-2005.PDF

¹⁰ See section 3.27-3.28 of the AIP.

models could work for G2W. In relation to the rate of return for long term financing the Authority expect any proposals to demonstrate that the long term financing would be consistent with the rate of return conditions set out in the licence.

Operating Expenditure

- 3.2.14 In line with the Gas Networks Extensions in Northern Ireland Conclusions paper, published on 6 February 2014, the licence application process allowed applicants to apply for a licence on the basis of opex pass through or on the basis of a standard revenue cap approach to opex and that the licence would reflect the application of the successful applicant.
- 3.2.15 The preferred applicant made its application on the basis of operating cost pass through. Therefore the draft HP licence contains conditions to give effect to this from the first operational commencement date. The draft licence includes the concept of 'eligible operating pass through cost' and these are defined in condition 4.1.3. This definition is based on the definition currently applicable to eligible pass through costs in the case of PTL. In addition the licence includes provisions requiring a shadow price control review every three years – see condition 4.7. These conditions are based on obligations in the existing PTL and BGTL licences.

Corporate governance arrangements

- 3.2.16 In the AIP the Authority highlighted the importance of protecting customers under the opex cost pass thorough model and that this model would require licence conditions to ensure customers are adequately protected. These conditions are set out in Part 3 of the high pressure licence.
- 3.2.17 Part 3 includes in particular requirements in relation to ring-fencing at 3.1.9, and a requirement to have a management incentive plan at the request of the Authority. In addition condition 4.1.4 seeks to ensure that only eligible costs of the licensed business are passed through to customers and includes an obligation to submit a compliance plan to the Authority which must be approved by the Authority. The Authority will consider any changes necessary to the high pressure licences of PTL and BGTL to ensure that all three MEL licences have

the same substantive effect as 4.1.4. The requirements in condition 2.29 (Trading with Associated Businesses) also complement and strengthen the ring-fencing obligations above.

Postalised Distribution Pipes

- 3.2.18 The HP and LP licences include conditions in relation to Postalised Distribution Pipelines and Excluded Pipelines respectively, with the two being effectively the same thing. This follows the approach which has been taken with all gas projects in NI and the conditions follow those in the BGE UK HP and firmus energy LP licences.
- 3.2.19 A significant amount of pipeline is required to bring gas to the towns and cities of NI and these main pipelines vary between higher and lower pressures – indeed the pressure of each pipeline on the route will not be clear until after licence grant. Within the area of each town, there will also be a network of smaller diameter low pressure pipelines.
- 3.2.20 As part of previous projects DETI has set out the NI policy that such main pipelines will be defined as Postalised Distribution Pipelines and run to the outskirts of the relevant towns. Please see previous consultation¹¹ on this matter. The assets are thus included within the postalisation tariffs which are paid by all consumers in NI. The network assets which run gas around the towns and cities are included within the LP asset base. Previous licences included a figure of 5km outside towns for main pipelines but the Authority has proposed to allow some flexibility with the G2W licences as the exact distance and costs to be included within each licence will depend on final design although the same principles will apply.
- 3.2.21 The Authority has noted the DETI consultation¹² in relation to the Gas to West and East Down projects. In particular the Authority notes that DETI included in its consultations the need to limit any increase in the postalised tariff. DETI's final impact assessment¹³ highlighted that the impact on overall bills, including

¹¹ http://www.uregni.gov.uk/uploads/publications/Postalisation_consultation_paper-June_final.pdf

¹² <http://www.detini.gov.uk/1011.pdf>

¹³ http://www.detini.gov.uk/deti_equality_impact_assessment_extension_of_the_gas_network_to_the_wes_2_.pdf?rev=0

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subvention, should result in a less than 8% increase in gas transmission tariffs, equating to less than 0.5% on final retail tariffs. The Authority will have regard to this position in arriving at a determination of an appropriate amount for Postalised Distribution Pipelines to be included within the HP licence.

Other Areas

Indexation

- 3.2.22 In line with the AIP, the licence uses RPI to index allowed costs and revenue in each year.

Territorial Scope and Exclusivity Licence Conditions

- 3.2.23 Territorial Scope will be the area of the high pressure pipeline and exclusivity will apply for five years. See condition 2.1 and Schedule 3 of the draft HP licence which would give effect to this intention. The territorial scope allows the HP network to facilitate the delivery of gas to the towns set out in DETI's decision on subvention for Gas to the West.

Conveyance Charges

- 3.2.24 The AIP indicated that the licence will include reference to arrangements when designation is not in place. These are set out in condition 2.2 and in 4.3.1 of the draft HP licence.
- 3.2.25 Part 2A of the existing high pressure conveyance licences include a set of standard conditions applicable to the conveyance of gas through designated pipelines. These conditions will be included in the HP licence and can be seen in Part 2A of the draft HP licence.

4.0 Low Pressure Special Licence Conditions

4.1. Overview

4.1.1 As well as standard conditions there are a number of special conditions which will be included in the Low Pressure licence. The Authority has set out our intentions in sections 3.37 to 3.73 of the AIP on the appropriate special conditions and the licence for consultation has been based on these.

4.1.2 This section focuses on the key areas within the Low Pressure Licence which are likely to be of interest to applicants.

4.2. Outline of the Low Pressure Licence Special Conditions

Capital Expenditure Licence Conditions

4.2.1 The capital expenditure licence conditions are set out in part 4 of the draft LP licence.

4.2.2 The Authority indicated in the AIP that the licence will include conditions for the Authority to set allowances for capital expenditure activities through periodic price control reviews in line with standard regulatory price control process. The Authority also indicated that as there will be no revenue recovery mechanism during the period before the first price review those costs allowed will be capitalised and included in the opening asset value, with the interest rate used for this purpose being a one year LIBOR + 0.5%.

4.2.3 The framework for the setting of capital expenditure activities through price control reviews is set out in conditions 4.4.6 to 4.4.10 of the licence. Licence condition 4.4.5 addresses specifics regarding the first period review. It clarifies:

- that the opening asset value will be determined as the sum of capital and operational expenditure reasonably incurred by the licensee before then, minus any conveyance revenue received by the licensee during that same

period;

- the formula for the calculation of the one year LIBOR rate.

Uncertainty mechanism

- 4.2.4 The AIP also indicated our intention to provide for an “uncertainty mechanism” to allow for adjustments to certain cost items for example actual against allowed Traffic Management Act related costs, connection capex costs driven by number of connections made by category and meter installation capex costs driven by number of meters installed per category.
- 4.2.5 This uncertainty mechanism has now been formalised in licence conditions 4.5.2 and 4.6.7. These conditions set out the framework of how the uncertainty mechanism will work; the detail of which capital expenditure items are adjusted under the uncertainty mechanism will be determined as part of the price control reviews.

Rolling incentive mechanism

- 4.2.6 The AIP indicated our intention to allow for capex (and opex) rolling mechanisms in order to encourage efficiency measures, and at the same time ensure that customers also benefit from licensee efficiencies. The Authority clarified that this would enable the licensee to receive a cost of capital return and depreciation on outperformance for a number of years. Conversely for overspends, providing there is not clear evidence of inefficient spend, the licence holder would only be liable to fund a number of years cost of capital and depreciation on the overspend and thereafter the overspend would be added to the TRV.
- 4.2.7 The rolling incentive mechanisms have been formalised in licence conditions 4.6.10 and 4.6.11. These conditions allow for the rolling incentive mechanisms to be turned on or off, as determined as part of the price control reviews.

Operating Expenditure

- 4.2.8 The operational expenditure licence conditions are set out in part 4 of the draft LP licence.
- 4.2.9 The Authority indicated in the AIP that the licence will include conditions for the

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Authority to set allowances for operational expenditure through periodic price control reviews. The Authority also indicated that using the cost information revealed in the application as a basis for the allowances provided in subsequent price controls will act as a powerful incentive to ensure that applicants reveal realistic cost information and that some link should be maintained beyond the first price control period.

4.2.10 The Authority clarified that it would not be minded to accept requests for increased allowances as a consequence of changes in the structure of costs or changes in the allocation of costs from parent or holding companies, but will consider different allowances where these are the result of unforeseen significant changes in the market since the application was submitted. The Authority noted that, over the passage of time, it is likely to become less feasible to continue to directly link allowances to the application and that, when allowances are set at periodic reviews, consideration will be given to the latest information and any changes in circumstances. The Authority clarified that it will not continue to link allowances to the application if that would cause them to be inappropriate in all the circumstances prevailing at the relevant time and that, to mitigate this issue, the Authority will increasingly rely on the cost drivers and other relevant factors identified in the applicant's operational business plan.

4.2.11 The framework for the setting of operational expenditure activities through price control reviews is set out in conditions 4.4.6 to 4.4.10 of the licence. These conditions allow for operational expenditure allowances to be determined with consideration of the data revealed through the competitive licence application process and/ or of other relevant information, as deemed appropriate at the time of the price control reviews. Such information may include, but will not be limited to, differences between the FMA design the AIP was based on and the actual network design.

Uncertainty mechanism

4.2.12 The AIP indicated our intention to provide for an "uncertainty mechanism" to allow for adjustments to certain operational expenditure items for example a marketing incentive linked to the number of domestic connections made to cover advertising, marketing and PR costs.

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4.2.13 This uncertainty mechanism has now been formalised in licence conditions 4.5.2 and 4.6.9. These conditions set out the framework of how the uncertainty mechanism will work; the detail of which operational expenditure items can be adjusted under the uncertainty mechanism will be determined as part of the price control reviews.

Reopeners

4.2.14 The AIP set out our intention to allow a re-opener if opex differed by more than 15% in any one year from forecast. The reopener would be implemented in the year after the 15% figure was triggered. The Authority also indicated that a reopener for capital expenditure was not envisaged as an uncertainty mechanism would be used.

4.2.15 Licence condition 4.7 sets out the conditions for special reviews reopening the price control and sets out that these may be triggered by differences:

- Between the actual and determined volumes of at least 15% after taking into account the effect of weather conditions;
- between the actual and determined opex of at least 15% after taking into account the effect of the uncertainty mechanism;

Rolling incentive mechanisms

4.2.16 The rolling incentive mechanisms for opex will be as per paragraphs 4.2.6. and 4.2.7 in the capex section.

Other Areas

Price cap regulatory model in the early years

4.2.17 The Gas Networks Extensions in Northern Ireland Conclusions paper, published on 6 February 2014 sets out the Authority's thoughts on using a price cap or revenue cap price control model for the low pressure licence. It states our intention to deliver the benefits of both models by:

- including licence conditions relevant to a price cap in the early years of the licence to incentivise the rapid development of gas connections; and

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- including a condition allowing the Authority to switch to revenue cap regulation for the remainder of the licence period so that the licence holder is not subject to the risk of demand variation.

The AIP also stated that the Authority considers ten years an appropriate period for a price cap to apply but will continue to keep this under review.

4.2.18 In line with the statements made in the AIP, part 4 of the licence, and in particular condition 4.2. set out the licence conditions relating to a price cap model which will apply in the early years of the licence. Condition 4.8 provides the Authority with powers to review, five years after commencement of the licence or at a later date, as appropriate, whether the form of price control shall be changed from a price cap to a revenue cap.

Date of first price control

4.2.19 The licence requires the date of the first price control, which runs in calendar years, to be set. The Authority proposes that the date is set as 1 January 2018. As gas will only be in the towns from Q4 2017 this seems like the optimal date although the Authority will monitor progress and will consider adjusting this if appropriate.

Profiling adjustment

4.2.20 The AIP set out our intention to use a 'profiling adjustment' to defer the recovery of some of the costs of developing the network for recovery in later years. The profiling adjustment works by deferring revenue from the early years and smoothing the tariff charged to customers across the recovery period. The profiling adjustment will require the effective capitalisation of operating expenditure. The Authority indicated in the AIP its view that the profile adjustment should be in place for 40 years with capitalised operating expenditure receiving the same rate of return as capital expenditure. Any un-depreciated assets at the end of the 40 year recovery period would then be recovered in line with standard regulatory practice.

4.2.21 Licence condition 4.6.9 sets out how the profile adjustment will be calculated.

Under recovery

- 4.2.22 The AIP set out our expectation that prices should be set each year broadly in line with the allowances set out at each price control and our anticipation to have a mechanism which would roll forward under recoveries at a one year LIBOR + 2% with a mechanism to allow this rate to be reset at the periodic price review. The AIP indicated that there will also be an overall constraint that will limit the amount of under recovery the licensee can recover in any year.
- 4.2.23 Licence condition 4.2 details the primary constraint, including the extent to which under-recoveries can be built up as well as the rate of return applicable to them. It specifies in particular the application of the one year LIBOR + 2% rate of return on under-recoveries and the mechanism by which this can be adjusted. Licence condition 4.3 details the supplemental constraint which limits the amount of under recovery the licensee can recover in any year.

Cost of Capital

- 4.2.24 The AIP indicated that the licence will include a process for periodic price reviews of the cost of capital. It also set out our intention that the cost of capital will equal as far as reasonable the costs revealed by the competitive process. This will particularly apply in the first price control period. For this first price control period, the cost of capital will equate to the 6.2% (pre-tax real) used by the GDN as part of their licence application¹⁴ and in setting the cost of capital after the fifth year and at future reviews the Authority will apply the CAPM model.
- 4.2.25 For the purposes of the licence competition process, the WACC review was undertaken using pre tax figures. However the Authority will review the treatment of tax at each price control review in line with best regulatory practice.

Appeal of Price Reviews

- 4.2.26 The AIP indicated that, in relation to periodic price reviews, the licence will have a mechanism which will allow reference to be made to the CMA in line with standard UK regulatory practice.

¹⁴ http://www.uregni.gov.uk/uploads/publications/2014-11-18_G2W_Determination_FINAL.pdf

4.2.27 This mechanism has been formalised in condition 4.4 of the licence. It is based on the mechanism for making references to CMA consulted on by DETI.¹⁵

Indexation

4.2.28 The AIP indicated that RPI will be used to index allowed costs and revenue in each year.

4.2.29 This has been formalised in condition 4.2.11 of the licence.

LP Development Plan

4.2.30 In the case of low pressure the AIP indicated that the licence will have a development plan which will require the licensee to convey gas in all main towns in the licence area and pass the properties set out in the FMA study on which the Authority used as the assumptions for all applicants in the competition. Consequently the draft LP licence includes a development plan at Annex 2 to Part 3 and the Authority have proposed a date of Q4 2017 for all towns receiving gas.

4.2.31 As with other licences the Authority has included provision within the licence to make changes to the development plan. While we cannot fetter future decisions of the Authority, the conditions recognise that there are circumstances which could occur where it would be appropriate to make changes to the plans. For example the LP plans are dependent on gas being available from the HP network and we would regard a review of the LP plans to be appropriate where gas is not available as a result of HP delays. We also recognise that there are uncertainties in building a cross country network and there may be technical events which require a review of the development plan. There may also be new information which allows for a more efficient roll-out of the network than the one initially envisaged and we will consider the implications of such findings on the development plan whilst at the same time ensuring that any resulting changes are not detrimental to consumers' interests. However we would not expect to review the development plan where delays result from a failure to apply adequate resources to deliver on targets.

¹⁵ http://www.detini.gov.uk/consultation_on_legislative_proposals_for_energy_licence_mod....pdf.

Territorial Scope and Exclusivity licence conditions

- 4.2.32 The AIP indicated that the Territorial Scope will be based on the relevant towns and exclusivity will apply for twenty years. It also clarified that there will be no supply exclusivity linked to the conveyance licence.
- 4.2.33 The Territorial Scope is defined in Schedule 1 of the licence, in combination with Annex 1 to Part 3 of the Licence.

Asset Management

- 4.2.34 The Authority considers that in order to ensure the efficient and economic operation of the network, the licensee needs to have in place an asset management system. This is reflected in licence condition 3.7. It is our intention to include an equivalent licence condition in the licences of the other gas distribution network operators in Northern Ireland in due course.

General Development Plan

- 4.2.35 The licence contains, in Annex 3 to Part 3, a general development plan to be provided by the licensee. We note that the drafting of the general development plan contained in the licence draft that forms part of this application is based on the general development plan of the firmus energy (Distribution) licence, and is likely to be amended as appropriate before the licence is granted.

Information Requirements

- 4.2.36 The Authority recognises that in both the HP and LP licences there are a number of licence conditions placing obligations onto the licensee such as providing documents and information to the Authority. We recognise that the dates for some of these obligations, particular those due before operational commencement, are difficult to predict at this point. In an effort to maintain consistency with other conveyance licences we envisage, rather than changing licence conditions to deal with the uncertainty, the Authority will deal with each obligation in a flexible manner and confirm separately with each licensee the appropriate dates which should apply.