

Consultation on modifications to the Price Control conditions of the firmus Energy (Distribution) Limited Licence

18 June 2015



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

This paper sets out the Utility Regulator's principle of changing the firmus licence from a price cap to a revenue cap form of control before formal licence modifications.

Audience

This document is likely to be of interest to the licensee affected, other regulated companies in the energy industry, government and other statutory bodies and consumer groups with an interest in the energy industry.

Consumer impact

The effect of the change from a price cap form of control to a revenue cap form of control will ensure firmus continues to be inventive to grow the market.

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1. Introduction

Purpose of this paper

- 1.1. The Utility Regulator indicated in its GD14 Price Control for NI's Gas Distribution Networks final determination¹ and again in its GD17 discussion document on our overall approach² and the GD17 approach document³ that as the firmus business is over 10 years old, it is appropriate to move firmus from a price cap to a revenue cap form of control which will reduce its exposure to volume risk.
- 1.2. firmus in their response to the December approach document said they noted *'UR's proposal (section 4.5 of the Discussion Document) to set revenue limits and would ask that any change to the current FE licence Price Cap regime should take account of the maturity of the network and be considered along with any wider licence amendments/alignment of the licences of GDNs.'*⁴
- 1.3. Therefore, this paper is consulting on the principles of changing the firmus licence before formal licence modifications. It will also focus the work for GD17 as we do not think it is appropriate to ask firmus to work on both types of control.

¹http://www.uregni.gov.uk/uploads/publications/2013-12-20_GD14_Price_Control_for_NI_GDNs_2014-2016_Final_Determination.pdf 20th December 2013 Section 16, para 16.17

²http://www.uregni.gov.uk/uploads/publications/2014-12-19_GD17_Price_Control_Scope_-_Final.pdf 19th December 2014

³http://www.uregni.gov.uk/uploads/publications/2015-04-17_GD17_-_Approach_Document_-_Final.pdf 17th April 2015

⁴ http://www.uregni.gov.uk/uploads/publications/2015-03-10_GD17_Approach_-_FE_response_-_100215_-_Final.pdf

Responding to this consultation

1.4. Responses to this consultation paper should be submitted by 17.00 on Thursday the 13 August 2015. Responses should be sent to:

Linda Beirne

Utility Regulator

Queens House

14 Queens Street

Belfast BT1 6ED

Linda.beirne@uregni.gov.uk

1.5. The Utility Regulator's preference would be for responses to be submitted by e-mail.

1.6. 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 Utility Regulator will also ask respondents to supply the redacted version of the response that can be published.

1.7. As a public body and non-ministerial government department, the Utility Regulator 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 Utility

Regulator to treat responses as confidential, respondents should specify why they consider the information in question should be treated as such.

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

2. Background

Company Overview

2.1. firmus Energy (Distribution) Limited (firmus) own and operate the distribution network, normally called the ten towns. firmus was awarded its conveyance licence in March 2005. In the first few years of network development, firmus focus was on connecting the large industrial and commercial companies in each of the towns, such as factories, hospital, large hotels and universities. Following the connection of these large users, firmus networks development is directed towards the connection of small businesses, new-build housing developments, owner occupiers and Northern Ireland Housing Executive (NIHE) properties, where economic in each of the towns. firmus had over 25,000 customers connected within the ten towns licensed area at the end of 2014.

Price Control Context

2.2. firmus currently has a price cap form of control and this provides strong financial incentives to outperform on volumes in the start-up phases of the business. We set allowed tariffs for firmus in each year. The capping of tariffs rather than revenue is more appropriate for a company in the early stage of its development as it provides strong incentives to increase volumes and to develop the gas industry. The firmus price cap form of control means that the maximum tariffs are fixed based on determined volumes (volume incentive control). The price cap provides an incentive to outperform on volumes as the revenue derived from outperformance can be retained.

2.3. Scotia Gas Networks Northern Ireland Ltd (SGN) was awarded its

conveyance licence in February 2015 with first customers scheduled to be on from late 2016. SGN also has a price cap form of control.

2.4. Phoenix Natural Gas Limited (PNGL) was awarded its conveyance licence in September 1996. It has over 182,000 customers connected within the Greater Belfast and Larne licensed areas at the end of 2014. It has a revenue cap, that is, we determine total allowed revenues and PNGL must set tariffs to avoid revenue over-recovery. We set allowed revenue for PNGL each year. PNGL had operated under a price cap in the period 1996-2006, when it was at a similar stage of development to firmus and therefore the focus was on providing incentives to grow the gas market. As the network matured, the strong volume incentive was no longer needed. Consequently, PNGL's control was changed to a cap on revenues in 2007⁵. The modifications to the PNGL's licence were made to Part 2; Condition 2.3; Conveyance Charges, other Terms for the Conveyance of Gas and the provision of Conveyance service⁶.

2.5. There are four gas distribution companies operating in Britain. These are National Grid Gas (NGG), Scotia Gas Network (SGN). Northern Gas Networks (NGN) and Wales & West Utilities (WWU). All four GB GNDs now have a revenue cap form of control.

2.6. The Utility Regulator indicated in its GD17 discussion document on our overall approach (19th December 2014) and its approach document (17th April 2015) that as the firmus business is over 10 years old, it is appropriate to move firmus from a price cap to a revenue cap form of control which will reduce its exposure to volume risk.

⁵ http://www.uregni.gov.uk/publications/phoenix_natural_gas_limited_conveyance_licence_modification_to_price_control

⁶ http://www.uregni.gov.uk/uploads/licenses/2014-03-28_PNGL_Conveyance_Licence_-_final.pdf

3. Revenue Cap versus Price Cap

Introduction

3.1. There are a number of issues to consider regarding the move from a Price Cap form of control to a Revenue cap.

Volumes

3.2. In 2007, 59% of firmus volumes were made up of gaining new customers. This was mainly due to circa 100 new contract I&C customers (P3-P6 customer categories) and therefore highlights that firmus could have a big impact on volumes by getting additional new customers. Following the connection of the contract customers, firmus' networks development has been directed toward tariff customers (P1 and P2 customer categories). In 2016 only 3% of firmus volumes are forecast to be made up of gaining new customers. Therefore the impact of new customers is much less and the incentive of the price cap is much reduced.

WACC comparability

3.3. Both firmus and PNGL currently have a fixed rate of return of 7.5% pre-tax until the end of 2016. Under a revenue cap form of control the rate of returns would be set on the same basis both firmus and PNGL and therefore the WACCs would be more comparable within the NI market and with the GB GDNs.

Growth

3.3. Under a revenue cap form of control, firmus would be slightly less incentivised to grow the market although this can be dealt with through the

connections incentive.

3.4. Our experience with PNGL following a change to revenue cap in 2007 was that large I&C and domestics customers continued to grow. PNGL connected a number of large I&Cs including Coca Cola, Larsen Ltd, Precision Liquids, Bombardier and Kilwaughter Chemical Co Ltd. Therefore, there is still an incentive to grow the market.

The Utility Regulator view

3.5. Given the firmus business is 12 years old in 2017; the Utility Regulator is minded to change firmus from a price cap to a revenue cap. The Utility Regulator is inviting stakeholders to express a view on the principles of changing the firmus licence before formal licence modifications.

3.6. After considering responses we will confirm the approach we intend to take on GD17 and consult on the licence modifications in September 2016 using the PNGL licence as a starting point. The section within the firmus licence that will require most of the changes will be Part 4: The Price Control Conditions.

4. Next Steps

4.1. Responses to this consultation are due by Thursday 13 August 2015 after which we will make our decision. We have set out the key milestones below.

Key milestone	Date
Publish consultation document	18 June 2015
Consultation period closes	13 August 2015
Publish decision document	September 2015
Licence mods in the GD17 price control if a change is approved	September 2016