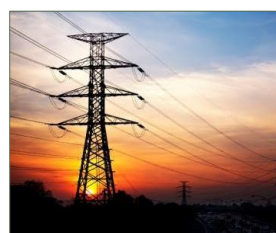


# Gas Network Extensions in Northern Ireland

Conclusions paper  
6 February 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

This paper summarises the comments received to the consultation paper 'Gas Network Extensions in Northern Ireland' published on 3 April 2013. It also presents the Utility Regulators' considered response to the comments made by interested parties during that consultation exercise. The licence application process for the available conveyance licences in the gas to the west extension area commenced on 6 February 2014.

## Audience

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.

# CONTENTS

<b><u>CONTENTS .....</u></b>	<b><u>3</u></b>
<b><u>LIST OF QUESTIONS IN THE APRIL 2013 CONSULTATION PAPER .....</u></b>	<b><u>1</u></b>
<b><u>1 INTRODUCTION .....</u></b>	<b><u>3</u></b>
PURPOSE OF THE PAPER .....	3
BACKGROUND .....	3
NOTICE OF APPLICATIONS FOR THE AVAILABLE LICENCES .....	5
<b><u>2 RESPONSES RECEIVED AND UTILITY REGULATOR CONCLUSIONS .....</u></b>	<b><u>6</u></b>
QUESTION 1 .....	6
QUESTION 2 .....	6
QUESTION 3 .....	7
QUESTION 4 .....	8
QUESTION 5 .....	9
QUESTION 6 .....	10
QUESTION 7 .....	10
QUESTION 8 .....	11
QUESTION 9 .....	11
QUESTION 10 .....	17
QUESTION 11 .....	17
QUESTION 12 .....	18
QUESTION 13 .....	19
QUESTION 14 .....	21
QUESTION 15 .....	21
QUESTION 16 .....	21
QUESTION 17 .....	22
QUESTION 18 .....	23
QUESTION 19 .....	24
QUESTION 20 .....	25
OTHER ISSUES RAISED BY RESPONDENTS.....	27

# LIST OF QUESTIONS IN THE APRIL 2013 CONSULTATION PAPER

Question 1	Is the respondent actively considering making an application for either or both the necessary licence(s)?
Question 2	Do respondents require any additional information on possible Northern Ireland Executive Subvention in order to construct any potential licence application effectively?
Question 3	What are respondents views on the options presented on linking applications and price control allowances?
Question 4	What are respondents views on having a structured competition in which applicants are asked to construct their applications on the basis of an established regulatory model and development plan?
Question 5	What are respondents views on whether the transmission and distribution competitions should be constructed to allow applicants to apply for each licence separately or jointly?
Question 6	We would welcome views on whether three months is sufficient to prepare a licence application.
Question 7	We would welcome views on our proposal to merge the pre-qualification and invitation to tender stages of the evaluation into a single evaluation stage.
Question 8	We would welcome views on the proposed timeline for the licence application process.
Question 9	We would welcome views on our proposed criteria and weightings for each criterion.
Question 10	In relation to the criterion 'Economic and Financial Standing' do respondents agree that the appropriate capital value for the network extension against which applicants should be required to provide proof of net assets should equal the total costs of the network over 40 years?
Question 11	Should there be an opportunity to rectify any omissions from the

	application?
Question 12	Do respondents consider that the proposed workbook is sufficient to capture the cost information necessary for the Utility Regulator to assess applicant determined costs effectively?
Question 13	We would welcome respondents' views on whether 40 years is the appropriate period over which operating cost data is to be provided.
Question 14	Do respondents consider that the proposed controllable operating expenditure cost lines in the workbook are appropriate to capture this data effectively?
Question 15	Do respondents consider that the proposed workbook notes are sufficiently detailed to allow applicants to complete the workbook effectively?
Question 16	Do Respondents consider that the proposed definitions of Controllable Operating expenditure as set out in the notes accurately reflect the structure of costs and the cost divers a licence holder would expect to experience?
Question 17	Do respondents consider that the network design information as set out in the accompanying FMA documents is sufficient for applicants to develop a robust application?
Question 18	We welcome respondents views on our proposals for the key features of the regulatory model to be used in the transmission 'competition.'
Question 19	We welcome respondents views on the incentive proposed to ensure the pipeline is operational as quickly as possible.
Question 20	We welcome respondents views on our proposals for the key features of the regulatory model to be used in the distribution 'competition.'

# 1 INTRODUCTION

## Purpose of the paper

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- 1.1. This paper summarises the responses received to the consultation paper 'Gas Network Extensions in Northern Ireland', published on 3 April 2013.<sup>1</sup> Eight responses were received, four from existing conveyance licence holders, three from consumer representatives and one from an industry consultancy. The non-confidential responses are published in full on the Utility Regulator website. The summary of responses to each question can be found in chapter 2 under the heading of the relevant question.
- 1.2. We have taken the responses into consideration when developing the competitive process by which the exclusive gas conveyance licences necessary to extend the natural gas network to the towns below will be granted. Accordingly, this paper also presents our conclusions on the how the competitive licence application process will be structured. Our conclusions in relation to each question are summarised in chapter 2 under the heading of the relevant question.

## Background

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- 1.3. In January 2013 the Northern Ireland Executive agreed to provide grant funding of up to £32.5m to assist the extension of the Northern Ireland natural gas network to the following towns:
- Dungannon including Coalisland
  - Cookstown including Magherafelt
  - Enniskillen including Derrylin
  - Omagh; and
  - Strabane.
- 1.4. The Utility Regulator will be responsible for the grant of the necessary licences, under Article 8 of the Gas (Northern Ireland) Order 1996 (the 'Gas Order'). We will run the licence application process in accordance with the Gas (Applications for Licences and Extensions) Regulations (Northern Ireland) 1996 (the Regulations) and the criteria for licence applications which have been determined

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<sup>1</sup> [http://www.uregni.gov.uk/publications/gas\\_to\\_the\\_west\\_consultation\\_paper](http://www.uregni.gov.uk/publications/gas_to_the_west_consultation_paper)

by the Department of Enterprise Trade and Investment ('DETI') (the Published Criteria).

- 1.5. It should be noted that the published criteria also apply to an application for an extension of an existing licence. Applicants which hold existing conveyance licences are entitled to apply for an extension. However, if the successful applicant is an existing licence holder we would anticipate that it would be appropriate to grant a new licence as the incorporation of the new licence obligations would require such very significant changes to an existing licence. For all practical purposes, applications for an extension will be treated in exactly the same manner as applications for a new licence.

## **Previous Regulatory Documents relating to the licence application process**

- 1.6. On the assumption that more than one party will apply for a licence in the new licensed area we initiated a process of discussion and consultation with industry in May 2012. This began with the publication of a discussion paper and hosting a workshop with industry participants.<sup>2</sup> The workshop presentations and a summary of the discussions at the workshop were subsequently published on the Utility Regulator website.<sup>3</sup>
- 1.7. Taking into consideration the responses received to the discussion paper and the discussion at the workshop, the Utility Regulator published a Consultation paper in April 2013 which identified a series of questions relevant to the design of the licence application process and the award of licence. The present document constitutes a summary of the responses received and the Utility Regulator's response to the comments received. From the responses received we anticipate that more than one party will apply for a licence in the new licensed area.
- 1.8. DETI also considered the responses to the April 2013 consultation paper in proposing amendments to the Gas (Applications for Licenses and Extensions) Regulations (Northern Ireland) 1996 and the Published Criteria. These amendments were necessary in order to facilitate a competitive licence application process. DETI consulted in July 2013 on changes to the Regulations and the Published Criteria. DETI's decision paper can be found on the DETI website.<sup>4</sup>

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<sup>2</sup> [http://www.uregni.gov.uk/publications/gas\\_network\\_extension\\_discussion\\_paper](http://www.uregni.gov.uk/publications/gas_network_extension_discussion_paper)

<sup>3</sup> [http://www.uregni.gov.uk/gas/projects/gas\\_to\\_the\\_west\\_initiative/](http://www.uregni.gov.uk/gas/projects/gas_to_the_west_initiative/)

<sup>4</sup> [http://www.detini.gov.uk/decision\\_paper\\_-\\_gas\\_applications\\_regulations\\_and\\_published\\_criteria](http://www.detini.gov.uk/decision_paper_-_gas_applications_regulations_and_published_criteria).



1.9. The various changes to the Regulations have not yet been consolidated but the Regulations as they were originally made together with all subsequent amendments are available online from the National Archives. The relevant links to the Regulations are set out below.<sup>5</sup> The amended Published Criteria are also available on the DETI website.<sup>6</sup>

1.10. We published an update for industry on some of the issues in the responses in October 2013. This indicated that the licence application period will be three months in length and applicants should use the gas network design and development plan prepared by Fingleton McAdam in 2010 and subsequently updated as the basis for applicants to construct their application i.e. the 'fat' business model. This publication included the network design provided by Fingleton McAdam.<sup>7</sup>

## Notice of applications for the available licences

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1.11. On the 6 February 2014 we published a Notice on our website calling for applications for the available exclusive gas conveyance licences. An applicant pack to assist potential applicants in preparing an application together with all other supporting materials was also published on the Utility Regulator website on the same date.

1.12. As set out in the Application Pack it is the intention of the Utility Regulator to grant at approximately the same time two exclusive gas conveyance licences in respect of the same authorised area but in relation to different descriptions of conveyance activity:

- One will relate to high pressure assets needed for the distribution of gas to the designated towns
- One will relate to low pressure assets in the designated towns needed for the distribution of gas to individually connected supply points

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<sup>5</sup> <http://www.legislation.gov.uk/nisr/1996/447/contents/made>

<http://www.legislation.gov.uk/nisr/2010/326/contents/made>

<http://www.legislation.gov.uk/nisr/2013/24/contents/made>

<http://www.legislation.gov.uk/nisr/2013/281/contents/made>

<sup>6</sup> [http://www.detini.gov.uk/gas\\_published\\_criteria](http://www.detini.gov.uk/gas_published_criteria).

<sup>7</sup> [http://www.uregni.gov.uk/uploads/publications/Website\\_update.pdf](http://www.uregni.gov.uk/uploads/publications/Website_update.pdf)

# 2 RESPONSES RECEIVED AND UTILITY REGULATOR CONCLUSIONS

## Question 1

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**Is the respondent actively considering making an application for either or both the necessary licence(s)?**

### **Summary of Responses**

2.1. Multiple respondents indicated that they were actively considering making an application for both high and low pressure conveyance licences. One respondent however, stated that they required much more certainty about the licence application process before they would invest the significant sums required to prepare an application. Another respondent was also concerned to ensure that the design of the licence application process did not exclude them from participating.

### **Utility Regulator response**

2.2. These responses confirm that a competitive process will be required to allocate the available exclusive gas conveyance licences. As set out in the introduction DETI has made changes to the Gas (Applications for Licenses and Extensions) Regulations (Northern Ireland) 1996 and the Published Criteria in order to facilitate the competitive process.

## Question 2

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**Do respondents require any additional information on possible Northern Ireland Executive Subvention in order to construct any potential licence application effectively?**

### **Summary of Responses**

2.3. Three respondents commented on this issue, all were in agreement that they would prefer that the licence application process was delayed until the European Commission had made a decision on the State Aid application to provide a grant funding of up to £32.5m for the extension. Respondents in particular wanted certainty about the level of grant funding available and the conditions that would be placed on them as recipients of any grant funding.

## Utility Regulator Response

- 2.4. DETI has provided the Utility Regulator with information about the grant funding and the conditions that will be placed on it. This will be published as part of the application pack for applicants.
- 2.5. DETI has indicated that any grant funding will be paid for the provision of the high pressure pipelines only.

## Question 3

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### What are respondents views on the options presented on linking applications and price control allowances?

#### Summary of Responses

- 2.6. Four respondents commented on this issue, all agreed that there should be a direct link between the cost information revealed in the application and allowances provided in subsequent price controls. The objective being to ensure that applicants reveal realistic cost information. However two respondent's comments referred to the first price control period only. Two respondents also commented that there needed to be clarification as to how allowances would be adjusted to take account of changes in project parameters and the economic environment between the application process and commencement of the first price control period.

#### Utility Regulator Conclusion

- 2.7. We agree that a direct link between the cost information revealed in the application and the allowances provided in subsequent price controls will act as a powerful incentive to ensure that applicants reveal realistic cost information. To strengthen this incentive further we consider that some link should be maintained beyond the first price control period. In particular we reaffirm that we will 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. However, we will consider requests for different allowances where these are the result of unforeseen significant changes in the market since the application was submitted.
- 2.8. We recognise that, over the passage of time, it is likely to become less feasible to continue to directly link allowances to the application. When allowances are set at periodic reviews we will take account of the latest information and any changes in circumstances, and will not continue to link them to the application if that would cause them to be inappropriate in all the circumstances prevailing at the relevant

time. To mitigate this issue we will increasingly rely on the cost drivers and other relevant factors identified in the applicant's operational business plan.

## Question 4

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**What are respondents views on having a structured competition in which applicants are asked to construct their applications on the basis of an established regulatory model and development plan?**

### Summary of Responses

2.9. Four respondents commented on this issue, only one of which supported all aspects of the proposal. One respondent was concerned about the use of an established regulatory model for the practical reason that the choice of model might result in them being unable to participate in the application process, as opposed to any objection to the concept in principle.

2.10. Two respondents expressed serious concerns regarding the use of the Fingleton McAdam network design and development plan as a basis for the application process claiming that it would restrict innovation amongst applicants. One noted that as the Fingleton McAdam study had been carried out in 2009 important information on potential gas consumers had altered. The other asserted that the design of the high pressure network was excessive and could be substituted in places with lower pressure pipes. This later respondent also stated that excluding capital expenditure from the competitive process would reduce its effectiveness as it removed a significant proportion of overall costs from competitive pressure.

### Utility Regulator Conclusion

2.11. In designing the regulatory model we have been mindful to make it open to as many potential applicants as possible and to ensure that it will provide a basis on which applicants can compete effectively against one another. See, for example, the conclusions on question 18 below.

2.12. The Utility Regulator remains content that the Fingleton McAdam network design and development plan (i.e. the fat model) represents a satisfactory basis for the competitive process. The 2009 design was reviewed in 2012 and certain information, such as that on potential connections, was updated as DETI prepared its case for Executive grant funding. An effective competitive process does not depend on the network design being finalised in advance, rather what is required is a common basis for competition between applicants. Allowing

applicants to apply based on alternative designs would make it extremely difficult to establish a common basis for competition between applicants.

2.13. We will also expect applicants to demonstrate their ability to design an efficient network as part of the Operational Business Plan submission. This should include consideration of whether any high pressure pipelines could be substituted for low pressure pipelines, taking into consideration the most appropriate size of pipeline and the pattern of connections.

2.14. The issue of excluding capital expenditure from the competitive process is considered below under question 9.

## Question 5

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**What are respondents views on whether the transmission and distribution competitions should be constructed to allow applicants to apply for each licence separately or jointly?**

### Summary of Responses

2.15. Of the four respondents who commented on this issue two were opposed to there being any link between the assessment of the two separate licences. Reasons included, the very different technical requirements of building and operating high and low pressure networks, the possibility of cross subsidies between licences being used to distort the application process, and that the aggregation of two separate scores might result in an unbalanced outcome whereby the successful applicant might have a very low score for one of the two licences. A third respondent, while supporting the concept of linking the applications, suggested that a minimum standard had to be achieved before any licence could be granted to an applicant. The fourth respondent was supportive of a link between the high and low pressure licence applications.

### Utility Regulator Conclusion

2.16. The issues discussed in relation to this question were taken forward by DETI through the amendments to the assessment criteria which were consulted on separately<sup>8</sup>. In drawing up their original proposals DETI was cognisant of the responses received to this and other questions. See also chapter 4 of the Application Pack for information on the licence application process.

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<sup>8</sup> [http://www.detini.gov.uk/consultation\\_paper\\_-\\_gas\\_applications\\_regs\\_and\\_published\\_criteria.pdf](http://www.detini.gov.uk/consultation_paper_-_gas_applications_regs_and_published_criteria.pdf)

## Question 6

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**We would welcome views on whether three months is sufficient to prepare a licence application.**

### Summary of Responses

2.17. Of the four respondents who commented on this issue three were of the view that a three month application period was not sufficient, but rather requested a period of between five and nine months to prepare their application. The fourth respondent however was of the view that any serious contender should be in a position to complete their application within a three month period. On a related issue this respondent also commented that no restriction should be placed on the size of the application as this would risk important information having to be excluded.

### Utility Regulator Conclusion

2.18. We have concluded that a three month application period should be sufficient for any competent applicant to prepare their application.<sup>9</sup> In designing the application process we have been careful to ensure that the burden on applicants will be appropriate. In our consultation paper we proposed that the application process would commence on 1 July 2013. However due to the requirement on DETI to amend the Regulations and assessment criteria this has been postponed and this was indicated to the industry in October 2013. This delay has provided potential applicants with an extended period of time in which they will have been able to consider, and perhaps undertake some initial preparatory work in relation to, their applications.

2.19. On this issue of application length we agree that the 'Operational Business Plan' should not have a fixed limit. However, we would encourage applicants to limit their submission to one hundred pages where possible.

## Question 7

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**We would welcome views on our proposal to merge the pre-qualification and invitation to tender stages of the evaluation into a single evaluation stage.**

### Summary of Responses

2.20. Of the four respondents that commented on this issue, two were in favor of merging the pre-qualification and invitation to tender stage, one expressed

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<sup>9</sup> See the update for industry published on the Utility Regulator website in October 2013. [http://www.uregni.gov.uk/uploads/publications/Website\\_update.pdf](http://www.uregni.gov.uk/uploads/publications/Website_update.pdf)

indifference and one was opposed. Those in favor thought it would streamline the process whereas the respondent who opposed the proposal argued that they were very separate processes.

## Utility Regulator Conclusion

2.21. The responses affirm our original proposal to merge the pre-qualification and invitation to tender stages. In any event the structure of the application process has been taken forward by DETI through the amendments to the assessment criteria which were consulted on separately.<sup>10</sup>

## Question 8

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**We would welcome views on proposed timeline for the licence application process.**

### Summary of Responses

2.22. Of the five respondents that commented on this issue, four were of the view that extra time should be made at certain points along the process while the fifth, an industry representative emphasised the need to deliver the network extension as expeditiously as possible. Those who sought more time required it for dispute resolution, negotiations with the Utility Regulator on the final licence conditions and to consider more fully the responses to the consultation.

## Utility Regulator Conclusion

2.23. As set out above we have published a Notice calling for applications for the available licences together with an Application Pack. The timetable for the application process is published in chapter 4 the Application Pack. Applicants will have three months to prepare their applications.

## Question 9

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**We would welcome views on our proposed criteria and weightings for each criterion**

### Summary of Responses

2.24. Six respondents commented on these issues.

2.25. Two respondents were concerned in particular that the pass / fail criteria as set out in the consultation, especially that relating to past experience within the last five years, was in danger of excluding potential applicants unduly. Another

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<sup>10</sup> [http://www.detini.gov.uk/consultation\\_paper\\_gas\\_applications\\_regs\\_and\\_published\\_criteria.pdf](http://www.detini.gov.uk/consultation_paper_gas_applications_regs_and_published_criteria.pdf)

respondent was concerned that the experience from elsewhere within a group structure might not be considered relevant if the applicant itself did not possess any of the necessary experience. As a consequence of it being an entirely new entity established specifically for the purpose of entering the competitive process. A fourth respondent was of the view that the requirement to have experience of building, owning and operating a similar asset within the last five years should be loosened and require only that two out of the three requirements need to have been met to pass the criterion.

2.26. On the issue of the weighting of the various assessment criteria the following views were expressed. One respondent was of the view that a weighting of 70% for Applicant Determined Cost was too high given that capital expenditure, the major cost component, was being excluded from the assessment process. This respondent suggested that the weighting of this criterion should be reduced to between 40% and 60% depending on the asset class in question. Another respondent agreed that the weighting for Applicant Determined Cost was excessive and would encourage applicants to submit unrealistically low cost bids which they would then attempt to adjust once the licence was granted. A third respondent expressed the view that cost should not be considered in isolation and wished to understand how the cost estimates revealed during the process would be reflected in final allowances. Three respondents were of the view that the Operational Business Plan should be given greater weighting, two of which had also expressed the view that Applicant Determined Cost had been given excessive weight. One respondent expressed the view that the Maximising Connections criterion should be given increased weighting, while another respondent thought this was key to the success of the project overall they expressed no view as to the weighting of this criterion.

2.27. With regard to the Operational Business Plan criterion one respondent wished that it should include an assessment of ability to build and operate networks in rural towns. Another respondent believed it should assess amongst other things the implementation of industry standard asset management systems, efficiency improvement programs and proposals to secure the connection of large energy consumers. A third respondent thought that it was important that the assessment of this criterion should include the ability to deliver the 'fat' business model of maximising domestic connections.

2.28. With regard to the Applicant Determined Cost criterion one respondent expressed concern that applicants were not required to reveal their capital expenditure requirements. The same respondent was of the view that as the cost estimates revealed in the application process would form the basis of the allowances provided for the first price control period greater weight should be given to these than revealed costs for later price control periods. This would



prevent applicants from underestimating long term cost estimates which they would attempt to adjust upwards at subsequent price control reviews. This respondent was also concerned that to protect consumers the level of cost risk borne by consumers under a mutual ownership rather than a traditional equity ownership model needed to be taken into account. Another respondent specifically agreed that rate of return should be included in the competitive process.

2.29. With regard to the Innovation and Technology criterion one respondent sought more clarity on what information would be sought in response to this criterion.

## **Utility Regulator Conclusion**

2.30. Decisions on the criteria and weightings for the criteria were taken forward by DETI through the amendments to the assessment criteria which were consulted on separately by DETI. In making their decisions DETI was cognisant of the responses received to this and other questions.

2.31. Applicants should refer to the DETI criteria, section two of the criteria sets out the general criteria which the applicant must meet and these apply to all applications for the grant of a licence or the extension of a licence. The specific criteria relevant to an application for the grant of an exclusive gas conveyance licence are set out in section three of DETI's Published Criteria.

2.32. The Published Criteria require the Utility Regulator to provide a Data Input workbook to applicants for the purpose of capturing the data relevant to the Applicant Determined Cost criterion. Separate workbooks are available for the high pressure and low pressure licences and have been published alongside the Notice calling for applications for the available licences. Detailed notes also accompany each workbook.

2.33. The Utility Regulator must also provide an Operational Business Plan template to applicants (templates for the high pressure and low pressure licences are also published alongside the Notice calling for applications for the available licences). The applicant's Operational Business Plan should set out in detail how the costs in the workbook were derived and justify how they are sufficient to deliver the outputs required of a licence holder. In particular applicants should set out how costs are linked to measurable parameters such as number of connections or length of network.

2.34. In developing the workbooks the Utility Regulator has concluded on which costs will be competed on and which will not. Our conclusions and reasoning are set out below.

2.35. Note that all cost in the workbooks must be submitted in April 2014 prices.

### **Conclusion on treatment of cost – high pressure workbook**

#### ***Capital expenditure:***

2.36. We have not been convinced to deviate from our proposals in the April 2013 consultation paper. Therefore we consider that the inclusion of all capex in the competition would increase the costs of preparing an application as applicants would be required to seek cost estimates from suppliers and contractors, however, any figures would be estimates only.

2.37. Therefore the high pressure workbook will fix a number of controllable capital expenditure lines such that these items are not competed on. The costs not competed on are largely dependent on the final design and many will be subject to tender. Those items not competed on are:

- Materials
- Construction
- Wayleaves & Land Acquisition
- Site Investigation / C&I / Commissioning

2.38. Design and project management, mobilisation, contingency, and 'other costs' will be determined by the applicant. We have concluded that only these costs will be competed on as applicants have significant control over these costs. All these cost lines are explained more fully in the notes which accompany the high pressure workbook.

2.39. Uncontrollable capital expenditure (e.g. in relation to archeology, planning conditions, and stock up gas) are not competed on given the uncertainty and level of risk this would bring to the licence application process. This data will therefore be hardwired into the workbook.

2.40. Applicants must base their cost submissions on the network design produced by Fingleton McAdam.

***Operating expenditure:***

2.41. We have concluded that operating expenditure costs will not be competed on and the reasoning for this is explained below under question 18.

2.42. However, in order to protect consumers from inappropriate behaviour, we will expect those applicants seeking an operating cost pass through form of control to set out their proposals (including any associated costs in the 'other costs' category) for the establishment of arrangements that will ensure that the pass through model could not be used to the detriment of customers. This has previously been achieved in other cases through the establishment of a Company Limited by Guarantee. However, we recognise that other company structures might deliver equivalent levels of assurance to consumers. It is for applicants seeking a cost pass through form of control to propose the arrangements that they would use and to demonstrate to our satisfaction that they will be sufficient to address the risks of inappropriate behaviour. Applicants should set out their proposals in the Operational Business Plan submission.

***Determination of the opening asset value:***

2.43. The nature of delivering high pressure pipeline assets is such that capital expenditure will occur over a period of years. For the purposes of the competition the pattern of expenditure indicated by Fingleton McAdam has been hardwired into the workbook. Applicants are not required to give any indication as to their proposed expenditure pattern.

2.44. The maximum amount of the Executive grant funding will be hardwired into the workbook. Further information on the grant funding is published by the Utility Regulator in the application pack.

2.45. As there will be no revenue recovery mechanism during the period when the pipeline is being constructed those costs allowed will be capitalised at a rate of LIBOR +0.5%. The reasoning for this is explained below under question 19.

2.46. Mobilisation and 'Other costs' will be required to be input by the applicant in line with our original proposals.

***Financing costs/WACC:***

2.47. In line with our proposals in the April consultation paper financing costs will be competed on and applicants will be required to indicate the rate of return they will require in order to accept the risks associated with building, owning, and operating the high pressure pipeline system over the 40 years of the project.

None of the responses raised any objections to this specific proposal although there were concerns more generally at the utility of data provision over 40 years (see below, question 13). Therefore the rate of return required over 40 years on a real pre tax basis is to be indicated by applicants in the workbook.

## **Conclusion on treatment of cost – low pressure workbook**

### ***Capital expenditure:***

2.48.As with high pressure capital expenditure we have not been convinced to deviate from our original proposals. Therefore capital expenditure for the low pressure licence will not be competed on. Also we believe that it will be difficult to assess the level of low pressure capital expenditure at this stage without more detailed network design.

### ***Operating expenditure:***

2.49.In line with our consultation proposals we have concluded that operating expenditure for the low pressure licence will be competed on. Therefore, the workbook will set out the controllable operating cost information which must be revealed in the competition. As with the high pressure licence the costs competed on are those which applicants have significant control over.

2.50.We have re-considered whether operating cost data should be provided for the full 40 years and have concluded that it must be provided for the first ten years only by applicants and we will then profile this forward to populate years 11-40. The reason for this is explained below under question 13.

### ***Financing costs/WACC:***

2.51.In line with our original proposals applicants for the low pressure licence will be required to indicate the (real pre-tax) rate of return they will require to own and operate the low pressure system over the first ten years of the project. We have concluded that the rate of return should be provided by applicants over 10 years and not 40 in line with the fact that operating expenditure is to be provided over 10 years. Similarly we will then roll this forward to populate years 11-40.

2.52.Applicants must base their submissions on the network design and development plan produced by Fingleton McAdam i.e. the 'fat' business model. This is explained in more detail in the application pack. Therefore the Fingleton McAdam capital expenditure figures will be hardwired into the workbook and cannot be changed.

## Question 10

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**In relation to the criterion ‘Economic and Financial Standing’ do respondents agree that the appropriate capital value for the network extension against which applicants should be required to provide proof of net assets should equal the total costs of the network over 40 years?**

### Summary of Responses

2.53. Of the three respondents who commented on this issue three fully supported the proposal. The other respondent merely sought clarification that in the case of an applicant being a joint venture between two other entities the financial strength of those two entities would be considered in the assessments of the applicant.

### Utility Regulator Conclusion

2.54. The issues discussed in relation to this question were taken forward by DETI through the amendments to the assessment criteria which were consulted on separately<sup>11</sup>. In drawing up their original proposals DETI was cognisant of the responses received to this and other questions. Applicants should refer to the DETI published criteria, section 3.9 and 3.10 which set out the requirements in relation to Financial Resources and Standing.

2.55. Section 3.9 of the Published Criteria requires the Utility Regulator to indicate any conditions (including the Standard Licence conditions) which the Utility Regulator proposes to include in the licence if it is granted. The proposed licence conditions for the new gas conveyance licences are set out in the Application Pack published alongside the Notice inviting applications for the licences themselves.

2.56. In addition section 3.10 of the published criteria requires the Utility Regulator to specify a minimum amount of capital that is to be available to the holder of each conveyance licence. The applicant must then demonstrate that it has, or can obtain, access to financial resources at least equal to 120% of this amount. The minimum amount for each conveyance licence is specified in Chapter 3 of the Application Pack in April 2014 prices.

## Question 11

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**Should there be an opportunity to rectify any omissions from the application?**

### Summary of Responses

2.57. Of the four respondents who commented on this issue, one was in favour of the proposal but believed that the opportunity to rectify omissions should be limited to

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<sup>11</sup> See Footnote Number 2

prevent gaming. Gaming was also raised by another respondent as being a concern. The other two respondents appeared to be of the view that this proposal should provide applicants with an opportunity to make significant changes to their submissions as a consequence of either some material change in the design of the licence to be awarded or requirement to clarify or adjust the detail of the design of the competitive process.

## Utility Regulator Conclusion

2.58. We have concluded that applicants will be given a short window of opportunity to rectify their application for any of the required information that may have been omitted. Once the application is received we will undertake a completeness/compliance check of the information received in order to identify any missing data. If this check identifies any omission(s) in the information required to be provided, we will notify the applicant, who will be given a short period of time (to be notified by Utility Regulator) in which to rectify the omission(s). In this event, the Utility Regulator will only commence evaluation of the application following receipt of the required information. If the applicant does not provide the information requested it will fail to meet criteria 2.4. We reserve the right not to consider any required information that has not been provided by the stipulated deadline.

2.59. We have concluded that it will not be necessary to provide applicants with an opportunity to amend their application for either of the reasons identified by respondents. During the three months for preparation of licence applications we will put in place a process whereby any applicant can seek clarification on any particular aspect of the process and or information being requested. All questions and responses will be published anonymously on the Utility Regulator website. See chapter 4 of the Application Pack.

## Question 12

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**Do respondents consider that the proposed workbook is sufficient to capture the cost information necessary for the Utility Regulator to assess applicant determined costs effectively?**

## Summary of Responses

2.60. Three respondents commented on this issue. One respondent commented that their initial assessment of the workbook was that both it and the accompanying

notes were comprehensive but that any issues would probably only come to light once applicants attempted to complete it. On this basis the respondent welcomed the proposal to allow applicants to seek clarification from the Utility Regulator during the process. Another respondent was also of the view that there needed to be a mechanism to change the cost lines set out in the workbook during the process if necessary. Another respondent commented that as much of the data contained in the workbook was out of date, being based on the 2010 Fingleton McAdam Feasibility Study, the information captured by the workbook might not be that reflective of final outcomes.

## Utility Regulator Conclusion

2.61. We are grateful to respondents for their comments on the workbook. We have continued to develop it further in advance of the application process commencing. Applicants will be able to seek clarification on specific issues during the process, but where they have such questions they are encouraged to raise them as early as possible. Both the clarification questions and our responses will be uploaded, on a non-attributable basis, onto the Utility Regulator website. Should it be demonstrated that amendments to the workbook are required then the Utility Regulator will publish an updated version on the Utility Regulator website as early as it is possible to do so.

2.62. The Utility Regulator is satisfied that the data included in the workbook from the Fingleton McAdam Study is a valid basis on which applicants can submit cost estimates. The original Fingleton McAdam Study was updated in 2012 for the DETI and this updated information is reflected in the workbook.

## Question 13

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**We would welcome respondents' views on whether 40 years is the appropriate period over which operating cost data is to be provided.**

## Summary of Responses

2.63. Five respondents commented on this issue. One respondent assumed that a 40 year period had been chosen to reflect the economic life of the assets concerned, while another felt that there need to be consistency between conveyance licences in terms of the duration of the financial model. Three respondents thought that there was little value in seeking cost estimates for a 40 year period due to uncertainty and complexity. One of these respondents suggested that an 8 year period would be more appropriate. Another respondent suggested that as

the intention was to use the cost data from the application to set allowances in the first price control period greater weighting should be given to these cost estimates than those for later periods. This would reflect the greater uncertainty associated with future cost estimates and would mitigate the gaming opportunities, where applicants would under estimate future costs in the hope of having them revisited during subsequent price control reviews.

## Utility Regulator Conclusion

2.64. In relation to whether 40 years is the appropriate period over which applicants should provide operating cost data we have concluded that in the case of:

- The conveyance licence relating to the high pressure pipeline system operating cost data will not be competed on. See question 9 above;
- The conveyance licence relating to the low pressure network; the operating cost data will be provided over a 10 year period and we will then profile this forward to populate years 11-40;

2.65. We have decided on a shorter period for low pressure on the basis that the level of uncertainty with respect to future operating costs is less for high pressure pipeline systems, once constructed and operational, than it is for greenfield low pressure networks.

2.66. In arriving at this conclusion we have considered more fully the pros and cons of the 40 year period for low pressure pipelines in light of the responses received. The advantages of the 40 year period are that it would ensure that the detailed costs (capex, opex and finance) likely to be borne by customers in the longer term are revealed in the competition and that it would also provide us with information it can use when setting future price controls. However, we agree with respondents who argued that cost predictions so far into the future are not likely to be very reliable. Consequently, we may not be able to rely on these costs at reviews far into the future. We also agree that the 40 year period could give rise to incentives to propose relatively higher costs in early years and lower costs in later years on the basis that the company may be rescued by the regulator when it can't achieve its projections from year 10 onwards. However, ten years is clearly not reflective of the costs that customers will actually face. We have therefore decided that applicants should only have to provide opex (and WACC) for ten years but we will roll this forward for years 11-40.



## Question 14

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**Do respondents consider that the proposed controllable operating expenditure cost lines in the workbook are appropriate to capture this data effectively?**

## Question 15

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**Do respondents consider that the proposed workbook notes are sufficiently detailed to allow applicants to complete the workbook effectively?**

## Question 16

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**Do Respondents consider that the proposed definitions of Controllable Operating expenditure as set out in the notes accurately reflect the structure of costs and the cost divers a licence holder would expect to experience?**

2.67. We have provided a composite summary and conclusion for these three questions as the issues are related.

## Summary of Responses

2.68. Three respondents commented on these issues. One respondent commented that their initial assessment of the workbook was that both it and the accompanying notes were comprehensive but that any issues would probably only come to light once applicants attempted to complete it. On this basis the respondent welcomed the proposal to allow applicants to seek clarification from the Utility Regulator during the process. Another respondent was also of the view that there needed to be a mechanism to change the cost lines set out in the workbook during the process if necessary. Another respondent stated that the cost information provided by applicants should be justified and supported by evidence.

## Utility Regulator Conclusion

2.69. See our conclusion under question 12 above and which also applies here.

## Question 17

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**Do respondents consider that the network design information as set out in the accompanying FMA documents is sufficient for applicants to develop a robust application?**

### **Summary of Responses**

2.70. Four respondents commented on this issue. One respondent commented that if the application process was to proceed then the Fingleton McAdam documents would provide sufficient information for an applicant to submit their application.

2.71. Two respondents however expressed concerns with regard to technical aspects of the design documents which brought into question whether this was an optimum network design. With respect to the high pressure system issues raised included, references to potential need for compression without further detail and queries over whether ground conditions had been taken into account sufficiently. With respect to the low pressure network issues raised included, lack of information on Special Engineering Difficulties, and the absence of low pressure mains in the network design raising the question of whether their provision had been included in supply point connection costs. One of these two respondents raised the question of how accurate the potential customer information provided was given that it had been compiled in 2009 and there had been significant economic change since then. All these uncertainties led the other respondent to comment that there need to be robust mechanisms in place to handle the impact of any changes in network design on both capital and operating costs.

2.72. The fourth respondent stated that there would need to be a process in place to manage technical questions relating to network design.

### **Utility Regulator Conclusion**

2.73. For the reasons explained above under Question 2 we have concluded that the Fingleton McAdam network design documents are sufficient for applicants to develop a robust application.

## Question 18

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### **We welcome respondents' views on our proposals for the key features of the regulatory model to be used in the transmission 'competition.'**

2.74. In our consultation paper we proposed that the licence application process would be based on a 'revenue cap' form of control with applicants competing both on operating expenditure and cost of capital. The advantages of this approach are that it maximises the information revealed in the application process and avoids any potential challenges in judging between applicants.

2.75. However, this proposal did not exclude the revenue cap model being amended or a different model being adopted in the licence granted, should it be demonstrated that it better facilitated the Utility Regulator in meeting its statutory duties. We specifically recognised that there were two regulatory models in Northern Ireland, the 'revenue cap' model and 'the operating cost pass through' model each with a different approach to opex and that we regarded either as being equally acceptable for the proposed high pressure pipeline system.

2.76. We did not believe that this proposal would exclude applicants seeking 'the operating cost pass through' form of control from the process, and we were very clear that we did not wish to exclude them. It would simply require them to adjust their financing cost submission to take account of the increased risks associated with a revenue cap. Therefore, we were clear that there was a possibility that the regulatory model assumed for the application process was not necessarily that which would be in the licence as granted.

2.77. It should be noted that this section does not set out the licence conditions that we envisage will be included in any high pressure licence granted. The detail of the licence conditions will be discussed in chapter three of the application pack.

## **Summary of Responses**

2.78. Four respondents commented on this question. One respondent claimed that the regulatory model set out in the consultation paper, a revenue cap form of control, ignored the benefits that would derive from a mutual funding model. This applicant also called on the Utility Regulator to set out in advance of the competition how a successful applicant could transition to a different regulatory model through a process of negotiation. Another respondent however expressed the view that a traditional equity based model was more suited to high pressure assets. A further respondent however was clear in their view that the licence

awarded should match that on which the competition was based; in all but for minor amendments. Otherwise the competitive process should be run again on the basis of the revised licence.

2.79. One respondent commented on the issue of contingencies supporting the view that the Utility Regulator should enforce a strict policy with regard to costs applicants had failed to include in their application.

## Utility Regulator Conclusion

2.80. As a result of the responses received we have considered whether it is appropriate to base the competition on the 'revenue cap' model only with the possibility that the regulatory model assumed for the application process may not necessarily be the same in the licence granted.

2.81. We have concluded that applicants will be able to base their applications on either of the two forms of control currently operational in Northern Ireland, that is 'revenue cap' and 'operating cost pass through'. The regulatory model in the successful application will be reflected in the licence granted.

2.82. The reasons for arriving at this conclusion are explained in a consultation paper published alongside this document which also consults on how the WACC of applicants with differing regulatory models will need to be adjusted to allow them to be compared on a consistent basis.<sup>12</sup>

2.83. In respect of contingency, see the high pressure workbook notes for an explanation of contingency costs to be competed on.

## Question 19

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**We welcome respondents' views on the incentive proposed to ensure the pipeline is operational as quickly as possible.**

### Summary of Responses

2.84. Four respondents commented on this issue. One respondent commented that they assumed we had proposed this as it had proved an effective incentive elsewhere in Northern Ireland. A second respondent approved in principle but

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<sup>12</sup> See the paper 'Gas Network Extensions: Approach to Comparing Licence Extensions.'

thought that LIBOR +0.5% was unattractive. The other two respondents were not in favor, one was of the view that too many factors are outside the control of the licence holder, such as ground conditions, archeology and permitted road closures, the other believed that the licence holder should receive an improved return for delays due to factors outside their control.

## Utility Regulator Conclusion

2.85. We have concluded that in order to provide an incentive for the timely delivery of the high pressure system, the licence holder will have those costs allowed during the period of construction until the pipeline becomes operational capitalised at a rate of LIBOR +0.5%.

2.86. We also note that in the assessment criteria published by the DETI applicants proposals for the building and operating of a high pressure pipeline against this criterion will be marked on inter alia, experience of managing the necessary processes to deliver the assets, proposals to ensure the timely delivery of assets and the mobilisation of the necessary resources to deliver the assets. As a consequence those applicants judged most likely to deliver the high pressure pipeline in a timely manner will be at an advantage.<sup>13</sup>

## Question 20

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**We welcome respondents' views on our proposals for the key features of the regulatory model to be used in the distribution 'competition.'**

2.87. It should be noted that this section does not set out the licence conditions that we envisage will be included in any low pressure licence granted. The detail of the licence conditions will be discussed in chapter three of the application pack.

## Summary of Responses

2.88. Five respondents commented on this issue. On the issue of an appropriate form of control one respondent supported the proposed 'price cap' model for a period of ten years followed by a revenue cap model, as providing appropriate incentives. Another respondent however was of the view that this would necessarily result in an under recovery in the early years of the financial model. A third respondent expressed surprise at the proposal as their understanding was

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<sup>13</sup> See sections 3.18-3.19 of the DETI Published Criteria.

that DETI had indicated their preference for a revenue cap model with a connections incentive. This respondent believed that the form of control which best delivered the Strategic Energy Framework should be chosen and as tackling fuel poverty was their primary concern promoting domestic connections should be the priority. This respondent also believed that an incentive regime which encouraged consumption was in tension with other policies to reduce consumption. A fourth respondent suggested that an alternative form of control might include incentive payments for the early completion of network development targets.

2.89. On the issue of whether to follow a fat or skinny model of network development one respondent favored the fat model on the basis that it was more stable and less dependent for its viability on a few larger industrial and commercial customers. Another respondent took the opposite view pointing to past experience in Greater Belfast, where the licence holder following a 'fat' model had required financial restructuring. As compared to the ten towns area where the licence holder following a skinny model was now in a position to successfully fatten the network.

2.90. One respondent sought clarification on a number of issues which were;

- The link between the Executive grant funding and the business model, fat or skinny, adopted in the design of the low pressure network;
- The licence condition which will oblige the licence holder to facilitate postalisation of Northern Ireland low pressure tariffs;
- Derivation of the £300 incentive for connection of existing domestic properties and whether this would fund the associated marketing and promotion expenditure;
- Impact of the Energy Efficiency Obligation.

## **Utility Regulator Conclusion**

2.91. We have concluded that the benefits of both forms of control can be delivered by including licence conditions relevant to a price cap in the early years of the licence to provide the appropriate incentives to the rapid development of gas connections. There will also be a condition allowing us to switch to revenue cap regulation so that the licence holder is not subject to the risk of demand variation. At this point we consider ten years an appropriate period for a price cap to apply but will continue to keep this under review.

2.92. The price cap form of control will provide a strong incentive for the licence holder to maximise volume through the connection of the largest industrial and

commercial consumers as early as possible. These anchor loads will provide the volume of revenue that will allow the licence holder to further roll out the network to domestic consumers. This price cap form of control has already proved effective in Northern Ireland as a means of providing an incentive for network development and timely connection of large consumers.

2.93. The fat business model will be the basis for the network development plan and roll out of the low pressure network. Both the Fingleton McAdam Feasibility Study completed in 2010 and the update completed in 2012 demonstrate that this model is financially viable and gives the best outcome in terms of economic impact and meeting wider policy objectives. Both DETI and the Utility Regulator have previously made it clear that the objective to maximise domestic connections will always be subject to the constraint that such connections must be financially viable at a reasonable low pressure tariff level.

2.94. With regard to the clarifications sought by respondents we would make the following points.

- The grant funding is a matter for DETI however we understand that while the objective is to support the extension project as a whole it will be used to fund the capital costs of the high pressure pipelines;
- We currently have no plans to introduce a Northern Ireland common low pressure network tariff. However, the licence will include an obliging the licence holder to cooperate in delivering a common tariff.
- The £300 figure for the connection incentive per existing household was an approximate figure. A figure of £425 will be hardwired into the workbook and this is derived from the GD14 Price Control for Gas Distribution Networks Final Determination.<sup>14</sup>
- The Energy Efficiency Obligation was considered as part of the GD14 price control review process. See chapter 16 of the determination, specifically the sections 'Energy Efficiency and Shrinkage Gas' and 'Environmental Impact of New Connections' for more details.

## Other Issues raised by respondents

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### Summary of Responses

2.95. In addition to responding directly to the questions set out in the consultation paper respondents raised a number of other issues which we have considered in

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<sup>14</sup> See p.82, section 6.44 of the Determination published on our website.  
[http://www.uregni.gov.uk/publications/gd14\\_price\\_control\\_for\\_gas\\_distribution\\_networks\\_final\\_determination](http://www.uregni.gov.uk/publications/gd14_price_control_for_gas_distribution_networks_final_determination)

reaching a conclusion on the conduct of the competitive licence application process.

- 2.96. One respondent supported the use of a competitive process as a means of delivering best value for consumers and the proposal that the assessment criteria would be in line with the statutory duties of the Utility Regulator. Another respondent supported the overall thrust of the proposals but was concerned that certain details might exclude them from participation. A third respondent was of the view that the assessment criteria should be based on which application was best at supporting the objectives of the Northern Ireland Strategic Energy Framework.
- 2.97. One respondent wished to know whether the licence application would be considered as a best and final offer on behalf of the applicant and in addition whether the contents of the application would be binding on the applicant.
- 2.98. One respondent expressed the view that a period of supply exclusivity would be of benefit in developing the network and making new connections, as has been the precedent in Northern Ireland. Another respondent sought clarity on the nature of the supply licence to be awarded and whether the low pressure business would be required to support retail competition from day one.
- 2.99. One respondent commented on the lack of information in the Fingleton McAdam Feasibility Study with regard to the impact of the network extension on the existing Northern Ireland high pressure system.
- 2.100. One respondent shared our concern regarding stranded assets but was of the view that this should be tackled at high pressure rather than low pressure level. Low pressure network operators already apply an economic test and increasing the cost of connection may result in a reduced rate of penetration amongst both domestic and commercial energy consumers. Another respondent did not believe that non domestic consumers should be asked to pay a connection charge, and that this was an unwelcome departure from previous practices. However two other respondents fully supported a review of existing policies in order to protect consumers against the stranding of assets and in light of the maturity of the Northern Ireland industry.

## **Utility Regulator Conclusion**

- 2.101. Issues relating to the assessment of licence applications were taken forward by DETI through the amendments to the assessment criteria which were consulted on separately. In making their decisions DETI was cognisant of the



responses received to this consultation. In line with the criteria published by DETI applicants should expect that this is a single stage process and that the application they make is their best and final offer.

2.102. There will be no supply exclusivity in the area of the gas network extension and applicants should have all relevant systems in place to support a competitive retail market.

2.103. All those holding a gas supply licence will have their licensed area extended to cover the new gas network.

2.104. We note the comments made on issues relating to the connection policy. We continue to view changes to the policy as necessary and will further consider the potential options highlighted in our April 2013 consultation in a full review in due course.