

# Consultation Paper on Gas Network Extensions in Northern Ireland

3 April 2013

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# 1. Introduction

1.1 At their meeting on 10 January 2013 the Northern Ireland Executive Committee agreed to provide a subvention of up to £32.5m to assist the extension of the Northern Ireland natural gas network to the five largest towns in counties Tyrone, Fermanagh and South Londonderry. These being;

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

1.2 The Northern Ireland Authority for Utility Regulation (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'). The Department of Enterprise Trade and Investment ('DETI') are responsible for the published criteria against which licence applications must be judged. We are in discussions with DETI about whether changes to aspects of the legislative framework might be necessary to facilitate the competition.

1.3 The paper is presented on the assumption that more than one party will apply for a licence in the new licensed area. It would therefore be useful to as part of responses to this consultation paper to establish the degree of interest amongst potential network developers in developing and operating this extension to the existing natural gas network in Northern Ireland.

1.4 On the expectation that more than one party will apply, the Utility Regulator will need to include a competition between applicants within the process by which licences are awarded. If only one party applies then the Utility Regulator would assess this application according to the existing award of licence process.

1.5 We are minded to award two separate gas conveyance licenses:

- One will relate to all the new transmission assets needed to connect the designated towns to the existing natural gas network.
  - One will relate to all the distribution assets required in the designated towns to provide connections to individual supply points.
- 1.6 However, it should be noted that ‘conveyance’ as a licensable activity covers both distribution and transmission. Therefore the Utility Regulator could award a single licence covering both transmission and distribution if this was considered appropriate depending on the winning application. We will therefore need to consider whether to facilitate an application for a single transmission and distribution conveyance licence.
- 1.7 This Consultation Paper considers the major issues which need to be decided upon in designing the competition phase of the process to award licences. The Utility Regulator has identified a number of options, including a preferred option, and respondents are asked to comment on these, but are not limited to considering only these options. This paper follows on from a previous paper<sup>1</sup> and workshop that was held in 2012.
- 1.8 The proposed award of licence process is set out in chapter 5 including a draft timetable for the process. The draft timetable indicates that the award of licence process could commence in early July 2013 with the licence(s) being awarded in the first quarter of 2014. As set out in chapter 5 we would welcome comments on the proposed award of licence process and draft timetable.
- 1.9 Our policy making process to date has included the publication of a discussion paper, the hosting of a workshop for interested stakeholders and the engagement of independent economic consultants. In developing our proposals we have also sought to take account of the principals of Better Regulation and best practice from other similar processes, for example Ofgem’s Off-shore Transmission process. Through this process we have reached minded to positions for consultation on the overall design of the competition and these are set out below.

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<sup>1</sup> [http://www.uregni.gov.uk/publications/gas\\_network\\_extension\\_discussion\\_paper](http://www.uregni.gov.uk/publications/gas_network_extension_discussion_paper)

1.10 It is important to note that we are designing a process that is unique to the gas industry in Northern Ireland. As such, the process proposed is unlikely to be identical to other processes stakeholders have participated in. In the light of this, we recognise that the process proposed may need refining over the coming months, and we would encourage continued stakeholder engagement. We therefore welcome any views on the process described before the final licence application process is finalized.

### ***Purpose of this Paper***

1.11 The purpose of this Consultation Paper is to seek the views of interested parties on a number of issues related to the design of the regulatory framework that will operate in the network extension area, and the design of the award of licence process, including the competition. The specific issues each chapter focuses on are as follows;

- Chapter 2 – Background, sets out the history of the natural gas industry, in Northern Ireland and the development of the network extension project to date. It also considers some of the issues with the current connections policy for the distribution network and some of the broad policy options going forward;
- Chapter 3 – Legislative Framework, sets out the legislative framework applicable to the grant of licence in Northern Ireland;
- Chapter 4 – High Level Approach, seeks views on a number of issues related to the high level design of the licence award process, e.g. how many phases the competition should have and the relationship between the transmission and distribution competitions;
- Chapter 5 – The Licence Application Process – describes the proposed award of licence process from this point until the licence(s) are awarded. The information we propose should be provided for licence applicants is set out in this chapter together with a draft timetable.

- Chapter 6- Competition Phase Assessment Criteria, seeks views on our proposals for the criteria to be used to evaluate licence applications, how applications will be scored using the criteria and how we propose to consider combined transmission and distribution applications;
- Chapter 7 – The Competition Treatment of Costs, seeks views on proposals for which costs applicants should be asked to compete on and how these might be translated into allowances for the purposes of setting price controls;
- Chapter 8 – Transmission Licence Competition - Regulatory Model, seeks views on specific proposals relating to the design of the transmission regulatory model for the purposes of the competition;
- Chapter 9 Distribution Licence Competition – Regulatory Model, seeks views on specific proposals relating to the design of the distribution regulatory model for the purposes of the ‘competition.’

### ***Responding to this consultation***

1.12 During the consultation period we will hold a workshop on the issues presented in the paper. This will be held in Utility Regulator offices on 7 May at 10am. Please contact Graham Craig (details below) if you wish to attend.

1.13 We have set out a number of questions for respondents to answer and these are set out throughout the document and brought together in a template for responses at annex 1. Respondents should not feel confined to the specific questions proposed and may comment on any other issue they feel relevant to the issues under consideration in the paper.

1.14 The Utility Regulator welcomes responses to the issues raised in this paper by Wednesday 29 May 2013.

1.15 Responses should be sent to:

Graham Craig

Gas Branch



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14 Queens Street  
Belfast BT1 6ER  
[graham.craig@uregni.gov.uk](mailto:graham.craig@uregni.gov.uk)

- 1.16 Our preference would be for responses to be submitted by e-mail.
- 1.17 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, we will ask respondents to also supply us with the redacted version of the response that can be published.
- 1.18 As a public body and non-ministerial government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1 January 2005. According to the remit of FOIA, it is possible that certain recorded information contained in consultation responses can 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 note these developments and in particular, when marking responses as confidential or asking to treat responses as confidential, should specify why they consider the information in question to be confidential.
- 1.19 This paper is available in alternative formats such as audio, Braille etc. If an alternative format is required, please contact the office and we will be happy to assist.

### ***Questions for Consultation***

Q. 1 Is the respondent actively considering making an application for the necessary licence(s)?

## 2. Background

### *The Development of the Natural Gas Network in Northern Ireland*

- 2.1 Natural gas was first introduced to Northern Ireland via the Scotland to Northern Ireland gas pipeline in 1996. Initially, natural gas was made available to customers in Greater Belfast, the immediate surrounding area and Larne where the gas distribution network in this area has been developed by Phoenix Natural Gas (PNG). PNG's business model is based upon making natural gas available to as many industrial and commercial, public sector and domestic customers as possible where it is financially viable to do so. By the end of 2012, natural gas was available to circa 300,000 properties in this licensed area, with approximately 155,000 of these actually connected to natural gas.
- 2.2 Firmus energy (firmus), a subsidiary of Bord Gáis Eireann (BGE), is engaged in work to develop the natural gas market outside Greater Belfast along the routes of the North-West gas transmission pipeline, which was completed in November 2004, and the South-North gas transmission pipeline, which was completed in October 2006. This covers rolling out the gas distribution network in the 10 towns and cities of Londonderry, Limavady, Ballymena, Ballymoney, Coleraine, Newry, Craigavon, Antrim, Banbridge and Armagh. To date, firmus has connected around 15,000 customers in the 10 towns/cities licence area, including taking natural gas to some additional urban areas, such as Tandragee and Warrenpoint. The firmus business model differs from the PNG business model in that it is based on connecting key gas loads, i.e. primarily businesses, but also public sector buildings; social housing as provided by the Northern Ireland Housing Executive or housing associations; and new private housing developments. Domestic customers in existing owner-occupied private housing may be connected to the gas network if they are adjacent to routes developed to meet business demand for natural gas.
- 2.3 It is worth noting that the South-North and North-West gas transmission pipelines provided by BGE(UK) between 2004 and 2006 received Government funding of £38 million which included an £8.5 million contribution from the Irish Government. However, the development of gas distribution networks in

Greater Belfast and Larne areas, and the 10 towns licensed area served by the South North and North West pipelines was not funded by Government.

2.4 Maps of the existing distribution licence areas are contained in annex 3 below.

## ***Gas Network Regulation in Northern Ireland***

2.5 Each gas network utility in Northern Ireland operates under a slightly different regulatory model. A brief outline of each of these models is set out below.

### *Gas Transmission*

2.6 Gas transmission tariffs in Northern Ireland are postalised, that is there is a single common capacity and single common commodity tariff for all gas transported across the Northern Ireland transmission system irrespective of the use made of the system. These postalised tariffs are paid into a common postalised revenue pot. The revenue from this pot is then divided between the transmission system owners on the basis of the allowed revenue that derives from their respective Gas Conveyance licence. There are currently two transmission system owners in Northern Ireland.

- Mutual Energy Limited. A company limited by guarantee who own and operate both the Scotland to Northern Ireland Pipeline (SNIP) and the Belfast Gas Transmission Pipeline (BGTP). Both these assets are mutualised and were purchased with a financial bond backed by all gas consumers in Northern Ireland. Due to the financing arrangements in place transmission assets are not subject to a normal revenue cap but instead all costs are treated as pass through items with consumers funding 100% of both capital and operating expenditure. There is however a periodic shadow price control so that that the Utility Regulator may assess the operating expenditure of the company.
- BGE (NI) owns and operates both the South North and North West Pipeline along with their associated spurs. These assets are subject to a

traditional form of control with a revenue cap set every five years by the Utility Regulator.

### *Gas Distribution*

2.7 Gas distribution tariffs in Northern Ireland are not postalised and so each distribution company sets a tariff to raise either the allowed revenue or to match the price cap that derives from their respective licenses. At present there are two distribution network owners in Northern Ireland.

- Phoenix Natural Gas owns and operates the distribution network in the Greater Belfast area and the retail market is now fully open to competition. The relevant aspects of the Phoenix regulatory model are capitalisation of opex expenditure and profiling of revenues so that over the recovery period unit distribution charges remain steady. The form of control derives maximum allowed revenue which is then collected through distribution charges. The company does not take volume risk.
- firmus owns and operates the distribution network in the ten towns area. Supply exclusivity for some consumers is still in place but this will be removed by April 2015. The relevant aspects of the firmus regulatory model are capitalisation of opex expenditure and profiling of revenues so that over the recovery period unit distribution charges remain steady. Unlike in the case of Phoenix Natural Gas the firmus regulatory model derives a maximum distribution tariff as opposed to a maximum allowed revenue. The company therefore is incentivized to increase volumes.

### ***The Gas Network Extension Project to Date***

2.8 In August 2009, DETI, assisted by the Utility Regulator, commissioned a high level study by Fingleton McAdam (FMA) to determine the technical and economic feasibility of extending the natural gas network in Northern Ireland. This was completed in 2010 and is referred to in this document as the FMA study. The [study](#) considered a number of options in terms of geographical

scope and business models, however all options required the construction and operation of both transmission and distribution networks.

2.9 Drawing upon the findings of the FMA study, the Department carried out a public [consultation](#), ending 30 September 2011, on the potential for extending the natural gas network in Northern Ireland. The majority of [responses](#) to this consultation, particularly those from the natural gas sector, local industry and the public sector, supported extending the natural gas network. In addition in May 2012 the Utility Regulator published a [discussion](#) paper seeking views on a range of issues that would need to be considered in designing the regulatory framework that would operate in the area of the network extension and the competitive award of licence process. As part of this process the Utility Regulator hosted a workshop at which a range of interested stakeholders, including a number of potential developers, were able to discuss these various issues. A summary of the [output](#) from this discussion process was published in August 2012.

2.10 Over the summer of 2012 the Department engaged external consultants to assist it in developing an Outline Business Case which formed the basis of paper to the Northern Ireland Executive Committee seeking approval for a subvention of up to £32.5m for the transmission system required to extend the natural gas network into Tyrone, Fermanagh, and south Londonderry.

2.11 The towns included in the business case were:

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

## ***Northern Ireland Executive Subvention***

- 2.12 At its meeting on 10 January 2013, the Northern Ireland Executive agreed to support extension of the natural gas network to towns in the West and North-West by means of a direct subvention of up to £32.5million towards the cost of the new gas transmission pipeline infrastructure. This will be contingent on DETI obtaining State Aid approval for the subvention. The outcome of this State Aid application is unlikely to be known until the end of 2013 and there is no certainty that it will be accepted in full. It should also be noted that the decision of the Northern Ireland Executive Committee was made on the basis that all the towns listed above would be connected at an estimated cost of £92.9m (2012 prices). Should actual cost exceed this no additional subvention will be payable, however if actual costs are lower or not all towns are connected then the subvention will be reduced accordingly.
- 2.13 Additionally, there will be quite stringent governance arrangements established for payment of any subvention including a detailed letter of offer from DETI, and payment only for what will be noted as "qualifying expenditure". This is likely to focus on materials and actual construction works rather than expenditure indirectly due to the project such as overhead costs. There will also be strict requirements for record keeping, furnishing original invoices, and detailed vouching of claims by Department staff.
- 2.14 Any subvention is also likely to be subject to specific requirements around equality, health and safety, sustainable development and social welfare. Department of Finance & Personnel guidance is that funding of this nature should be subject to "social clauses" in relation to the engagement of trainees / apprentices. This could require employment opportunities for the long term unemployed and or the employment of apprentices for a given level of funding. All such conditions will be set out in the letter of offer.
- 2.15 Payment of any subvention will also be subject to satisfactory technical verification by a suitably qualified and experienced technical person / consultant, for example in respect of documentary evidence of design

standards, welding procedures and standards adhered to, materials specification, etc.

2.16 As it is not permissible to provide state aid to a company that is the subject of a recovery order in respect of illegal state aid, any such applicant will not be eligible to be awarded a gas conveyance licence for the purposes of transmission. An example could be where a private company received government grant support which was not approved by the European Commission and who subsequently made a recovery order against the Member State and the company in respect of the illegal aid.

### ***Connections Policy on the Distribution Network***

2.17 At present in Northern Ireland consumers wishing to connect to the gas distribution network are subject to an 'economic test' which means that a free connection will be provided if the present value of future distribution tariff revenue is greater than the cost of providing the connection. The Utility Regulator considers that such a connection policy might no longer be appropriate for the more mature gas industry that now exists in Northern Ireland. In particular the policy would appear;

- To be out of step with existing arrangements in Great Britain where supply points are required to fund the full or part of the cost of the connection downstream of the existing network;
- To be out of step with developments in Great Britain where user commitment in the form of a financial guarantee is required before network reinforcement is undertaken;
- Not to protect gas consumers from the risks of having to fund stranded assets resulting from the early closure of other supply points: and
- Not to provide sufficient certainty about the future pattern of gas demand to facilitate robust economic and efficient network planning.

2.18 Of particular concern is the need to protect consumers against the risk of having to fund stranded assets. This extension is dependent on a number of

large loads connecting therefore it would appear appropriate to consider whether some form of financial guarantee would be appropriate. It is also important that those who benefit from the subvention contribute to the costs of connection where appropriate. For these reasons the Utility Regulator intends reviewing the existing Northern Ireland policy with a view to introduce a policy which more effectively facilitates efficient network planning and protects against stranded assets. It may be that any policy changes will focus on large gas consumers. It is intended that this review should be completed, with any policy changes implemented before first gas flows in the area of the network extension.

2.19 While no decisions have been made, the shape of the broad policy options which will be considered could include some combination of the following;

- A continuation of the 'economic test';
- A requirement that supply points should fund the cost of providing supply point specific assets downstream of the existing distribution network in advance of the connection being made;
- A requirement that supply points should partially fund the cost of general network provision in advance of the connection being made, with any charge being cost reflective taking account of both supply point capacity and distance from a network reference point;
- A requirement that supply points should commit to paying an agreed amount of capacity/commodity based distribution tariff for a period of years following connection irrespective of whether or not gas is consumed. An example that is currently in place for the transmission network between BGE(NI), and the ESB/ESBI in relation to the Coolkeragh power station connection.

2.20 In considering the appropriate connections policy going forward the Utility Regulator will need to balance the need to protect consumers from the risk of funding stranded assets against our duty to promote the economic development of the gas industry in Northern Ireland. This duty can be achieved by promoting economic connection to the gas network by new gas consumers.



2.21 The Utility Regulator intends bringing forward proposals for consultation on a revised connections policy in due course.

### ***Questions for Consultation***

Q. 2 Do respondents require any additional information on possible Northern Ireland Executive Subvention in order to construct any potential licence application effectively?

### **3. The Legislative Framework**

3.1 The regulatory framework for the Northern Ireland gas industry is provided for in a number of instruments including primary legislation, secondary legislation, licences issued by the Authority, industry codes and technical standards. This includes but is not limited to.

- The Gas (NI ) Order 1996.
- The Energy (NI) Order 2003
- Transmission and Distribution Network Codes;
- Transmission - Distribution System Operator Agreement
- Northern Ireland Network Operators Agreement; and
- Gas Safety Management Regulations.

3.2 Within this framework the Utility Regulator exercises its powers in a manner consistent with its statutory duties under the Energy (NI) Order 2003. Our principal objective in carrying out our gas functions, as set out at Article 14(1) of the Energy Order, is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland, and to do so consistently with our fulfilment of the objectives set out at Article 40 of the Gas Directive.

#### ***Published criteria for licence grant***

3.3 The Utility Regulator has the power to grant licences by virtue of Article 8 of the Gas Order. A gas conveyance licence provides the licence holder with the right to convey gas within the designated area, as set out in the licence.

3.4 The Utility Regulator also has the power under Article 9 of the Gas Order, where it thinks it appropriate in the light of its statutory duties, to grant an exclusive conveyance licence in relation to a particular area for a specified period of time. The Utility Regulator proposes to rely on this power to grant exclusive conveyance licences in the area which covers the network plan

developed by Fingleton McAdam. The Utility Regulator proposes to grant exclusivity for the maximum period of time permitted by statute (20 years) in an area which covers the network plan developed by Fingleton McAdam in their 2010 study (the FMA study) and utilised in the 2012 Outline Business Case completed by KPMG for the Department.

- 3.5 However, the present arrangements for dealing with licence applications make no specific provision for a situation in which there is more than one applicant for an exclusive licence. DETI are responsible for the published criteria against which licence applications must be judged. We are in discussions with DETI about whether changes to aspects of the legislative framework might be necessary to facilitate the competition.
- 3.6 Potential interested parties should also note that since the criteria were last amended a package of European legislation on the liberalisation of European gas and electricity markets (the Third Package) has come into force. The Third Package will require changes to the gas conveyance licences and consequently an applicant for a licence will need to demonstrate that it will be able to comply with these licence obligations as per the current published criteria for licence applications.
- 3.7 In our May 2012 consultation we proposed to use a set of principles to guide our approach to the issues to be considered in extending the network and in particular to inform the design of the licence award process and regulatory model. The proposed principles were grounded in our statutory duties and included for example that the arrangements should be efficient, economic, and result in a coordinated gas industry. DETI shares the same statutory duties in the exercise of its functions under the Gas Order and they are embodied in the published criteria. We will therefore apply them to the decisions made within the licence application process.

## 4. High Level Approach

- 4.1 Our May 2012 paper and subsequent workshop considered a number of high level issues and we set out some of them here along with a minded to position on how we propose to proceed in relation to those issues.

### ***One Phase or Two Phases***

- 4.2 The Utility Regulator has considered how the benefits of competition could be incorporated into the award of licence process. In considering how this might be achieved a recent example for comparison is the Ofgem process to award Off-shore Electricity Transmission licences (transitional regime). In this award of licence process applicants submitted their annual revenue requirement to finance, operate and maintain a given transmission asset for a set period of 20 years, with the lowest application being awarded the licence. The Ofgem approach could be described as a fixed price application where the applications are directly translated into allowed revenues.

#### *Fixed Price Application Approach*

- 4.3 We have set out below how such an approach would work in respect of the current licence extension. With regard to capital expenditure, applicants would be asked to put in a fixed price application. Time would be allowed for applicants to conduct the necessary activities to develop a fixed price application, including verification of the network design and tendering for materials and construction contracts. The securing of wayleaves, planning permissions and other consents would not be required prior to the fixed price application being submitted.
- 4.4 With regard to operating expenditure, applicants would be required to set out the allowances they would require for each 'controllable' opex activity for the first price control period and these would be used to set the operating cost allowance for that five year control.

- 4.5 The main advantage of this approach is that it provide clear and objective parameters on which to base decisions. It might also be expected that it would ensure that consumers receive the full benefits of competitive tendering where applicable for capital and operating activities. It also provides a sound basis for making allowances to the licence holder in advance of the first price control period.
- 4.6 It has been suggested however that tendering processes carried out at this stage may not be effective in revealing suppliers actual costs. This is the consequence of there being an air of unreality to the process. In addition as the final specification of tender requirements and delivery times is uncertain at this point in time, any tender arrangements secured will by necessity require flexibility. This will in itself add significant costs to the tender which in turn would be funded by consumers.
- 4.7 This approach would require increased time and resources on the part of applicants which would extend the process and increase applicants' costs. This increase in costs may discourage some potential applicants, reducing the effectiveness of competitive pressures.
- 4.8 We also note that the Ofgem process has been criticised by the Public Accounts Committee. In particular the awarding of an index linked revenue stream fixed for a period of twenty years was considered not to deliver best value for consumers. In addition this process related to a pre-existing set of assets of known value and this is very different from the situation that exists regarding the network extension project in Northern Ireland.
- 4.9 The Utility Regulator's initial view is that such an approach would not be appropriate in our circumstances because there is a much greater level of uncertainty which applicants would reflect in their applications and consumers would be required to fund. There is only high level design and cost analysis available with regard to the assets to be delivered. In addition while there is a broad understanding of the likely licence conditions there is no detail on issues such as how ownership structure should be reflected.

4.10 One solution would be to remove these uncertainties in advance of the award of licence process. However this would unduly delay the process and would require a large commitment of resources by the Utility Regulator in areas such as network design and costing which it is not best placed to carry out. In addition a number of uncertainties could not be resolved ahead of the licence being awarded, including how ownership structure would be reflected in the licence.

4.11 In a situation where it is determined that a licence should be granted to an existing gas conveyance licence holder, the Utility Regulator may consider whether a more efficient approach would be to extend the existing licence rather than to grant a new one. However, for all substantive purposes, an existing licence holder will be treated in the competition for the licence in exactly the same way as an applicant which does not currently hold any licence.

#### *Two Phase Approach*

4.12 To resolve these problems the Utility Regulator proposes a process split into two phases, with the first being a competition to assess how applicants perform against the criteria. During the second phase the Utility Regulator will consult on the licence conditions and grant the licence(s).

4.13 Should the award of licence process fail to attract any more than one competent applicant then the Utility Regulator proposes moving to phase two immediately but still using the competition network design and regulatory model as a starting point for these discussions.

4.14 The proposed stages in the competition phase are set out in more detail in Chapter 5.

## ***Link between Applications and Final Allowed Revenues***

4.15 If a fixed price application process is not pursued we have identified two broad options to allow applicants to effectively compete against each other on the basis of cost, both of which are discussed in detail below.

### *Competency Based Applications*

4.16 Applicants would be asked to set out in writing how they intend to meet a set of core competencies related to the various activities involved in the development and operation of network assets. This would be demonstrated by means of procedures and methodologies for each activity, for example tendering processes, along with examples from previous projects which demonstrated successful delivery of these activities. The Utility Regulator would then make a judgment as to which application best demonstrated an ability to deliver on these core competencies.

4.17 Unlike a fixed price application this process could be conducted fairly quickly and would require a limited resource input from applicants, therefore encouraging participation. It is also not uncommon in the tendering of large infrastructure projects where there is a large degree of uncertainty as to the costs and design of the final project for such an approach to be adapted to some extent at least. However the subjective nature of such an approach means that it might be difficult to base a robust decision on such a methodology alone.

4.18 The main drawback to this approach is that it fails to utilize competitive pressures to force applicants to reveal their true costs of providing the licensed activity. This approach would therefore be unlikely to benefit consumers. It also fails to provide any indication as to the allowance that would be required in the first price control period and so negates one of the major purposes of the competition phase of the award of licence process.

### *Hybrid Approach*

- 4.19 While we believe the fixed price approach is too rigid for this licence application process, there remain significant cost elements which applicants should be able to compete on.
- 4.20 We therefore propose a hybrid approach which would involve identifying those cost lines which applicants should at this point have significant control over. This would include most operating costs and potentially some elements of capital cost. It would also include financing costs. Where these elements are competed on we would expect the actual cost allowances to be based on the application values.
- 4.21 The cost areas that we believe would be most difficult to compete on would be those costs that are dependent on the final design and that are likely to be subject to tender. For example much of capex will be dependent on the outcome of tenders and for this reason we see limited value in competing on large elements of capex.
- 4.22 Where costs are not competed applicants would have to set out their approach to delivering this activity and it would continue to be included in certain assessment criteria at various stages of the competition in particular assessment of managerial and operational capacity.
- 4.23 The advantage of this methodology is that it avoids the time and resources required by the fixed price methodology, while at the same time permitting applicants to compete on the basis of the objective criteria of cost.

### *Utility Regulator Proposal*

- 4.24 The Utility Regulator considers that each of the methodologies outlined above has its merits and disadvantages and the balance between these depends on the nature of the activity being considered. As far as possible the Utility Regulator wishes to design a competition where applicants are allowed to effectively reveal costs. This cost information can then be used to make



objective judgments' and to set allowances for various activities. On the whole therefore the Utility Regulator is minded to propose the hybrid approach.

4.25 Chapter 6 sets out in more detail how the assessment criteria could be applied and chapter 7 considers the detail of how costs could be competed on.

### ***Flexible or Detailed Instructions to Applicants***

4.26 While we are proposing a two phase process and the competition will not be directly for a finalised licence we will need to decide what instructions to give to the applicants in making their applications. There are two options here which were discussed in our previous paper and at the workshop.

4.27 We could leave the competition open for applicants to put in any application they wished with very loose parameters. Applicants could propose different routes, volume assumptions, ownership models, business plans, incentive mechanisms etc. This would obviously make it more difficult to compare the applications and judge them against a set of assessment criteria. On the other hand it could allow for more innovative applications with new ideas which have not been considered in Northern Ireland.

4.28 The alternative is to have a detailed set of instructions with a clear regulatory model that will allow applicants to understand the business model they are applying for. This provides for greater comparability between applications and allows for the objective criteria to be applied more easily. There would be an issue in designing the instructions on what model to choose. This is especially the case where we have alternative models in Northern Ireland which can both work well e.g. opex pass through with a mutual model and opex price control with a more standard model.

4.29 Our minded to position is to have a detailed approach which will set out clearly what model applicants should compete against. Our proposals for each model are set out in chapters 8 and 9.

4.30 We believe that this approach will allow applicants clarity on what they are applying for while still allowing flexibility in discussions on the licence. Any changes between the regulatory model set out in the competition and the final licence conditions will only be considered where we determine they better facilitate our duties. In particular we should note that there may be changes to the licence conditions to reflect the ownership structure of the successful applicant or to take into account the possibility that an existing licence could be extended rather than having a new separate licence.

### ***Relationship between Transmission and Distribution ‘Competitions’***

4.31 In our discussion paper a number of alternatives were considered as regards the possible relationship between the transmission and distribution licence award processes. This included hosting a single process whereby both licenses would be issued to a single applicant and a sequential process whereby the process to award the transmission licence is hosted first followed later by the process to award the distribution licence.

4.32 Our initial view is that neither of these options is capable of delivering best value for consumers. This is because hosting either a single or sequential competition may reduce the number of applicants willing to participate in the process and as a consequence reduce the level of effective competition. Some applicants may only be interested in one of the two gas conveyance licenses being awarded while others might only be interested if they can compete for both. In addition a sequential process prevents applicants from revealing any potential cost benefits that may be derived from the synergies that result from constructing and operating a transmission and distribution system together.

4.33 For these reasons the Utility Regulator’s initial view is that the most effective means of awarding these licenses would be to host a joint process which allowed applicants to either;

- Apply for a single licence;
- Apply for each licence separately;
- Apply for both licenses jointly; or

- Submit separate applications on the basis of being awarded a single licence and being awarded both licences.
- 4.34 This approach allows maximum flexibility with regard to how parties might structure their applications and so it is expected that it will allow for the maximum number of applicants to participate in the process facilitating vigorous competition.
- 4.35 In determining which applicant or applicants should be awarded the gas conveyance licences, the Utility Regulator proposes to base its decision on which application or combination of applications achieves the highest number of marks, across both the transmission and distribution licences, when assessed against the objective criteria.
- 4.36 Therefore an individual application, based on being awarded either only the transmission or only the distribution licence, even if it achieves the highest mark for that particular licence, would not be guaranteed the award of that licence in a case in which a combined application, based on being awarded both licences, achieved higher marks in total than any combination of individual applications.
- 4.37 It should be noted that while we are minded to award a single conveyance licence for transmission and a single conveyance licence for distribution, 'conveyance' as a licensable activity covers both distribution and transmission. Therefore the Utility Regulator could award a single licence covering both transmission and distribution if this was considered appropriate depending on the winning application.
- 4.38 We will therefore need to consider whether to facilitate an application for a single transmission and distribution conveyance licence. We envisage that applicants seeking such a licence would need to fill in all the relevant questionnaires/workbooks in relation to transmission and distribution applications (see chapter 6 for information on these). This will enable the application for the combined licence to be assessed on the same basis as all other applications.

## ***Questions for consultation***

Q.3. What are respondents views on the options presented on linking applications and price control allowances?

Q.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?

Q.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?

## **5. The Licence Application Process and Timeline**

- 5.1 This section sets out the proposed stages in the licence application process and our projected timeline for the process. It also sets out the consultation process which the Utility Regulator proposes to follow.
- 5.2 As with the rest of the paper, this section pre-supposes that there will be more than one party interested in a licence in the area of the network extension.
- 5.3 As noted earlier we are in discussions with DETI about whether changes to aspects of the legislative framework might be necessary to facilitate the competition.

### ***Stage 1 – The Application***

- 5.4 Those who wish to apply for one or both licenses will be invited to do so by a date that will be set by the Utility Regulator. All applications received by that date will be considered in accordance with the process outlined below.
- 5.5 We propose that applicants should have 3 months to prepare their applications. We would welcome views on whether this will allow applicants sufficient time to develop detailed proposals.
- 5.6 Applications must be made in accordance with the requirements laid down in the Application Regulations made by DETI. Each application will need to be made in the form, and provide all the supporting information, which the Regulations specify. We propose that the form of the application should be standardised by means of a questionnaire and workbooks (one each for distribution and transmission) which applicants would fill in. This will ensure consistency across licence applications. Before the form of the application is finalized we will give consideration to whether a limit should be placed on the size of the submission.
- 5.7 Although the Utility Regulator may require further information later in the competition, the information supplied with an initial application will provide the

basis on which applications will be assessed and will be relevant to further stages. It must be accurate and complete. Providing false information could amount to a criminal offence.

- 5.8 The Application Regulations will also specify a fee that must be paid when the application is made.
- 5.9 In addition, each application will need to be published in the manner set out in the Regulations so as to draw it to the attention of those who are interested in it.
- 5.10 The Utility Regulator proposes to treat this as an initial consultation, and will consider the views of any interested parties, submitted in response to the publication of the applications, during the evaluation stages (see below).

#### *Information for applicants*

- 5.11 The natural gas industry in Northern Ireland has developed over many years and operates under a structured framework. Applicants will be responsible for ensuring they understand the regulatory framework related to the conveyance of natural gas in Northern Ireland.
- 5.12 However, we recognize that applicants will need a large amount of information to provide sufficiently detailed applications. We therefore propose to provide applicants with information about the transmission and distribution assets that will be required to deliver the network extension. We expect that this will predominantly be information derived from the detailed technical analysis contained in the FMA study of January 2010.
- 5.13 The outputs from the FMA study that we propose to make available to applicants in order to develop a robust application are:

- Transmission and Distribution network design information including detailed technical specifications and maps to a scale of 1:5000;
- Transmission and Distribution network capital cost estimates;
- Detailed load analysis including data for each potential non domestic supply point;
- Environmental constraint maps.

5.14 To assist respondents we have published examples of each of these pieces of information alongside this document. We would welcome views from respondents on whether the network design information as set out in the accompanying FMA documents is sufficient for applicants to develop a robust application.

5.15 We also propose to provide applicants with a questionnaire and workbook in which to enter the information which the Application Regulations made by DETI will require.

5.16 For illustrative purposes we have developed a sample workbook and accompanying notes covering the cost information proposed. The notes are attached in annex 2 and the workbook is published alongside this paper.

5.17 To ensure that the transparency of the competition is maintained the Utility Regulator would act as the hub whereby all queries or points of clarification and the responses received would be made available to all applicants.

## ***Stage 2 Evaluation of applications***

5.18 Once applications are submitted the Utility Regulator will need to evaluate them in order to select the licence application which best meets the criteria. The Utility Regulator will be required to assess applications at this stage against the criteria published by DETI (under Article 8(7B) of the Gas Order).

5.19 The proposed criteria are outlined in detail in chapter 6.

- 5.20 An applicant who fails to satisfy the criteria would play no further part in the competition.
- 5.21 The Utility Regulator has considered whether the evaluation should incorporate a pre-qualification stage followed by a separate invitation to tender stage (ITT). The pre-qualification stage would require applicants to demonstrate that they have the high level experience and capability to build and operate a conveyance network whereas the ITT stage would contain their detailed application for the particular licence they are applying for. The ITT would only be open to those applicants which had passed the pre-qualification stage.
- 5.22 Alternatively we could merge these stages in one thereby requiring applicants to submit complete detailed licence applications at the outset.
- 5.23 Having considered this issue we see no particular value in incorporating a pre-qualification stage followed by a separate invitation to tender stage and so would propose to merge these stages in one. The rest of the paper is drafted on the basis of this proposal. We would welcome views on our proposal to have a single evaluation stage.
- 5.24 The purpose of the evaluation stage will be to set out how each applicant meets the criteria.
- 5.25 Where the Utility Regulator has concluded that an applicant fails to satisfy the criteria or has not best met the criteria, the Utility Regulator will inform it of the reasons for that conclusion. The Utility Regulator will also inform it that it has the right, within 28 days, to challenge that conclusion, in which case it will be reviewed by the Utility Regulator which will then make a final decision (see Article 8(7A) of the Gas Order and section 5 of the DETI published criteria).



### ***Stage 3 – Consultations and Licence Grant***

- 5.26 Before it may grant each of the licenses, the Utility Regulator must publish notice of its intention to do so and consult on it for at least 28 days (Article 8(4) of the Gas Order).
- 5.27 In parallel with this, the Utility Regulator will carry out a public consultation (expected to be of 28 days) on its provisional conclusions on criteria assessment.
- 5.28 The Utility Regulator will consider the views of any interested parties, and the outcome of any review that has been requested, before making a final decision on the granting of a licence.
- 5.29 The Utility Regulator will have regard to any representations received as to the licence to be granted, and make any modifications to the draft conditions of that licence if appropriate.
- 5.30 Where it determines to grant each licence it will publish a notice of the fact that it has done so for the purposes of Article 8(6) of the Gas Order.

### ***Recovery of costs***

- 5.31 As a result of specific regulations Ofgem has been able to recover the cost of hosting the Off-shore Electricity Transmission licence competition from participants. The Utility Regulator does not intend to follow this approach and in any case does not have the legal vires to do so; rather any Utility Regulator costs incurred will be recovered from the generality of gas industry licence fees.
- 5.32 As is the case currently applicants will not be in a position to recover their costs and any expenditure is at their own risk. Existing licence holders will not receive an allowance for any such costs they may choose to incur. This will extend to the successful applicant who will not receive a specific allowance in their price control determination for application related costs.

## ***Proposed Timeline for the Application Process***

5.33 The table below sets out our proposed timetable for delivering the competition phase of the process and is based on a single stage evaluation process. The objective is to have completed the process and granted the licences in the first quarter of 2014.

<b>Start</b>	<b>Activity</b>	<b>Party</b>	<b>Finish</b>
3 April 2013	Public Consultation on Licence Award Process	UR	28 May 2013
7 May 2013	Workshop on award process for interested parties	UR	7 May 2013
Mid June 2013	Decision Paper on Award of Licence Process	UR	Mid June 2013
1 July 2013	Notice of Interest Published	UR	1 July 2013
July 2013	Preparation of Licence Applications	Applicant	End September 2013
1 October	Submission of licence application	Applicant	
1 October 2013	Publication of licence applications for public consultation	Applicant	End October 2013
1 November 2013	Consideration of licence applications and public responses	UR	End November 2013
Early Feb 2014	Public Consultation on final licence conditions	UR	Early March 2014
March 2014	Final Licence(s) Granted	UR	March 2014

## ***Questions for Consultation***

Q.6. We would welcome views on whether three months is sufficient to prepare a licence application.

Q.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.

Q.8. We would welcome views on the proposed timeline for the licence application process.

## **6. The Competition Phase – Assessment Criteria**

- 6.1 As set out above DETI are responsible for the published criteria against which licence applications must be judged. We are in discussions with DETI about whether changes to aspects of the legislative framework might be necessary to facilitate the competition.
- 6.2 To inform these discussions this chapter sets out for consultation criteria which the Utility Regulator proposes could be used at the various stages of the competition, including our initial proposals as to how each of the criteria should be weighted in relation to the others.

### ***Questionnaire Assessment Criteria***

- 6.3 In Chapter 5 we proposed that there would be a single evaluation stage to the competition and that we proposed to provide participants in the process with a questionnaire and a workbook which would cover the information required to be submitted by the Gas (Applications for Licenses and Extensions) Regulations 1996.
- 6.4 In this section we have attempted to distinguish between the information that the Regulations may require to be provided and our proposed criteria for judging the licence applicants.
- 6.5 We propose that the initial sections of the Questionnaire will capture the following:
- Applicant Identification
  - Organisation Structure
  - Economic and Financial Standing
  - Management & Operational Capability
  - Signing of Pre Qualification Certificate

6.6 These are aimed at establishing the fitness of the applicant to hold a licence. Therefore, we propose that applicants must pass these sections before the Utility Regulator evaluates the rest of the application.

6.7 In respect of any piece of information which is required to be provided by the DETI Regulations, if an applicant fails to provide information required by the Regulations then we propose that the licence application will fail.

#### *Applicant Identification*

6.8 In this section of the questionnaire we propose that the applicant<sup>2</sup> would provide information on the details and evidence of its identity such as:

- Name of applicant
- Registered address, registration number and date of registration
- Office contact details
- List of financial, technical, legal and other professional advisors

#### *Organisation Structure*

6.9 In this section of the questionnaire we propose that the applicant should provide information on and evidence of its ownership and organisation structure.

6.10 This section of the questionnaire does not constitute an assessment criterion but as above if an applicant fails to provide information required by the Regulations then the licence application will fail.

6.11 The information which we propose could be provided is:

- Directors names and addresses
- Legal status of applicant - public limited company , partnership etc
- Principal shareholders

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<sup>2</sup> The applicants in this context means anyone who makes a licence application including where two or more persons act together as a consortium for the purposes of a licence application.

- Details relating to the parent or holding company
- Particulars of any gas or electricity licence(s) held or applied for in Great Britain, Northern Ireland or the Republic of Ireland.

### *Economic and Financial Standing*

6.12 We consider that a key issue to establish early in the process is whether an applicant has the necessary financial strength to support the necessary expenditure over time required by the licence(s) for which the applicant wishes to hold, i.e. an expenditure level based on the FMA Study. We therefore propose to assess the financial solvency and strength of each applicant during the evaluation stage of the licence application process. We therefore propose that economic and financial standing should be a criterion that needs to be met.

6.13 In order to pass this criterion the applicant will need to provide:

- Either proof that the net assets of the applicant are at least 120% of the capital value of the assets expected to be delivered by the licence holder. We anticipate that this total transmission and distribution capital value will be in the order of £200 million but would welcome views on this point.
- Or proof that the applicant has access to debt finance and equity finance equal to at least 120% of the capital value of the assets expected to be delivered by the licence holder, and the ratio between these two funding sources.
- Where debt finance is proposed evidence from the last five years:
  - ✓ of raising debt finance or
  - ✓ of investing in an infrastructure business with debt finance; or
  - ✓ a letter of comfort from a financial institution or institutions with a Grade 'A' credit rating stating their willingness to provide debt finance
 to a level at least equal to 100% of the debt finance proposed by the applicant.
- Where equity finance is proposed evidence from the last five years:
  - ✓ of holding net assets or
  - ✓ of raising equity finance; or

- ✓ a letter of comfort from an entity or entities with a Grade 'A' credit rating stating their willingness to provide equity finance to a level at least equal to 100% of the equity finance proposed by the applicant.

6.14 In order to support the assessment of the criterion we propose that the following information should be provided. As above if an applicant fails to provide information required then the licence application will fail.

- ✓ Detail of the build-up of the applicant's proposed WACC and evidence that it is based on market rates;
- ✓ Copies of the last three years audited financial accounts;
- ✓ A statement of contingent liability or loss, if not otherwise stated in the most recent annual report that would require disclosure in accordance with International Accounting Standard 10;
- ✓ A signed statement of significant changes from the last audited balance sheet if more than ten months has elapsed since the last set of audited accounts.

#### *Management & Operational Capability*

6.15 We also propose to establish early in the competitive process that an applicant has the necessary expertise to build and operate a regulated infrastructure asset of a similar size and complexity to the proposed licensed activity. We therefore propose that management and operational capability should be a criterion that needs to be met.

6.16 In order to pass this criterion for transmission we propose that an applicant should provide one example from the past five years of owning, developing, and operating a network of similar size and complexity to which the gas conveyance licence will apply, i.e. a high pressure, >7 barg, gas transmission pipeline.

6.17 This example should demonstrate experience of;

- ✓ delivering to required technical, regulatory and statutory requirements;

- ✓ securing and managing the necessary resources and or contracts;
- ✓ managing and engaging with external stakeholders including wayleaves and planning;
- ✓ management to specified operational standards;

6.18 In order to pass this criterion for distribution we propose that an applicant should provide one example from the past five years of owning, developing, and operating a network of similar size and complexity to which the gas conveyance licence will apply, i.e. a lower pressure, 7 barg, distribution network.

6.19 This example should demonstrate experience of;

- ✓ delivering to required technical regulatory and statutory requirements;
- ✓ securing and managing the necessary resources and or contracts;
- ✓ managing and engaging with external stakeholders;
- ✓ management to specified operational standards;

## ***Evaluation Process***

6.20 Once the application is received the Utility Regulator could 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 could notify the applicant and give them a period of time in which to rectify the omission(s). Alternatively, we could evaluate the application using only the information that is provided thus creating a clear incentive on applicants to submit a complete submission as there would be no opportunity to rectify any omissions. We would like to have stakeholder views on this point as allowing this could potentially be gamed as a means to increase the amount of time to prepare the application.

*Pass mark*



6.21 The Utility Regulator proposes that it will evaluate responses to the requirements above in the Questionnaire on a pass/fail basis. A failure would result where the applicant is unable to supply the necessary information requested in the DETI Regulations.

6.22 In addition, we propose that in order to qualify for the next stage, an applicant must pass both of the criteria set out above. Therefore in relation to Economic and Financial Standing:

- Either proof that the net assets of the applicant are at least 120% of the capital value of the assets expected to be delivered by the licence holder.
- Or proof that the applicant has access to debt finance and equity finance equal to at least 120% of the capital value of the assets expected to be delivered by the licence holder, and the ratio between these two funding sources.

6.23 In relation to Management and Operational Capability:

- One example from the past five years of owning, developing, and operating a network of similar size and complexity to which the gas conveyance licence will apply.

6.24 A failure to meet any of the criteria at this stage would result in that applicant exiting the process. We propose that the rest of their application would not be assessed.

### ***Detailed Assessment Criteria***

6.25 We propose that the rest of the questionnaire will cover the areas set out below and that each will be evaluated according to its own assessment criteria.

- Applicant Determined Cost
- Operational Business Plan
- Innovation and Knowledge Transfer
- Maximising Connections (for Distribution only)

## *Workbook*

6.26 In relation to applicant determined cost we propose that applicants should fill in a work book constituting the detail of the cost elements of their application. We have provided a sample data workbook and accompanying notes for illustrative purposes.

6.27 The workbook also illustrates how the proposed criteria and weightings could translate into assessment calculations. We invite responses in particular on the proposed weightings as well as the specific criteria. This chapter should therefore be read in conjunction with the attached sample Workbook and accompanying notes.

6.28 We continue to develop the workbook and notes and would welcome comments on it, in particular around :

- the effective capture of cost data;
- the description of cost lines and the effectiveness of the accompanying notes.
- The calculations included in the workbook

6.29 We consider below the proposed criteria for transmission and distribution separately although there is a high degree of overlap between them.

## ***Assessment Criteria - Transmission***

6.30 For transmission the criteria we propose are explained in detail below. Before examining the criteria we will set out how we propose to weight the criteria and mark the applications against the criteria.

### *Weighting the criteria*

6.31 We propose that the criteria should be weighted and so have set out for consultation a percentage of available marks which could be allocated to each criteria. The weighted marks added together would determine an individual

application's overall score. The three criteria and associated weights proposed for transmission are:

- Applicant Determined Cost (70% of available marks)
- Operational Business Plan (20% of available marks)
- Innovation and Technology Transfer (10% of available marks)

6.32 In proposing these weightings we have taken the view that cost should be the criteria for which the majority of marks are available. It is the criteria that will allow applicants to compete one against the other most effectively. It is also the criteria that will have the greatest bearing on whether the extension is delivered in an economic and effective manner. That is not to say that the other criteria are not important. However we consider that once applicants reach this stage in the evaluation their capacity to build and operate the network successfully will have been demonstrated to a large extent. We also believe that there is a more limited opportunity for effective competition on the basis of these criteria so they each have a comparatively lower weighting.

#### *Applicant Determined Costs*

6.33 The Utility Regulator proposes that 70% of available marks should be awarded on the basis of this criterion. Total cost is calculated as the net present value of 40 years revenue.

6.34 The lowest cost application would receive the maximum marks available with each other application receiving a mark below the maximum relative to how much above the lowest cost application it was. So for every 1 % percentage point above the lowest cost application 5% of the marks available for this criterion would be deducted from the maximum. This will mean that an application with cost 20% above that of the lowest cost application will receive zero marks for this criterion. We consider that this relationship between cost and marks awarded will deliver an effective differentiation between applicants on the basis of cost. It is proposed that only full percentage differences are used in the calculation of these deductions so that marginal cost differences between applications do not impact the marks received.

#### *Operational Business Plan*

6.35 The Utility Regulator proposes that 20% of available marks should be awarded on the basis of this criterion. In addition to having a very clear link between applications and price control allowances applicants will be required to submit an operational business plan built up to a professional standard.

6.36 This should therefore explain how controllable operating expenditure forecasts are derived and explain the scope of activities they cover. The business plan must be linked to the costs submitted in the workbook so that it is clear how the costs are built up and that the business plan and associated costs fully meet all the operational and licence requirements of transmission in Northern Ireland and any other technical, regulatory and statutory requirements on the licensee. For example, the safety requirements stipulated by the Health and Safety Executive Northern Ireland (HSENI) drive a number of transmission system operator activities in relation to safety and maintenance and so should feature in the business plan and associated costs.

6.37 A key feature of the business plan should be the skills and experience of key staff members.

6.38 The business plan should also cover the management of:

- The proposed tendering arrangements for materials, construction works and design services
- engagement with external stakeholders in the delivery of wayleaves, land acquisition , planning permission and environmental consents;
- operational risks to ensure the timely delivery of the transmission assets;
- the connection of these transmission assets with existing and proposed upstream and downstream assets necessary for network extension;
- the delivery of system operation and grid control;
- the operation of these transmission assets with existing and proposed upstream and downstream licence holders;
- interactions with the regulatory authorities and compliance with the gas conveyance licence conditions.

6.39 Applications will be evaluated on the completeness of the business plan in relation to the operational requirements of transmission in Northern Ireland. A low score would result from failure to ensure that all the statutory costs of operating a transmission system in Northern Ireland are included.

#### *Innovation & Technology Transfer*

6.40 The Utility Regulator proposes that 10% of available marks should be awarded on the basis of this criterion. Innovation now plays a central role in the Ofgem, RIIO, approach to price controls. But as noted in the Utility Regulators consultation on cross utility price controls, the Northern Ireland industry is of a scale where the promotion of knowledge transfer is more likely to be an effective policy option than is indigenous innovation. For this reason applicants will be required to set out;

- Those innovation projects they are currently involved in or have been in the past five years;
- How these innovations might be applied to the gas industry in Northern Ireland;
- How the applicant promotes innovation and knowledge transfer; and
- What skills knowledge and experience the applicant can bring to the Northern Ireland gas industry and how this will assist the Utility Regulator in meeting its statutory objectives.

6.41 Applicants will be evaluated on the basis of their capability in driving innovation in relation to environmental sustainability, new sources and use of gas, cost efficiency, and developing the network to remote geographical areas,

## ***Assessment Criteria - Distribution***

### *Weighting the criteria and marking the applications*

6.42 The criteria we propose for distribution are similar to those proposed for transmission with the addition of a criterion on delivering domestic connections.

6.43 As with transmission we propose that the criteria should be weighted and our proposed weightings are set out below:

- Applicant Determined Cost (60% of available marks)
- Operational Business Plan (20% of available marks)
- Maximising connections (10% of available marks)
- Innovation & Technology Transfer (10% of available marks)

6.44 In proposing these weightings we have taken the view that cost should be the criteria for which the majority of marks are available. It is the criteria that will allow applicants to compete one against the other most effectively. It is also the criteria that will have the greatest bearing on whether the extension is delivered in an economic and effective manner. That is not to say that the other criteria are not important. However we consider that once applicants reach this stage in the evaluation their capacity to build and operate the network successfully will have been demonstrated to a large extent. We also believe that there is a more limited opportunity for effective competition on the basis of these criteria so they each have a comparatively lower weighting.

### *Applicant Determined Costs*

6.45 The Utility Regulator proposes that 60% of available marks should be awarded on the basis of this criterion.

6.46 The lowest cost application would receive the maximum marks available with each other application receiving a mark below the maximum relative to how much above the lowest cost application it was. So for every 1 % percentage point above the lowest cost application, 5% of the marks available for this criterion would be deducted from the maximum. This will mean that an

application with cost 20% above that of the lowest cost application will receive zero marks for this criterion. We consider that this relationship between cost and marks awarded will deliver an effective differentiation between applicants on the basis of cost. It is proposed that only full percentage differences are used in the calculation of these deductions so that marginal cost differences between applications do not impact the marks received.

### *Operational Business Plan*

6.47 The Utility Regulator proposes that 20% of available marks should be awarded on the basis of this criterion. In addition to having a very clear link between applications and price control allowances applicants will be required to submit an operational business plan built up to a professional standard. For example the business plan must also explain clearly how costs for emergencies and maintenance have been built up.

6.48 This should therefore explain how controllable operating expenditure forecasts are derived and explain the scope of activities they cover. The business plan must be linked to the costs submitted in the workbook so that it is clear how the costs are built up and that the business plan and associated costs fully meet all the operational and licence requirements of distribution in Northern Ireland and any other technical, regulatory and statutory requirements on the licensee.

6.49 A key feature of the business plan should be the skills and experience of key staff members.

6.50 The business plan should also cover the management of:

- The proposed tendering arrangements for materials, construction works and design services;
- engagement with external stakeholders in the delivery of any consents necessary, e.g. planning or environmental consents;
- operational risks to ensure the timely delivery of the distribution assets;

- the connection of these distribution assets with existing and proposed upstream and downstream assets necessary for network extension;
- the delivery of system operation and grid control;
- the operation of these distribution assets with existing and proposed upstream and downstream licence holders;
- interactions with the regulatory authorities and compliance with the gas conveyance licence conditions.

6.51 Applications will be evaluated on the completeness of the business plan in relation to the operational requirements of distribution in Northern Ireland. A low score would result from failure to ensure that all the statutory costs of operating a distribution system in Northern Ireland are included. Applicants will be evaluated on their understanding of the required outputs and the coherence and viability of their proposals for controllable operating expenditure.

#### *Maximizing connections*

6.52 The Utility Regulator proposes that for distribution 10% of available marks should be awarded on the basis of the robustness of the plans the applicant has to maximise connections and in particular how they would intend to spend any revenue they are permitted under the domestic connection incentive.

6.53 In allocating marks the Utility Regulator will assess each application according to the robustness of the detailed proposals provided against a set of competencies. We propose that these may include but are not limited to:

- Experience of delivering connections in an area not previously connected to the natural gas network;
  - Management procedures to promote sales;
  - Development of the downstream industry;
  - Development of relationships with social landlords;
  - Development of relationships with the industrial and commercial sector;
- And
- Targeting connection of vulnerable customers including the disabled, pensioners and those on a low income.



6.54 In order to achieve a high score on this criterion an applicant would need to demonstrate experience and a track record of delivering connections with reference to all the bullets above.

### *Innovation & Technology Transfer*

6.55 The Utility Regulator proposes that 10% of available marks should be awarded on the basis of this criterion. Innovation now plays a central role in Ofgem's RIIO approach to price controls. But as noted in the Utility Regulators consultation on cross utility price controls, the Northern Ireland industry is of a scale where the promotion of knowledge transfer is more likely to be an effective policy option than is indigenous innovation. For this reason applicants will be required to set out:

- Those innovation projects they are currently involved in or have been in the past five years;
- How these innovations might be applied to the gas industry in Northern Ireland;
- How the applicant promotes innovation and knowledge transfer; and
- What skills knowledge and experience the applicant can bring to the Northern Ireland gas industry and how this will assist the Utility Regulator in meeting its statutory objectives.

6.56 Applicants will be evaluated on the basis of their capability in driving innovation in relation to environmental sustainability, new sources and use of gas, cost efficiency, and developing the network to remote geographical areas,

### ***Assessment Criteria – Transmission & Distribution Combined***

6.57 The Utility Regulator proposes that in addition to making an application for an individual licence an interested party should also be permitted to apply for both licences in a combined application. As noted in chapters one and four above (4.37 and 4.38) we will also consider whether to facilitate an application for a

single transmission and distribution conveyance licence. The Utility Regulator proposes that combined applications will have a mark consisting of their marks for the transmission and distribution elements marked separately, and then added together.

6.58 In determining which applicant or applicants should be awarded the gas conveyance licences the Utility Regulator will base its decision on which application or combination of applications achieves the highest number of marks, across both the transmission and distribution licence, when assessed against the objective criteria.

6.59 Therefore an individual application, based on being awarded either only the transmission or only the distribution licence, even if it achieves the highest mark for that particular licence category, would not be guaranteed the award of that licence in a case in which a combined application, based on being awarded both licences, achieved higher marks in total than any combination of individual applications.

6.60 We propose that where a combined application is submitted it will be assessed and scored as a combined application and will not be disaggregated into separate applications unless also submitted separately.

### ***Application Declaration***

6.61 We also propose that an applicant should sign a declaration confirming that the statements and information contained in the application are accurate and complete. The making of false statements is an offence under Article 46 of the Gas Order.

### ***Questions for Consultation***

Q.9. We would welcome views on our proposed criteria and weightings for each criterion.

Q.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?

Q.11. Should there be an opportunity to rectify any omissions from the application?

Q.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?

## 7. The Competition – Treatment of Costs

### *Overview*

- 7.1 We have set out our minded to views in Chapter 4 that the competition will not be run on a fixed price application basis. However we are keen that the competition incentivises the efficient construction and operation of the conveyance networks. We have already highlighted the importance of costs in Chapter 6 on the assessment criteria. This chapter considers the detail of how costs could be competed on within the competition.
- 7.2 This Chapter should be considered alongside the draft workbook which allows applicants to understand our initial thinking on how costs will be competed. It is proposed that applicants would be asked to submit applications on the basis of a pre-determined network design and development plan and regulatory model for the licensed activity. This will provide a common basis on which all applications can be judged effectively against each other.
- 7.3 Ensuring that the competition phase reveals the applicants that will build and operate the assets needed to deliver the network extension at least cost is a central function of hosting a competition. There is much recent experience of developing and operating both transmission and distribution assets in Northern Ireland of similar scale to those required by the network extension. This experience has resulted in detailed unit cost information being available to the Utility Regulator indicating the likely structure and magnitude of capital investment needed to deliver networks, and operating expenditure required to ensure their continued effective operation. In addition FMA study contains high level estimates for both capital and operating costs. Both these sources provide similar outputs in terms of both cost structure and level of costs.
- 7.4 For the purposes of the competition it is proposed that applicants will be asked to construct their applications using July 2013 prices as the base. This will ensure consistency between applications and facilitate comparison. It is recognized that costs are likely to have increased by the time of the first price

control allowances are set. We therefore propose to index application costs using the Retail Prices Index when setting price control allowances.

7.5 For the purposes of the competition costs have been split into three broad categories.

- Capital Expenditure
- Operating Expenditure
- Financing Costs / Rate of Return

7.6 Note we have not repeated here the information which we propose to make available to applicants – this is set out in chapter five.

## ***Transmission Capital & Operating Expenditure***

### *Costs which are not competed*

7.7 It is clear from the history of the gas industry in Northern Ireland that a significant proportion of capital costs over the years have been based on tendered rates. This was particularly explicit with BGE (UK) transmission assets where many of the cost allowances were only set after tender. There would only be a benefit in competing on these costs if we subsequently used the applications to form the allowances in the licence. However as discussed in Chapter 4, we are not minded to pursue this approach given the uncertainty and level of risk this would bring to the competition.

7.8 For the purposes of this workbook the costs estimated by Fingleton McAdam, updated to July 2013 prices, will be taken as representing the most reliable estimate of a number of cost lines. These data are hardwired into the sample workbook and are not required to be input by the applicant. The cost lines which are hard wired in the draft model include:

- Materials and Construction Costs;
- Wayleaves and Land Acquisition;

- Site Investigation , Communication & Instrumentation and Pipeline Commissioning;
- Uncontrollable Capital Costs (Archaeology, Planning, Stock Gas);
- Government Subvention; and
- Uncontrollable Operating Costs (Licence Fees and Rates).

7.9 These efficiently incurred costs would be allowed into any price control allowance once the project design has been completed and tenders have been run. More detail on how these costs could be treated is set out in Chapter 8 on the regulatory model.

*Costs which are competed*

7.10 We believe that some of the cost lines would benefit from inclusion in the competition at this stage and these have not been hardwired into the workbook. These include:

- Design & Project Management – We consider that applicants may have some level of control and understanding of their costs for design and project management given the detail already set out in the FMA study. The Utility Regulator currently proposes that allowances for design and project management will equal as far as possible the costs revealed by the competitive process. However we remain open to the possibility that these costs might not be competed on.
- Contingency – We understand that most standard construction contracts will have a level of contingency. We believe that applicants should have a good understanding of this cost and therefore we propose that they populate the draft model with their proposals. In revealing their contingency requirements we propose that applicants should assume that the contracts they enter into will be structured to ensure that any variations in the contract will be at the discretion of the applicant and should not be designed so as to permit the builder to pass large elements of costs through. Instead we would expect that the contract incentivises the builder to ensure that cost over runs are minimised. Therefore that the contract would include a fixed price element based on a defined scope

with any deviation between indicative and actual quantity being at the contractors own risk. Also, a defined provisions contingency for variations in scope at the discretion of the engineer covering a range of anticipated but difficult to quantify items. It is the intention of the Utility Regulator that this allowance will be based on data derived from the competitive process. However we will be setting out the type of contract we expect and applicants should keep this in mind in assessing their required contingency. We also propose that contingency should relate only to the cost of construction contract.

- Other Capital Costs – This allows applicants to indicate other cost items which they may incur but are not recognised in the draft model. Any costs not highlighted in the application will be excluded from the setting of the capital allowance unless it can be demonstrated that these could not have been foreseen at the time the application was submitted. Applicants will need to set out in detail what these costs relate to.
- Controllable Operating Costs – We consider that applicants should be able to compete on all of these costs. We recognise that the cost of certain of these activities may be determined by a competitive tendering process, for example maintenance and gird control. However we remain of the view that applicants should have a good indication of the likely costs given the Fingleton McAdam network design. However we remain open to the possibility that these costs might not be competed on.

7.11 We propose that applicants should base their submissions on the network design and development plan produced by Fingleton McAdam and in the case of operating costs should provide data for 40 years which is the period over which the competition is to be judged. We would welcome respondents' views on whether 40 years is the appropriate period over which operating cost data is to be provided.

7.12 Applicants in their operational business plan will be required to detail how these costs were derived and to justify how the level of resources requested is sufficient to deliver the requirements of the licence.

7.13 Applicants should not amend the design but rather base their cost estimates on the provision of a network as set out in the accompanying documents to this paper.

## ***Distribution Capital & Operating Expenditure***

### *Costs which are not competed*

7.14 As with transmission we believe that it will be difficult to assess the level of distribution capital expenditure at this stage without more detailed network design. We therefore propose to hardwire the following items into the draft model.

- All Capital Expenditure Costs
- Uncontrollable Operating Costs (Licence Fees and Rates)

### *Costs which are competed*

7.15 We believe that some of the cost lines would benefit from inclusion in the competition at this stage and these have not been hardwired into the workbook. These include:

- Mobilisation Costs – We recognize that in the years between the licence being awarded and the first year in which the network becomes operational some costs could be incurred. We propose that the following costs may be relevant. However, it will be for each applicant to set out in detail the mobilization costs that it considers will be required and this should be a complete set of costs. Any costs not highlighted in the application will be excluded from the setting of the operating allowance unless it can be demonstrated that these could not have been foreseen at the time the application was submitted.
  - Network design
  - Conveyance licence agreement
  - Contractual arrangements with other parties, e.g. other TSOs/DSOs
  - Network code



- Discussions with potential large customers
- Controllable Operating Costs – We consider that applicants should be able to compete on all of these costs. Therefore, we propose that applicants should base their submissions on the network design and development plan produced by Fingleton McAdam and in the case of operating costs should provide data for 40 years. Applicants in their operational business plan will be required to detail how these costs were derived and to justify how the level of resources requested is sufficient to deliver the requirements of the licence. In particular, applicants need to set out how costs are linked to measurable parameters such as number of connections or network length. For example, we expect applicants to provide a detailed explanation of how maintenance and emergencies are calculated over the 40 year period.

### ***Financing Cost / Rate of Return - Transmission & Distribution***

7.16 The rate of return a licence holder receives is reflective of a number of factors most importantly the level of risk to which the investors own equity is exposed and the rate at which investors can secure debt finance which is itself dependant on the level of risk inherent in the business. In designing the competition the Utility Regulator has considered a number of options with regard to how this cost might be treated.

#### *Applicants Compete Freely*

7.17 It might be expected that in the normal course of events an effective competitive process might be expected to reveal the lowest rate of return licence holders would require. Certainly that is the intention of the competitive process Ofgem have employed to award offshore electricity transmission licences.

### *Applicants Do Not Compete*

7.18 The Utility Regulator could set the rate of return in advance of the competition, applicants would then not compete on this cost item. As a starting point the Utility Regulator would take the rates received by equivalent licence holders in Great Britain as a reasonable estimate of the appropriate rate of return. Further adjustment might be necessary to reflect variations in the level of risk experienced by licence holders in the area of the network extension.

7.19 This approach however would remove one of the major parameters on which participants would normally be expected to compete from the competition and might therefore be said to have reduced the value of having such a process.

### *Applicant Behavior is Constrained*

7.20 In this option while the Utility Regulator does not fix the rate of return in advance, applicant behaviour is curtailed in some way by having imposed a range within which applications must fall or setting a cap above which they are not permitted. Applicants would then compete subject to the constraints set by the Utility Regulator. This approach would ensure that the rate of return in the area of the network extension was not excessive but would still permit competitive pressures to set the actual rate of return received. It would be important that any constraints on applicant behaviour did not dissuade potential investors from participating in the competition, which may result in constraints being set in such a way as to be largely ineffective.

### *Utility Regulator Proposal*

7.21 In order to ensure that the competition retains its value as part of the award of licence process the Utility Regulator believes that applicants must be asked to reveal their financing costs. While there is a danger that an unrestricted competition might result in a rate of return that some might consider above requirements, a greater risk to consumers would result from potential investors not participating. In any event, within the regulatory model set out for the purposes of the competition, the allowance for financing costs will be reviewed

at the end of the first price control period at which point it will be set using the standard capital asset pricing model (CAPM) methodology.

7.22 The Utility Regulator therefore proposes that applicants should compete freely with regard to financing costs for both the transmission and the distribution licence.

### ***Questions for Consultation***

Q. 13. We would welcome respondents' views on whether 40 years is the appropriate period over which operating cost data is to be provided.

Q. 14 Do respondents consider that the proposed controllable operating expenditure cost lines in the workbook are appropriate to capture this data effectively?

Q. 15 Do respondents consider that the proposed workbook notes are sufficiently detailed to allow applicants to complete the workbook effectively?

Q. 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?

Q. 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?

## 8. Transmission Licence Competition - Regulatory Model

### *Discussion*

- 8.1 It is proposed that applicants would be asked to submit applications on the basis of a pre-determined network design and development plan and regulatory model for the licensed activity. Applicants will not be permitted to vary any of these parameters. This will provide a common basis on which all applications can be judged effectively against each other. The aim is to design a competition that reflects as far as is practical the final licence so that it provides a firm basis for determining the application that will deliver the best possible outcome for consumers.
- 8.2 It is proposed that the competition should be based on the network design and development plan developed by Fingleton McAdam for DETI and the Utility Regulator in 2010. Our engineering consultants have reviewed the network design information available from the FMA study and are content that it is sufficiently detailed for any competent application to develop a robust application.
- 8.3 The regulatory model proposed for the competition will represent the model that the Utility Regulator considers would form an acceptable model for the final licence. This however does not exclude this model being amended or a different model being adopted in finalising licence conditions should it be demonstrated that it better facilitates the Utility Regulator in meeting its statutory objectives. In particular we recognise that there are two models of ownership in Northern Ireland and we aim to ensure the competition is open to both models. This means that there is a possibility that the regulatory model assumed for the competition is not identical to the final licence granted. However we believe the competition is designed to transparently identify the best applicant irrespective of what ownership model they wish to operate.

- 8.4 For the purposes of the transmission licence competition the Utility Regulator has considered two forms of operating cost control both of which are currently operational in the Northern Ireland gas transmission industry.

#### *Full Operating Cost Pass Through*

- 8.5 This form of control applies to Premier Transmission Ltd and Belfast Gas Transmission Ltd who own the transmission system between Scotland and Ballylumford, and between Ballylumford and Belfast respectively. Under this form of control in return for an asset base that is one hundred per cent debt funded with no shareholder equity the licence holder is allowed to pass 100% of capital and operating expenditure on to consumers and consequently faces no cost or revenue related risk. While the Utility Regulator carries out a regular shadow price control this has no impact on the level of costs the licence holder is entitled to recover. In return for this cost pass through mechanism consumers benefit from reduced debt financing costs.

#### *A Revenue Cap*

- 8.6 This form of control applies to BGE (NI), who own the transmission system between Coolkeeragh Power Station and Gormanston in the Republic of Ireland, and to Phoenix Natural Gas Ltd who own the distribution network in the Greater Belfast area. Under this regulatory model the licence holder receives a guaranteed level of income for a given period based on an assessment of the capital and operating costs of the licensed activity in that period. The licence holder is protected against the risk of variations in demand but not variations in the cost base.
- 8.7 The revenue cap form of control is the typical form of control applied to network utilities in the United Kingdom. In return for a guaranteed level of revenue consumers receive the benefits of relatively low financing costs. The main risk to the licence holder relates to variations in the cost base of the business, but as the majority of costs related to an established regulatory asset base this risk is also reasonably low.

### *Utility Regulator Proposal*

- 8.8 The Utility Regulator considers that either of the two regulatory models discussed above would provide a suitable regulatory framework for the transmission licence. However for the purposes of creating a robust competition it is necessary to pick one because to allow applicants to choose either would make it difficult to fairly judge between applications.
- 8.9 For this reason the Utility Regulator has proposed that all applicants must compete on the basis of a revenue cap regulatory model. The Utility Regulator does not believe that this will exclude other applicants seeking a different regulatory model from competing as it will merely require them to adjust their financing cost submission to take account of the increase risks associated with a revenue cap regulatory model.

### ***Summary of Proposed Competition Regulatory Model***

- 8.10 In order for applicants to design their application effectively key features of the regulatory model used in the competition need to be set out in advance. Our proposals are set out below.

#### *General*

- 8.11 The Utility Regulator proposes that the licence holder will be subject to a revenue cap form of control and will receive a guaranteed income for a period of five years based on an ex-ante assessment of the capital, financing and operating costs of the licensed activity during the period. The licence holder would be protected against the risk of variations in demand but not variations in the cost base.
- 8.12 It is anticipated that the Department of Enterprise Trade and Investment will designate the transmission assets in the area of the network extension as forming part of the Northern Ireland postalised transmission system. As a result the allowed revenue derived from this licence will be collected by means of the

Northern Ireland postalised transmission tariff meaning that all gas consumers in Northern Ireland will be responsible for funding these assets.

8.13 We also propose that the licence holder will be subject to a price control review period of five years, and that at each review the Utility Regulator will set allowances for capital, operating and financing costs for the next control period.

8.14 In addition we propose that indexation will be based on the Retail Prices Index and that the full opening asset value will be recovered over a period of 40 years.

### *Capital Expenditure*

8.15 In relation to capital expenditure we propose that the capital allowances the licence holder will receive for materials and construction works will be determined by the Utility Regulator taking into account the output from effective competitive tendering processes conducted by the licence holder and will be subject to review by engineering consultants.

8.16 In relation to contingency we propose that the level of contingency that will be permitted for these activities will be determined during the competition. We propose that contingency relates only to the construction contract.

8.17 Regarding the capital allowances the licence holder will receive for wayleaves and land acquisition, we propose that these will be determined by the Utility Regulator based on market rates based on advice supplied by the Northern Ireland Land & Property Service, Valuation Division.

8.18 We also propose that capital allowances for a number of activities will be treated as uncontrollable with the allowance equaling actual expenditure, so long as this is efficiently incurred. The activities we propose to treat in this way are: construction archaeology, planning consents and stock up gas.

8.19 In addition we propose that all controllable capital expenditure allowances will be subject to a Verified Forecast Capital Expenditure and an Actual Forecast Capital Expenditure process similar to that set out in the BGE (UK) licence.

Also that these allowances will also be subject to a sharing mechanism in line with standard regulatory practice in the United Kingdom of five years.

8.20 As there will be no revenue recovery mechanism during the period when the pipeline is being constructed we propose that interest paid on working capital will be capitalised and included in the opening asset value. As was the case in the construction of the BGE (UK) transmission network, the interest rate we propose to use will be LIBOR + 0.5%. We have proposed this to create an incentive to ensure the pipeline is operational as quickly as possible. We would welcome the views on this incentive and any alternative incentives respondents would wish to propose.

8.21 The Northern Ireland Executive will make available a subvention of up to £32.5m for the construction of the transmission assets, more details on this subvention are set in chapter two.

### *Operating Expenditure*

8.22 It is anticipated that by the time the gas transmission system in the area of the network extension becomes operational there may be a single system operator for Northern Ireland rather than the present arrangements whereby each licence holder acts as a system operator on their particular pipeline system. While the precise arrangements are yet to be determined this may mean that the transmission system licence holder will not control the costs of providing this service. For the purposes of the competition however applicants should assume that they will be responsible for system operation.

8.23 We propose that existing Northern Ireland licence holders will be required to apply an appropriate cost allocation methodology such that shared costs are fairly allocated between the existing and new licence. Also that allowances related to the existing licence will be adjusted accordingly at the appropriate price control review.

8.24 Controllable Operating expenditure will be reviewed at each price control. However the Utility Regulator is not minded to accept requests for increased allowances as a result of a change in cost structure. For example in the case



where an applicant did not include a dedicated separate head office in the application then allowances for such will not be provided at subsequent price controls.

8.25 Uncontrollable operating expenditure will be treated as pass through with allowances equal to expenditure. The uncontrollable cost will include licence fees and rates.

### *Financing costs*

8.26 We propose that allowances for financing costs will be largely determined by the competitive process (we recognise that if a mutual model is the winning applicant the licence structure is likely to be different). We therefore propose that applicants are required to indicate the (real pre-tax) rate of return they will require to own and operate the transmission system over the 40 years of the project.

### ***Questions for Consultation***

Q. 18 We welcome respondents views on our proposals for the key features of the regulatory model to be used in the transmission 'competition.'

Q. 19 We welcome respondents views on the incentive proposed to ensure the pipeline is operational as quickly as possible.

## 9. Distribution Licence Competition – Regulatory Model

### *Discussion*

9.1 It is proposed that applicants would be asked to submit applications on the basis of a pre-determined network design and development plan and regulatory model for the licensed activity. Applicants will not be permitted to vary any of these parameters. This will provide a common basis on which all applications can be judged effectively against each other. The aim is to design a competition that reflects as far as is practical the final licence so that it provides a firm basis for determining the applicant that will deliver the best possible outcome for consumers.

9.2 It is proposed that the competition should be based on the network design and development plan developed by Fingleton McAdam in the FMA study 2010. We propose that the competition should be based on a ‘fat’ distribution business model where as many existing domestic properties as is financially viable are connected.

Our engineering consultants have reviewed the network design information available from the FMA study and are content that it is sufficiently detailed for any competent applicant to develop a robust application.

9.3 The regulatory model proposed for the competition will represent the model that the Utility Regulator considers would form an acceptable model for the final licence. This however does not exclude this model being amended or a different model being adopted in finalising licence conditions should it be demonstrated that it better facilitates the Utility Regulator in meeting its statutory objectives. In particular we recognise that should an existing licence holder be awarded the licence this may impact on the design of an appropriate regulatory model. This means that there is a possibility that the regulatory model assumed for the competition is not identical to the final licence granted. However we believe the competition is designed to transparently deliver the optimal winner irrespective of the detailed design of the regulatory model.

- 9.4 For the purposes of the distribution licence competition the Utility Regulator has considered two forms of control both of which are currently operational in the Northern Ireland gas distribution industry.

#### *A Revenue Cap*

- 9.5 This form of control applies to Phoenix Natural Gas, who owns the distribution network in the Greater Belfast area. Under this form of control the licence holder receives a guaranteed level of income for a given period based on an assessment of the capital and operating costs of the licensed activity in that period. The licence holder is protected against the risk of variations in demand but not variations in the cost base. This simple model can be added to by the inclusion of various incentive mechanisms which adjust the allowed revenue according to how effective the licence holder has been in delivering the desired output. So for example Phoenix Natural Gas has an incentive to increase the number of network connections above the business as usual rate.
- 9.6 The revenue cap regulatory model is the typical form of control applied to network utilities in the United Kingdom and is suited to mature networks. In return for a guaranteed level of revenue consumers receive the benefits of relatively low financing costs. The main risk to the licence holder relates to variations in the cost base of the business, but as the majority of costs related to an established regulatory asset base this risk is also reasonably low.

#### *A Price Cap*

- 9.7 This form of control applies to firmus energy who own and operate the distribution network outside of the Greater Belfast area. Under this regulatory model the licence holder is permitted to charge up to a certain tariff based on an assessment of the capital and operating costs and projected demand. The licence holder therefore is subject to both demand and cost variation risks. In recognition of this increased risk the licence holder may receive a higher rate of return as compensation. In order to protect the licence holder against some of these risks there may be automatic stability mechanisms should either demand

or costs deviate significantly from their projected levels e.g. provision of special reviews where forecasts deviate from actual by over 15%.

- 9.8 Linking of the price cap to a more stable measure of demand such as capacity rather than consumption volumes is another option that could be considered although this is not currently operated in NI and the details of how this would fit in with licence conditions would need to be considered.
- 9.9 The price cap model however has been used to regulate networks in the early stages of development as it places a very strong incentive on the licence holder to connect the largest supply points to the network as quickly as possible to maximise collected revenue. The more quickly large loads are connected and begin to consume gas the more stable the finances of the network become, which is of benefit to all gas consumers. In addition the more quickly connection occurs the more quickly the other benefits of natural gas get delivered such as reduced energy costs to business and reductions in greenhouse gas and other emissions.

#### *Utility Regulator Proposal*

- 9.10 The Utility Regulator proposes that for the purposes of the competition applicants should design their applications on the basis of a 'price cap' regulatory model with the measure of demand being consumption rather than aggregate supply point capacity. We propose that this should be the case for a limited amount of time, say 10 years, after which we would propose to change the form of control. We would welcome responses on this proposal.

#### ***Network Design and Development Plan***

- 9.11 In the FMA study and subsequent Outline Business Case (2012) two alternative business models of developing the distribution network were considered. In both business models the spine of the distribution network is constructed in the manner which most efficiently supports the connection of

industrial & commercial supply points. In one business model which we shall term 'skinny' only new build domestic supply points and those existing domestics which are adjacent to the distribution network are targeted for connection. In the other business model which we shall term 'fat' however the distribution network is further extended to maximise the number of existing domestic supply points targeted for connection.

- 9.12 Both these studies concluded that either business model would result in a positive NPV when all five towns were considered together. The domestic connections cost assumptions were taken from experience from other distribution networks in Northern Ireland as opposed to actual detailed analysis in the network extension area itself.
- 9.13 Both the Utility Regulator and DETI have made it clear that while maximising the number of domestic connections in the area of the network extension is a desirable policy object this will not be achieved at the expense of a financially viable business model or a sustainable level of distribution tariff. While subvention will be available for the transmission business none will be made available for the distribution business.
- 9.14 The Utility Regulator will need to consider how the development plan and associated connections/volumes should be taken account of in the competition phase of the award of licence process.
- 9.15 One option would be to determine which business model was to be delivered and applicants would be expected to apply on this basis. For both business models the Fingleton McAdam network design includes detailed information on the likely pattern of domestic connections over time and the likely costs of such connections.
- 9.16 Alternatively we could not make any direction with regard to the appropriate approach to domestic connections but allow applicants to decide this themselves and include this as part of the assessment criteria in determining the winning application.

9.17 Another option is to defer consideration of what level of domestic connections would be financially viable until the first price control review.

#### *Utility Regulators Proposal*

9.18 Allowing applicants to decide what business model to include would make comparisons very difficult and we have already proposed separate criteria in Chapter 6 linked to maximising connections which will allow competition in this area. Therefore we propose that it would be more effective for applications to be developed on a common set of assumptions.

9.19 The Utility Regulator therefore proposes that the Fingleton McAdam network design and development plan will be the basis on which the competition will be judged, i.e. the 'fat' business model. Applicants should also assume that this development plan will be the starting point for discussions on the final distribution licence awarded. Also the starting point for the level of volumes and connection to be delivered should be the numbers set out in the FMA data provided to applicants.

### ***Summary of Proposed Competition Regulatory Model***

9.20 In order for applicants to design their application effectively key features of the regulatory model used in the competition need to be set out in advance. Our proposals in this regard are set out below.

#### *General*

9.21 The licence holder will be subject to a price cap form of control where it is permitted to charge up to a certain level of distribution tariff based on an assessment of capital, financing and operating costs associated with forecast demand. It is proposed that the measure of demand should be consumption.

- 9.22 Revenues due to the licence holder will be recovered solely from gas consumers in the area of the network extension, although there will be a common tariff across all the designated towns. This however should not be taken to mean that at some time in the future it might be determined that the introduction of a postalised distribution tariff was in the interests of gas consumers. And we are minded that the licence will include an obligation to facilitate distribution postalisation at some point in the future.
- 9.23 The licence holder will be subject to a price control review period of five years. At each review the Utility Regulator will set allowances for capital, operating and financing costs for the next control period.
- 9.24 To ensure a constant level of distribution tariff over the life of the project, the Utility Regulator considers that a profile adjustment should be in place to be calculated over 40 years. This will require the effective capitalisation of operating expenditure with capitalised operating expenditure receiving the same rate of return as actual capital expenditure.
- 9.25 The licence will contain a network development plan. Applicants should assume that this will be as set out in the workbook as derived from the FMA study for the development of a 'fat' business model (Business Model Two).
- 9.26 Indexation will be based on the Retail Prices Index.

### *Capital Expenditure*

- 9.27 Capital expenditure will be subject to a sharing mechanism. As is standard regulatory practice in the United Kingdom the licence holder will retain out performance for a limited period of five years.
- 9.28 For the purposes of the competition the licence holder will recover their total costs over a period of 40 years. However in the final licence depreciation will be taken account of in line with normal regulatory practice with all assets being depreciated in a way that reflects their economic life.

## *Operating Expenditure*

9.29 The unit rate capital allowances the licence holder will receive for constructing the network and making connections will be set as part of the price control process. The Utility Regulator proposes to take into account the output from effective competitive tendering processes conducted by the licence holder, benchmarked against data from other distribution networks. The actual capital allowance received will be determined by the volume of outputs delivered over the price control period. The licence holder will receive an allowance for the purpose of promoting the development of the network. The value of this allowance will be based on the number of existing domestic properties connected by the licence holder. For the purpose of the competition we propose that this allowance will be calculated on the basis of £300 per existing domestic connection made and will be limited to the first 10 years of the project. Applicants should note however that the Energy Efficiency Obligation will apply to all licence holders in Northern Ireland from 2014 and this may impact on how this incentive mechanism is funded.

9.30 Uncontrollable operating expenditure will be treated as pass through with allowances equal to expenditure. The uncontrollable cost will include licence fees and rates.

## *Financing costs*

9.31 It is the intention of the Utility Regulator that allowances for financing costs will be largely determined by the competitive process. Applicants are required to indicate the (real pre-tax) rate of return they will require to own and operate the transmission system over the 40 years of the project.

## ***Questions for Consultation***

Q. 20 We welcome respondents views on our proposals for the key features of the regulatory model to be used in the distribution ‘competition.’



## **Annex 1 Questions for respondents**

### *Chapter 1*

Q.1 Is the respondent actively considering making an application for either or both the necessary licence(s)?

### *Chapter 2*

Q. 2 Do respondents require any additional information on possible Northern Ireland Executive Subvention in order to construct any potential licence application effectively?

### *Chapter 3*

No questions

### *Chapter 4*

Q.3. What are respondents views on the options presented on linking applications and price control allowances?

Q.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?

Q.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?

### *Chapter 5*

Q.6. We would welcome views on whether three months is sufficient to prepare a licence application.

Q.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.

Q.8. We would welcome views on the proposed timeline for the licence application process.

### *Chapter 6*

Q.9. We would welcome views on our proposed criteria and weightings for each criterion.

Q.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?

Q.11. Should there be an opportunity to rectify any omissions from the application?

Q.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?

### *Chapter 7*

Q. 13. We would welcome respondents' views on whether 40 years is the appropriate period over which operating cost data is to be provided.

Q. 14 Do respondents consider that the proposed controllable operating expenditure cost lines in the workbook are appropriate to capture this data effectively?

Q. 15 Do respondents consider that the proposed workbook notes are sufficiently detailed to allow applicants to complete the workbook effectively?

Q. 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?

Q. 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?

*Chapter 8*

Q. 18 We welcome respondents views on our proposals for the key features of the regulatory model to be used in the transmission ‘competition.’

Q. 19 We welcome respondents views on the incentive proposed to ensure the pipeline is operational as quickly as possible.

*Chapter 9*

Q. 20 We welcome respondents views on our proposals for the key features of the regulatory model to be used in the distribution ‘competition.’

## Annex 2 Illustrative Workbook Notes

### Transmission Worksheet Notes

#### General

1. These notes should be read by those completing the data input workbook as part of their application for a gas conveyance licence relating to the transmission system in the area of the network extension.
2. This data input workbook is for the purpose of calculating the Applicant Determined Cost criterion. While it reflects the current thinking of the Utility Regulator with regard to the regulatory model that will be set out in the licence it should not be regarded as being a definitive statement. In addition while it is the intention of the Utility Regulator to use the data supplied by applicants as far as possible to set allowances in the first price control period it is recognised that adjustments may be required to reflect the final licence and possible costs which could not have been foreseen at this time.
3. All data should be supplied on the basis of July 2013 prices this includes capital, operating and financing costs.
4. All cost data should be expressed in £m and to two decimal places only.

Cost Category	Notes to Applicants
Controllable Capital Expenditure <ul style="list-style-type: none"> <li>• Materials</li> <li>• Construction</li> <li>• Wayleaves &amp; Land Acquisition</li> <li>• Design</li> <li>• Project Management</li> <li>• Site Investigation / C&amp;I / Commissioning</li> </ul>	<p>Applicants must base their submissions on the network design and development plan produced by Fingleton McAdam. Applicants should not amend the design but rather base their cost estimates on the provision of a network as set out.</p> <p>Allowances for controllable capital expenditure will be subject to a Verified Forecast Capital Expenditure and Actual Forecast Capital Expenditure process, applicants should expect that this will follow a similar process to that set out in the BGE (UK) licence.</p> <p><b>Materials and Construction Costs</b> – It is the intention of the Utility Regulator that allowances for these activities will be determined following the outcome of an effective competitive tender process carried out by the licence holder. For the purposes of this workbook the costs estimated by Fingleton McAdam, updated to July 2013 prices, will be taken as representing the most reliable estimate of cost. These data are hardwired into the workbook and are not required to be input by the applicant.</p>

<ul style="list-style-type: none"> <li>Contingency</li> </ul>	<p><b>Wayleaves &amp; Land Acquisition</b> - It is the intention of the Utility Regulator that allowances for these activities will be based on market unit rates, on advice from the Land &amp; Property Service in Northern Ireland. For the purposes of this workbook the costs estimated by Fingleton McAdam, updated to July 2013 prices, will be taken as representing the most reliable estimate of cost. This figure is hardwired into the workbook and is not required to be input by the applicant.</p> <p><b>Design &amp; Project Management</b> - It is the intention of the Utility Regulator that allowances for these activities will equal as far as possible the costs revealed by the competitive process and so applicants are asked to input the allowances they will require for these activities.</p> <p><b>Site Investigation / C&amp;I / Commissioning</b>- It is the intention of the Utility Regulator that allowances for these activities will be based on market rates For the purposes of this workbook the costs estimated by Fingleton McAdam, updated to July 2013 prices, will be taken as representing the most reliable estimate of cost. This figure is hardwired into the workbook and is not required to be input by the applicant.</p> <p><b>Contingency</b> – It is the intention of the Utility Regulator that this allowance will be based on data derived from the competitive process and so applicants are asked to input the allowance they will require taking into account the structure of contracts discussed in the consultation paper. This contingency should relate only to the cost of the construction contract.</p>
<p>Uncontrollable Capital Expenditure</p> <ul style="list-style-type: none"> <li>Archeology</li> <li>Planning Consents</li> <li>Stock Up Gas</li> </ul>	<p>It is the intention of the Utility Regulator that allowances for these activities will equal efficiently incurred expenditure. The licence holder will be required to demonstrate to the Utility Regulator that these costs have been incurred in an efficient and effective way and the Utility Regulator will reserve the right to disallow costs which it judges have not been so incurred. For the purposes of this workbook the costs estimated by Fingleton McAdam, updated to July 2013 prices, will be taken as representing the most reliable estimate of cost. These data are hardwired into the workbook and are not required to be input by the applicant.</p>
<p>Opening Asset Value</p> <ul style="list-style-type: none"> <li>Capital Expenditure</li> </ul>	<p>The nature of delivering transmission 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</p>

<ul style="list-style-type: none"> <li>• Executive Subvention</li> <li>• Capitalised Interest</li> <li>• Other Costs</li> </ul>	<p>proposed expenditure pattern.</p> <p><b>Government Subvention</b> – while the precise mechanisms are yet to be determined by the Department of Enterprise Trade &amp; Investment the Northern Ireland Executive Committee has agreed that a subvention of up to £32.5m will be made available. For the purpose of the competition it is assumed this subvention is made available in a way that matches the pattern of capital expenditure. Applicants should also note that payment of this subvention will be dependent on the licence holder delivering a number of wider social benefits through the construction of the transmission pipeline.</p> <p><b>Capitalised Interest</b> - it is recognised that the licence holder will need to finance the construction of the asset for a period of time before it becomes operational and revenue is recovered. In recognition of this need for working capital the Utility Regulator will capitalise the interest payments, for the purpose of the competition the interest on working capital is assumed to be equal to LIBOR + 0.5%.</p> <p><b>Other Costs</b> – this allows applicants to indicate other cost items which they may incur but are not recognised above, any costs not highlighted in the application will be excluded from the setting of the capital allowance unless it can be demonstrated that these could not have been foreseen at the time the application was submitted. Applicants will need to set out in detail what these costs if any relate to.</p>
<p>Finance Costs</p> <ul style="list-style-type: none"> <li>• Weighted Average Cost of Capital</li> <li>• Indexation</li> </ul>	<p><b>Weighted Average Cost of Capital (real)</b> – it is the intention of the Utility Regulator that allowances for financing costs will be largely determined by the competitive process (we recognise that if a mutual model is the winning applicant the licence structure is likely to be different). Applicants are required to indicate the (real pre-tax) rate of return they will require to own and operate the transmission system over the 40 years of the project.</p> <p><b>Indexation</b> – for the purposes of the competition no inflation measure will be used to derive a nominal rate of return, in the licence however inflation will need to be taken into account and we are assuming the Retail Prices Index as the measure of inflation.</p>
<p>Controllable Operating Expenditure</p>	<p>It is the intention of the Utility Regulator that allowances for these activities for the first price control period will equal as far as reasonable the costs revealed by the competitive process, and then be subject to a five year periodic review. Applicants are required to input the allowance they will require for each activity</p>

<ul style="list-style-type: none"> <li>• Maintenance</li> <li>• System Operation</li> <li>• Property Management</li> <li>• Insurance</li> <li>• Business Services</li> <li>• Other</li> </ul>	<p>over each of the forty years. Applicants will need to set out in detail in their Operational Business Plan how these costs were derived and justify how they are sufficient to deliver the outputs required of a licence holder. In particular they should identify relevant cost drivers. Any costs not highlighted in the application will be excluded from the setting of the operating allowance unless it can be demonstrated that these could not have been foreseen at the time the application was submitted. Definitions of each of these activities are set out below.</p>
<p>Mobilisation Costs</p>	<p>We recognize that in the years between the licence being awarded and the first year in which the network becomes operational some costs will be incurred. We propose that the following costs may be appropriate</p> <ul style="list-style-type: none"> <li>○ Network design</li> <li>○ Conveyance licence agreement</li> <li>○ Contractual arrangements with other parties, e.g. other TSOs/DSOs</li> <li>○ Network code</li> <li>○ Discussions with potential large customer</li> </ul> <p>it will be for each applicant to set out in detail the mobilization costs that it considers will be required and this should be a complete set of costs. Any costs not highlighted in the application will be excluded from the setting of the operating allowance unless it can be demonstrated that these could not have been foreseen at the time the application was submitted</p>
<p>Uncontrollable Operating Expenditure</p> <ul style="list-style-type: none"> <li>• Licence Fees</li> <li>• Rates</li> </ul>	<p>It is the intention of the Utility Regulator that these will be treated as pass through costs in line with standard regulatory practice in the United Kingdom</p>

## Transmission Controllable Operating Expenditure - Defined

Maintenance	<p>Direct activity cost resulting from the invasive examination of plant and equipment including:</p> <ul style="list-style-type: none"> <li>• Engineering Works</li> <li>• Engineering Compliance</li> <li>• Emergency Response</li> <li>• Vendor maintenance</li> </ul>
System Operation	<p>System Control ensures the safe, secure and efficient supply of gas across the transmission system from system entry point to offtake.</p> <ul style="list-style-type: none"> <li>• Grid Control</li> <li>• Shipper services and network code development</li> <li>• Gas Transmission Management System and other IT</li> <li>• SCADA and Communications</li> </ul>
Other (Direct Activities)	<p>Other operational activities not covered elsewhere which may include but are not limited to</p> <ul style="list-style-type: none"> <li>• Agricultural liaison and Remediation,</li> <li>• Security</li> <li>• Gas quality monitoring</li> </ul>
Property Management	<p>Property Management</p> <p>The activity of managing, providing and maintaining non-operational premises, i.e. premises used by people; such as offices and depots.</p> <ul style="list-style-type: none"> <li>• Rent and business rates,</li> <li>• Utilities gas / electricity / water</li> <li>• Maintenance and repair</li> <li>• Facility services reception / security / access</li> </ul> <p>Does not include IT System costs</p>
Insurance	<p>Support and expertise to develop the business risk profile, managing the claims process and provision of information and understanding to the business in relation to insurable and uninsurable risks.</p> <ul style="list-style-type: none"> <li>• Insurance premiums Insurance premium tax; Insurance contract negotiating and monitoring; Insurance claim processing;</li> <li>• Insurance risk management;</li> <li>• Payments relating to uninsured claims,</li> <li>• Costs of in house insurance team,</li> <li>• Brokers fees.</li> </ul>



Business Services	<p><b>IT &amp; Telecoms excluding System Operation</b></p> <p>Provision of IT &amp; Telecom Services for the day to day service delivery.</p> <ul style="list-style-type: none"> <li>• Help Desk and Data Centres,</li> <li>• IT application maintenance and running support</li> <li>• Establishing &amp; maintaining IS Infrastructure</li> <li>• Voice &amp; Data Telecoms both fixed and mobile and covering rental and call charges</li> </ul> <p><b>Stores / Procurement / Logistics</b></p> <p>The procurement of goods &amp; services in the support of the business operations, through the management of procurement contracts with suppliers.</p> <ul style="list-style-type: none"> <li>• Tendering and contract negotiation</li> <li>• Establishing tender guidelines and monitoring supplier performance</li> <li>• Acquisition / warehousing / Transport costs of goods</li> <li>• Stock management</li> </ul> <p><b>Human Resources &amp; Training</b></p> <p>Provide services in the full range of professional activity for an individual's career path from recruitment to retirement, and from related professional advice to directly resolving grievances for staff.</p> <ul style="list-style-type: none"> <li>• Payroll &amp; Pensions management and operation</li> <li>• Recruitment</li> <li>• Industrial &amp; Employee relations</li> <li>• HR strategy, policies and procedures</li> <li>• Compliance with statutory requirements</li> <li>• Training operational / non-operational / professional / behavioral / leadership both internal and external costs</li> </ul> <p><b>Audit / Finance / Regulation</b></p> <p>Performing the statutory, regulatory and internal management of cost and performance reporting requirements; and customary financial and regulatory compliance activities.</p> <ul style="list-style-type: none"> <li>• Processing payments and receipts</li> <li>• Financial Risk Management</li> <li>• Financial / Management / Investment accounting</li> <li>• Pricing</li> <li>• Statutory and Regulatory reporting</li> <li>• Tax compliance and management</li> <li>• Internal / External audit.</li> </ul>
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	<p><b>Marketing</b></p> <ul style="list-style-type: none"> <li>• Advertising including safety campaigns</li> <li>• Marketing and Market Development</li> <li>• Public Relations</li> <li>• Corporate Affairs</li> </ul> <p><b>CEO / CFO and Other Overhead Costs</b></p> <ul style="list-style-type: none"> <li>• CEO / CFO not carrying out specific departmental duties.</li> <li>• Non Executive Director Costs</li> <li>• Board and shareholder meetings</li> <li>• Investor relations.</li> <li>• Legal Services</li> <li>• Company Secretary</li> <li>• Community Awareness</li> <li>• Any other costs not directly attributed to a single entity, and not capable of easy allocation.</li> </ul>
Other (Indirect)	AS specified by Applicant

## ***Distribution Worksheet Notes***

### **General**

1. These notes should be read by those completing the data input workbook as part of their application for a gas conveyance licence relating to the distribution system in the area of the network extension.
2. This data input workbook is for the purpose of calculating the Applicant Determined Cost criterion. While it reflects the current thinking of the Utility Regulator with regard to the regulatory model that will be set out in the licence it should not be regarded as being a definitive statement. In addition while it is the intention of the Utility Regulator to use the data supplied by applicants as far as possible to set allowances in the first price control period it is recognised that adjustments may be required to reflect the final licence and possible costs which could not have been foreseen at this time.
3. All data should be supplied on the basis of July 2013 prices this includes capital, operating and financing costs.
4. All cost data should be expressed in £m and to two decimal places only.

Cost Category	Notes to Applicants
Capital Expenditure <ul style="list-style-type: none"> <li>• 4 barg Network</li> <li>• 75 mbarg Network</li> <li>• Supply Point Connection</li> <li>• Engineering &amp; Project Management</li> <li>• Lifecycle Costs</li> </ul>	<p>Applicants must base their submissions on the network design and development plan produced by Fingleton McAdam.</p> <p>Applicants should not amend the design but rather base their cost estimates on the provision of a network as set out.</p> <p>It is the intention of the Utility Regulator that allowances for these activities will be derived from unit rate allowances. These unit rates will be determined taking account of the outputs from an effective competitive tendering process conducted by the licence holder. These outputs will be benchmarked against data from other distribution networks. For the purposes of the competition the cost estimated Fingleton McAdam, updated to July 2013 prices, will be taken as representing the most reliable estimate of cost. These data are hardwired into the workbook and are not required to be input by the applicant.</p>
Existing Domestic Connections Incentive	<p>It is the intention of the Utility Regulator that the licence holder will receive an allowance for the purpose of promoting the development of the network. The value of this allowance will be based on the number of domestic properties connected by the licence holder. The expenditure of this allowance is at the discretion of the licence holder. For the purposes of the</p>

	<p>competition the Utility Regulator has hardwired into the workbook a value for this allowance equivalent to £300 per existing domestic property connected per annum and will be limited to the first 10 years of the licence.</p>
<p>Finance Costs</p> <ul style="list-style-type: none"> <li>• Weighted Average Cost of Capital</li> <li>• Indexation</li> </ul>	<p><b>Weighted Average Cost of Capital (real)</b> – it is the intention of the Utility Regulator that allowances for financing costs will be largely determined by the competitive process. Applicants are required to indicate the (real pre-tax) rate of return they will require to own and operate the distribution system over the 40 years of the project.</p> <p><b>Indexation</b> – for the purposes of the competition no inflation measure will be used to derive a nominal rate of return, in the licence however inflation will need to be taken into account and we are assuming the Retail Prices Index as the measure of inflation.</p>
<p>Controllable Operating Expenditure</p> <ul style="list-style-type: none"> <li>• Work Management</li> <li>• Maintenance</li> <li>• Emergency</li> <li>• IT &amp; Telecoms</li> <li>• Property Management</li> <li>• Insurance</li> <li>• Marketing</li> <li>• Business Services</li> <li>• Other</li> </ul>	<p>These cost estimates must not include any expenditure related to the Domestic Connections Incentive discussed above. However costs related to achieving I &amp; C connections should be included.</p> <p>These cost estimates must also not include life cycle costs as these are set out in the workbook</p> <p>It is the intention of the Utility Regulator that allowances for these activities for the first price control period will equal as far as reasonable to the costs revealed by the competitive process, and then be subject to a five year periodic review. Applicants are required to input the allowance they will require for each activity for each of the forty years of the project. Applicants will need to set out in detail in their Operational Business Plan how these costs 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. Any costs not highlighted in the application will be excluded from the setting of the operating allowance unless it can be demonstrated that these could not have been foreseen at the time the application was submitted.</p>
<p>Uncontrollable Operating Expenditure</p> <ul style="list-style-type: none"> <li>• Licence Fees</li> </ul>	<p>It is the intention of the Utility Regulator that these will be treated as pass through costs in line with standard regulatory practice in the United Kingdom</p>

• Rates	
Profile Adjustment	It is the intention of the Utility Regulator that the distribution licence will contain a profile adjustment to deliver a constant level of distribution tariff over the life of the project. This will require the effective capitalisation of operating expenditure. The Utility Regulator considers that the profile adjustment should be in place for 40 years with capitalised operating expenditure receiving the same rate of return as actual capital expenditure.

### **Distribution Controllable Operating Expenditure - Defined**

Work Management	<p><b>Asset Management</b></p> <p>The activity of managing the assets that comprise the gas distribution network, including:</p> <ul style="list-style-type: none"> <li>• Network Integrity - network controller and responsible engineer roles</li> <li>• Network Policy - developing asset related policies and procedures</li> </ul> <p><b>Operations Management</b></p> <ul style="list-style-type: none"> <li>• Day to day planning &amp; supervision of field force</li> <li>• Operational HSE</li> <li>• Performance management</li> </ul> <p><b>Customer Management</b></p> <ul style="list-style-type: none"> <li>• Emergency and other call centre functions</li> <li>• GSMR administration</li> <li>• Manager key customer relations</li> <li>• Quality of Service obligations and related activities</li> <li>• Managing contracts for services provided by the regulated business such as connections</li> </ul>
Emergency	<p>Direct activity cost of providing a service to respond to all reported gas escapes to make safe, including a repair allowance and the cost of rechecks.</p> <ul style="list-style-type: none"> <li>• Call out &amp; Render Safe</li> </ul> <p>The following Costs should be excluded</p> <ul style="list-style-type: none"> <li>• Consultancy services (Work Management)</li> <li>• Emergency Advertising - TV Ads (Indirect)</li> <li>• Leakage control surveys (Maintenance)</li> <li>• Tools &amp; consumables (Other Direct)</li> <li>• Emergency Call Centre (Work Management)</li> </ul>

Maintenance	<p>Direct activity cost resulting from the invasive (“hands on”) examination of plant and equipment including:</p> <ul style="list-style-type: none"> <li>• Routine maintenance activities are recurring and largely predictable in their timing and cost. Where there is a sufficient stock of assets that do not each require individual maintenance every year, but collectively there is a stable annual workload (that does not vary materially in either cost or activity), the programme as a whole counts as routine maintenance. Routine maintenance comprises functional checks, overhaul maintenance, and site husbandry activities, and includes associated materials (e.g. filters, consumables).</li> <li>• Non-Routine maintenance activities are irregular in their timing and cost, and have a material distorting effect upon activity and expenditure in the years in which the activity is undertaken. Typically the requirement to carry out this work on any individual site may arise less than once in every five years and the number of individual sites is insufficient to allow smoothing of the costs of this activity from one year to the next.</li> </ul>
Other (Direct Activities)	<p>Other operational activities not covered elsewhere may include but are not limited to.</p> <ul style="list-style-type: none"> <li>• Reinstatement (inspections)</li> <li>• Non Salary Staff Costs</li> </ul>
IT & Telecoms	<p>Provision of IS Services for the day to day service delivery.</p> <ul style="list-style-type: none"> <li>• Help Desk and Data Centres,</li> <li>• IT application maintenance and running support</li> <li>• Establishing &amp; maintaining IS Infrastructure</li> <li>• Voice &amp; Data Telecoms both fixed and mobile and covering rental and call charges</li> </ul>
Property Management	<p>Property Management</p> <p>The activity of managing, providing and maintaining non-operational premises, i.e. premises used by people; such as offices and depots.</p> <ul style="list-style-type: none"> <li>• Rent and business rates,</li> <li>• Utilities gas / electricity / water</li> <li>• Maintenance and repair</li> <li>• Facility services reception / security / access</li> </ul> <p>Does not include IT System costs</p>
Insurance	<p>Support and expertise to develop the business risk profile, managing the claims process and provision of information and understanding to the business in relation to insurable and uninsurable risks.</p> <ul style="list-style-type: none"> <li>• Insurance premiums Insurance premium tax; Insurance contract negotiating and monitoring; Insurance claim</li> </ul>

	<p>processing;</p> <ul style="list-style-type: none"> <li>• Insurance risk management;</li> <li>• Payments relating to uninsured claims,</li> <li>• Costs of in house insurance team,</li> <li>• Brokers fees.</li> </ul>
Marketing	<ul style="list-style-type: none"> <li>• Advertising including safety campaigns</li> <li>• Marketing and Market Development</li> <li>• Public Relations</li> <li>• Corporate Affairs</li> </ul> <p>Does not include expenditure derived from the domestic connections incentive.</p>
Business Services	<p><b>Stores / Procurement / Logistics</b></p> <p>The procurement of goods &amp; services in the support of the business operations, through the management of procurement contracts with suppliers.</p> <ul style="list-style-type: none"> <li>• Market analysis and supplier identification</li> <li>• Tendering and contract negotiation</li> <li>• Establishing tender guidelines and monitoring supplier performance</li> <li>• Acquisition / warehousing / Transport costs of goods</li> <li>• Stock management</li> </ul> <p><b>Human Resources &amp; Training</b></p> <p>Provide services in the full range of professional activity for an individual's career path from recruitment to retirement, and from related professional advice to directly resolving grievances for staff.</p> <ul style="list-style-type: none"> <li>• Payroll &amp; Pensions management and operation</li> <li>• Recruitment</li> <li>• Industrial &amp; Employee relations</li> <li>• HR strategy, policies and procedures</li> <li>• Compliance with statutory requirements</li> <li>• Training operational / non-operational / professional / behavioural / leadership both internal and external costs</li> </ul> <p><b>Audit / Finance / Regulation</b></p> <p>Performing the statutory, regulatory and internal management of cost and performance reporting requirements; and customary financial and regulatory compliance activities.</p> <ul style="list-style-type: none"> <li>• Processing payments and receipts</li> </ul>

	<p>Financial Risk Management</p> <ul style="list-style-type: none"> <li>• Financial / Management / Investment accounting</li> <li>• Pricing</li> <li>• Statutory and Regulatory reporting</li> <li>• Tax compliance and management</li> <li>• Internal / External audit.</li> </ul> <p><b>CEO / CFO and Other Overhead Costs</b></p> <ul style="list-style-type: none"> <li>• CEO / CFO not carrying out specific departmental duties.</li> <li>• Non Executive Director Costs</li> <li>• Board and shareholder meetings</li> <li>• Investor relations.</li> <li>• Legal Services</li> <li>• Company Secretary</li> <li>• Community Awareness</li> <li>• Any other costs not directly attributed to a single entity, and not capable of easy allocation.</li> </ul>
Other (Indirect)	AS specified by Applicant





## Map of the BGE Firmus Ten Towns Area

