

Ofreg's regulation of the Northern Irish gas markets: principles and priorities

July 2006

Executive summary

1. This paper sets out Ofreg's interpretation of its statutory duties regarding some of the most important challenges facing Northern Ireland's gas industry at this time. The paper also highlight the priority issues for Ofreg's work on gas for the coming months, and sets out our approach on one specific issue (the Phoenix licence).
2. Ofreg acknowledges the achievements of the natural gas industry to date, and wishes to see this fuel continue to grow in importance in Northern Ireland. Over the past 10 years the availability of natural gas has helped to improve fuel diversity and choice for both household and non household customers in Northern Ireland. Notwithstanding recent price rises, gas has helped to deliver many individuals from fuel poverty by allowing them to convert to more efficient natural gas central heating systems. As natural gas is the least polluting fossil fuel it has contributed to environmental improvements.
3. Ofreg's duties are set out in the Energy (Northern Ireland) Order 2003. These duties include the promotion of an economic and efficient gas industry; the protection of consumers, ensuring licence holders can finance their activities and promoting competition. Ofreg considers these duties to be mutually reinforcing and ultimately of benefit to consumers. Promoting development of the natural gas industry will enable more consumers to choose the benefits of natural gas, and investors in the natural gas industry need satisfied customers to make their business a growing success. Moreover, consumers rely on investors to provide the necessary capital to build and operate natural gas networks and provide services. Developing competition can not only ensure prices to customers are as low as possible, it can also empower customers to choose from a wider range of service offerings. Therefore, although Ofreg's statutory duties in gas are not so focused on consumers as is the case with electricity, nevertheless Ofreg views achievement of its gas duties as substantially to the benefit of consumers.
4. The paper explains Ofreg's view that in current circumstances these duties can best be met by:
 - Putting Phoenix Natural Gas' licence on a sounder (longer-term) financial footing which will ensure stable long term prices for gas distribution;
 - Bolstering consumer confidence in gas as a fuel by promoting competitive choice of supplier;
 - Encouraging the development of the network outside Belfast;
 - Bolstering consumer and investor confidence in the regulation of gas by modernising relevant licences; and

- Reducing the cost-base of Northern Ireland's transmission arrangements
5. Given this view of its duties, Ofreg considers that its most immediate work priorities are:
- Developing a longer-term revenue recovery formula for Phoenix. This will provide stability for consumers regarding the distribution element of the final price, and create a stable financial footing both for Phoenix and for competing suppliers. In addition Ofreg will continue to work on the normal five yearly price controls, which seek to ensure that only efficiently incurred costs are passed to consumers by both Phoenix and firmus energy.
 - Encouraging competition in the supply of natural gas in the Phoenix area. This should provide consumers with more confidence in the industry. In general competitive pressures help to ensure efficiency for consumers. Encouraging competition will be a key priority in the first half of 2007. During 2006 Ofreg will examine the need for a supply price control for Phoenix. The function of a supply price control would be to act as a proxy for competition in the event that consumers are not protected either by competition from alternative fuels, or by gas to gas competition.
 - Modernisation, in particular of the Phoenix licence, to be taken forward alongside the creation of a longer-term licence and so as to meet legal deadlines arising from Directive 2003/55/EC (the Gas Directive).
 - Reducing the costs of gas transmission.
6. Taken together the four priorities target all of the elements that go to make up the final price to consumers: transmission, distribution and supply. In addition, modernisation should provide both consumers and regulated companies with the confidence in regulation in Northern Ireland.
7. Comments on Ofreg's approach to fulfilling its statutory duties are welcomed, in particular on the prioritisation of work outlined above and the timetable and approach to Phoenix refinancing set out in Appendix 2 of this document. Please send comments by 28 August to

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Purpose of paper

8. The Northern Ireland gas industry is currently undergoing a period of major change and development. The purpose of this paper is to clarify Ofreg's view of how it can best discharge its statutory duties on gas. The paper focuses on four major issues. It will not attempt to list all issues currently being worked on. Respondents will understand that there are many other work streams currently ongoing which are not mentioned in the paper because the purpose of the paper is not to set out detail.

Background

9. Ofreg's statutory duties are set out in Article 14 of the Energy (Northern Ireland) Order 2003 (the Energy Order). The text of Article 14 is set out in Appendix 1 of this paper. Under the Energy Order Ofreg's principal objective is to promote the development of an economic and efficient gas industry in Northern Ireland. In following this objective Ofreg will have due regard for the interests of gas consumers (in particular those on low income, chronically sick or of pensionable age) and the need for licence holders to finance the activities, which are the subject of obligations imposed by the Gas (Northern Ireland) Order 1996. Subject to this Ofreg will also have due regard to the promotion of the efficient use of gas, fuel diversity and sustainability, and the promotion of competition.
10. Natural gas first arrived in Northern Ireland in 1996, at this time Phoenix Natural Gas (Phoenix) was entrusted with the development of a downstream gas distribution market in the Greater Belfast and Larne areas. At that time Phoenix was a wholly owned subsidiary of British Gas. Phoenix became a wholly owned subsidiary of East Surrey Holdings (ESH) in 2003, and in 2005 Kellen Acquisitions purchased ESH.
11. Gas will now be made available outside the Phoenix area in towns along the route of the following pipelines:
 - a) The North West pipeline, which runs from Carrickfergus to Coolkeeragh powerstation in the North West of the province and,
 - b) The South North pipeline, which runs from just north of Dublin to connect with the North West pipeline near Antrim.
12. Firmus energy, a subsidiary of Bord Gais Eireann has been given the responsibility to develop natural gas networks in the towns of Ballymena, Ballymoney, Coleraine, L'Derry, Limavady, Antrim, Armagh, Banbridge, Craigavon and Newry. In addition firmus has an opportunity over the next five years to bring forward development plans for other towns along the route of the North West and South North Pipelines.

13. The two companies listed above are at a very different stage in their development: Phoenix has completed the network construction phase and has now almost reached 100,000 connected customers. This is a great achievement which should be acknowledged. Phoenix is now concentrating on continuing to connect customers and develop the market within its area. Ofreg estimates that there could be over 250,000 potential customers in the Phoenix area. Firmus energy is just beginning the construction phase of its development. Currently firmus energy has around 100 connected customers. It has the potential to connect up to 88,000 customers by 2027.
14. Building mostly new networks is very capital intensive. The nature of developing a new gas distribution network from scratch is that in the early years when the network is under construction there is a need for a high level of capital investment. This phase involves substantial execution risk, and during the construction programme revenues tend to be at their lowest as customer connections and volumes take time to build up. Once the network is built, it has a continuing financing requirement so as to replace rolling debt, but the risk profile is substantially different.
15. Natural gas distribution and transmission companies are regulated as natural monopolies. Because network assets are not transferable, there is a risk of expropriation through regulatory hold-up. There is therefore a need for fairness in the regulation of gas networks, for instance a fair rate of return. This can be achieved through maintaining a risk-weighted rate of return over the whole project lifetime. However, the rate of return might reflect risk more accurately if it is adjusted as the network moves from construction to exploitation.
16. Fair regulation is best achieved through transparent regulatory processes and relying on approaches that are internationally recognised as good practice. Such approaches can help to manage the inevitable short-term tensions between fairness to investors and companies, and fairness to consumers.
17. During an early phase natural gas tends to be in competition with other fuels. This competition with alternative fuels is generally thought to be sufficient to protect the interests of gas consumers regarding the supply of gas. However, once sufficient customer numbers have connected, a company's incentives can shift to maximising revenues from those customers, rather than to recruiting new customers. This can lead to high prices, which can create a rationale for a supply price control.
18. However price controls are likely to be an unsatisfactory proxy for effective competition. Therefore there is an economic driver to introduce gas on gas competition, and in this case this driver coincides with a legal obligation to create competition for all customers within the Phoenix area by January 07.

Ofreg's priority goals as they relate to its duties

19. Promoting development of the industry means building confidence in the industry from both consumers and from shareholders. In the context of a mature industry this means normal regulatory best practice will be adhered to. It can also mean innovative thinking regarding unique situations. For example Northern Ireland is in the unique situation of having developed an entirely new gas industry based on private investment. This uniqueness was recognised by the European Commission when they granted to Northern Ireland derogation from certain Articles of Directive 2003/55 (the Gas Directive).

20. The maturing of the industry means that it is now time to take stock of the challenges facing the regulation of the Northern Ireland gas industry. There have been many achievements, which we celebrate, but more importantly there now exists an opportunity for improvement. Ofreg believes that its duties will be best pursued by concentrating on the achievement of the following priority goals.

- Putting Phoenix Natural Gas' licence on a sounder (longer-term) financial footing by developing a longer-term revenue recovery formula for Phoenix. This will provide a stable financial footing for the company, a fair return for shareholders, and stability for consumers regarding the distribution element of the final price. In addition Ofreg will continue to work on the normal five yearly price controls which seek to ensure that only efficiently incurred costs are passed to consumers.
- Bolstering consumer confidence in gas as a fuel by promoting competitive choice of supplier. Encouraging competition will be a key priority in the first half of 2007. Within 2006 Ofreg will examine the need for a supply price control for Phoenix. The function of a supply price control would be to act as a proxy for competition in the event that consumers are not effectively protected either by competition from alternative fuels, or by gas to gas competition.
- Encouraging the development of the network outside Belfast, thus bringing the social, economic and environmental benefits of natural gas to more of the people of Northern Ireland.
- Bolstering consumer and investor confidence in the regulation of gas by modernising relevant licences. Not only will this increase investor and consumer confidence but it will also help Northern Ireland to meet its legal requirements under the Gas Directive.
- Reducing the cost-base of Northern Ireland's transmission arrangements

Comments are welcomed on the relationship between Ofreg's statutory duties and these proposed areas of action.

Work priorities

21. Ofreg's work priorities are based on the above goals.

Phoenix

22. Working with Phoenix's owners regarding putting Phoenix Natural Gas' licence on a sounder (longer-term) financial footing which will ensure stable long term prices for gas distribution. This will help to promote confidence in the industry, it will help consumers who wish to see stable and affordable gas prices, and it is also consistent with the duty to ensure that licence holders can finance their activities. Ofreg intends to make the achievement of this goal a top priority during 2006, due to its potential impact on consumers and the industry as a whole.

23. In addition Ofreg will continue to work on the five yearly review of Phoenix's forecast costs and volumes. This is a requirement of the current Phoenix licence and is standard regulatory practice. It will help to ensure that only efficient costs are passed on to consumers. It is necessarily being carried out under the assumptions of the existing licence. However Ofreg may revisit the assumptions to reflect wider progress on the licence.

24. Ofreg's proposed timetable for working with Phoenix's owners is set out in Appendix 2 along with the high level principles which Ofreg considers to be appropriate given Phoenix's particular circumstances.

25. Comments on this timetable and these principles are welcomed.

Competition

26. Bolstering consumer confidence in gas as a fuel by promoting competitive choice of supplier is consistent with Ofreg's duty to promote the industry and with Ofreg's duty to promote competition. Competition will promote consumer confidence in the industry. Competition also protects consumer interests as it has been shown to promote efficiency, choice and good customer service.

27. When Phoenix first arrived in Northern Ireland the licence gave Phoenix three years exclusivity to supply natural gas to customers with an annual consumption in excess of 75,000 therms. For customers who consumed less than 75,000 therms per annum the exclusive period was to until 31 December 2001. The periods of exclusivity in the licence have been extended and currently all customers who consume in excess of 25,000 therms per annum are entitled to choose an alternative supplier. In July 06 all non household customers will become eligible to choose an alternative supplier, and in January 07 all customers will become eligible to choose an alternative supplier.

28. Ofreg is working with Phoenix, and other stakeholders through the Gas Market Opening Group (GMOG) to identify and remove barriers to competition, and to ensure that eligible customers are effectively able to switch. Ofreg recognises that in order to attract alternative suppliers to the market it is imperative to ensure stable and transparent long term distribution prices. Therefore during 2006 Ofreg intends to concentrate its resources on achieving stable long term distribution prices, but will begin focusing more strongly on other aspects of gas market opening during the first half of 2007.
29. In addition to promoting gas to gas competition within the Phoenix area, Ofreg is examining the appropriateness of a supply price control for Phoenix. A supply price control can act as a proxy for competition, where effective competition is not provided by either alternative fuels or alternative gas suppliers.
- 30. *Ofreg welcomes comments on its proposal to reduce its resource commitment to the Gas Market Opening Group during the rest of 2006, with this being a top priority during 2007.***

firmus

31. Encouraging the development of the network outside Belfast is consistent with Ofreg's duty to promote the industry. Natural gas is the least polluting fossil fuel. Its availability in Greater Belfast has helped to reduce harmful emissions, provide competitive pressures on alternative fuels, provide fuel diversity for industry, and help many vulnerable consumers to escape fuel poverty by converting to more efficient natural gas heating systems.
32. In March 2005 BGE(NI), now known as firmus energy, was entrusted with the task of developing the gas industry in new towns along the route of the North West and South North pipelines. Ofreg has a duty to promote the economic and efficient development of the gas industry in these towns. Within this Ofreg will support firmus energy where possible, but will also carry out rigorous scrutiny of firmus' costs and practices. Ofreg will carry out this scrutiny by carrying out price controls and ensuring licence compliance.
33. Under the licence granted firmus energy (supply) has the exclusive right to supply customers who consume in excess of 25,000 therms per annum for 5 years and customers who consume less than 25,000 therms per annum for 8 years (on a town by town basis). Ofreg has a duty to promote competition. In the context of the towns Ofreg will work to ensure that cost effective systems are put in place at the right time so that competition can be delivered within the timetable in the licence.
34. This is a long term priority area, Ofreg will seek to complete the first firmus price control by the end of 2006. Ofreg will then begin work on the second

price control. This will give a firm foundation for the promotion of the industry going forward.

Modernisation

35. Bolstering consumer and investor confidence in the regulation of gas by modernising relevant licences in line with Ofreg's duty to promote an economic and efficient industry. Promotion of an economic and efficient industry is best achieved where there is confidence both on the part of investors (who are needed to finance the development of the industry) and from existing and potential customers who will continue to use natural gas or who may convert to natural gas from alternative fuels.
36. Ofreg intends to carry out the functions assigned to it under the Gas Order in a clear and transparent way with the engagement of all stakeholders. The publication of this transparency statement is the first step in bolstering confidence. In addition Ofreg intends to encourage modernisation and best practice via the introduction during 2006 of licence modifications designed to fully implement EU Directive 2003/55 (the Gas Directive). Full statutory consultation on the proposed modifications is planned for September 2006. The modifications introduced under the banner of the Gas Directive will further the principles of the Directive, that is the introduction of competition where it is possible to do so, effective regulation where competition is not possible, and the protection of vulnerable customers.
37. The Gas Directive will give Ofreg the power to bring forward modifications specifically designed to give effect to the Directive. In addition to Gas Directive work, during 2006 Ofreg intends to continue its work on reviewing the need for "ring fencing" conditions, both within the Phoenix licence and within standard licence conditions. During 2007 Ofreg intends to carry out a policy review regarding the need for a wider review of standard licence conditions. Ofreg intends to consult in early 2007 on specific areas for improvement to the standard licence conditions, for example improved corporate governance.

Transmission

38. The transmission networks are the back bone of gas infrastructure in Northern Ireland and all consumers pay for them through the postalised tariff. Ofreg considers that its duty to promote the industry will be served by simplifying the system, adapting it to the completion of the South North pipeline, and ensuring all stakeholders continue to have confidence in it.
39. The completion of the South North pipeline in October 2006 and the associated spurs pipeline will finalise a period of significant growth in the transmission network over the last few years. The gas transmission regime is currently made up of three Designated Pipeline Operators (DPOs) with three

network codes and two balancing zones. Ofreg believes that this regime is complex and could give rise to inefficiencies. To address this we have initiated a process of streamlining which aims to move to one balancing zone this year and Ofreg welcomes the role played by the DPOs in facilitating this ongoing process. Ofreg will continue to support efforts to further develop an effective and cost efficient gas transmission regime.

40. The proposed development of regional gas markets on a European level has the potential to trigger significant benefits for all national gas markets in Europe. Northern Ireland is a member of the North West region and Ofreg has ensured that it is represented on the regional co-ordination committee (RCC) which is currently setting out the roadmap and timetable for moving towards a regional market. Ofreg will ensure that all stakeholders in Northern Ireland are updated on developments and have the opportunity to input on consultations. An element of the regional market will focus on regulatory co-ordination and cross border trades. Ofreg has raised concerns as to the impact of regulations in jurisdictions through which Northern Ireland transits gas and will seek to ensure changes in other jurisdictions do not adversely impact on customers here.
41. The 2004 Development Framework on an all-island energy market set out a policy context for actions by governments and regulators in terms of an all-island gas market. Ofreg recognises the potential benefits which an all-island market could achieve and is committed to progressing the framework policy. The timing of that progress will be dependent on the resourcing of both regulators.

Conclusion

42.6.1 Ofreg acknowledges Phoenix's accomplishments over the past ten years. That is that Phoenix has built the gas industry in its licensed area from the ground up, starting with zero customers in 1996 with nearly 100,000 today.

43. Over the past 10 years natural gas has delivered many social, environmental and economic benefits to the people of Northern Ireland. Ofreg is committed to continuing to extend these benefits to as many of the people of Northern Ireland as is viable and recognises the tremendous potential for the growth of the industry.

44. Ofreg has a duty to promote an economic and efficient gas industry, protect customers, ensure licence holders can finance their activities and promote competition.

45. Within this, Ofreg's top priority goals are as follows:

- Putting Phoenix Natural Gas' licence on a sounder (longer-term) financial footing which will ensure stable long term prices for gas distribution;
- Bolstering consumer confidence in gas as a fuel by promoting competitive choice of supplier;
- Encouraging the development of the network outside Belfast;
- Bolstering consumer and investor confidence in the regulation of gas by modernising relevant licences; and
- Reducing the cost-base of Northern Ireland's transmission arrangements

46. ***Comments on Ofreg's approach to fulfilling its statutory duties are welcomed, in particular on the prioritisation of work outlined above and the timetable and approach to Phoenix refinancing set out in Appendix 2 of this document.***

Appendix 1 Article 14 of the Energy (Northern Ireland) Order 2003

The principal objective and general duties of the Department and the Authority in relation to gas

14. - (1) The principal objective of the Department and the Authority in carrying out their respective gas functions is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland.

(2) The Department and the Authority shall carry out those functions in the manner which it considers is best calculated to further the principal objective, having regard to -

- (a) the need to protect the interests of consumers of gas;
- (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Gas Order or this Order;
- (c) the need to secure that the prices charged in connection with the conveyance of gas through designated pipe-lines (within the meaning of Article 59) are in accordance with a common tariff which does not distinguish (whether directly or indirectly) between different parts of Northern Ireland or the extent of use of any pipe-line; and
- (d) the need to protect the interests of gas licence holders in respect of the prices at which, and the other terms on which, any services are provided by one gas licence holder to another.

(3) In performing that duty, the Department or the Authority shall have regard to the interests of -

- (a) individuals who are disabled or chronically sick;
- (b) individuals of pensionable age; and
- (c) individuals with low incomes;

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

(4) The Department and the Authority may, in carrying out any gas

functions, have regard to the interests of consumers in relation to electricity.

(5) Subject to paragraph (2), the Department and the Authority shall carry out their respective gas functions in the manner which it considers is best calculated -

(a) to promote the efficient use of gas;

(b) to protect the public from dangers arising from the conveyance, storage, supply or use of gas;

(c) to secure a diverse and viable long-term energy supply; and

(d) to facilitate competition between persons whose activities consist of or include storing, supplying or participating in the conveyance of gas;

and shall have regard, in carrying out those functions, to the effect on the environment of activities connected with the conveyance, storage or supply of gas.

(6) In this Article "gas functions" means -

(a) functions under Part II of the Gas Order; and

(b) functions under this Order relating to gas.

Appendix 2

Putting Phoenix Natural Gas' licence on a sounder (longer-term) financial footing.

1 Under the current formula in the Phoenix licence, the licence holder is entitled to recover all capital and operating expenditure along with a rate of return of 8.5% by 2016. It is apparent that the application of the current formula could lead to substantial increases in gas distribution prices in some sectors. It follows that any increase in gas prices will have a detrimental effect on consumer confidence in the industry, the overall development and growth of the industry, and will also have a detrimental effect on vulnerable gas consumers. Therefore Ofreg believes that it is appropriate to work with Phoenix's owners to re-examine the revenue recovery formula in the licence, with the goal of achieving stable long term distribution prices, while at the same time offering share holders a fair and equitable return in relation to the risks associated with the business.

2 Ofreg believes that the following principles should be adopted in relation to the long term financing of the distribution company:

- A 40 year revenue recovery period. This time period is consistent with the useful life of the asset. It also reduces risk to shareholders in that they are given more certainty and it stabilizes the current distribution price.
- Mutualisation of the current Transmission Asset Base (TAB). Ofreg will be seeking to identify a solution that minimises the costs of transmission, while also furthering its objective of simplifying the transmission system in Northern Ireland. This is currently complicated by the fact that there are three transmission asset owners in a small area, which raises costs and could affect supply security.
- Opening regulatory asset value to be based on actual investment in developing the industry plus a fair reward for efficiency savings. Our starting point on rates of return for past investments and under recoveries will be the rates published in the existing licence
- The rates of return going forward should reflect the level of risk which will face the company having been placed on a sound long term footing and international norms.

3 Ofreg welcomes comments from interested parties as to the appropriateness of the above principles. In addition Ofreg hopes to be able to work in partnership with Phoenix and its owners to continue to develop the industry. If agreement can be reached on the above high level principles, Ofreg believes that a detailed financial model and set of licence modifications could be ready for public consultation by the beginning of 2007. Ofreg is hoping to implement the following timetable:

- July - September – Reviewing and agreeing the core principles with Phoenix and their owners. Coming to a common understanding of the impact of the core principles.
- October - public consultation on progress to date. At this point the basis for any potential agreement is likely to be known. In the event that agreement is possible Ofreg will be in a position to continue with the timetable below. If agreement is not possible Ofreg will outline its proposed time table as part of the public consultation in September.
- October – February –detailed modelling and elaboration of licence modifications, including public consultation on proposed licence modifications.