GD23 - Gas Distribution Price Control 2023-28

Draft Determination Annex Q

Promoting connections

March 2022

About the Utility Regulator

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

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

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

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

Our mission

To protect the short- and long-term interests of consumers of electricity, gas and water.

Our vision

To ensure value and sustainability in energy and water.

Our values

- Be a best practice regulator: transparent, consistent, proportionate, accountable and targeted.
- Be professional – listening, explaining and acting with integrity.
- Be a collaborative, co-operative and learning team.
- Be motivated and empowered to make a difference.

Abstract

This annex provides the Utility Regulator's proposals on funding to promote connections during the GD23 price control period. It proposes that: connections should be provided free to consumers at the time the connection is made; that a cost to serve revenue mechanism should replace that owner-occupied connection incentive applied in GD23; and that lump sum and variable allowances are provided to promote and service non-owner occupied-occupied connections.

Audience

This assessment forms part of our draft determination for GD23 and is of direct relevance to the gas distribution regulated companies. It may also be of interest to consumers and their representatives, government and other regulated bodies.

Consumer impact

The overall consumer impact of GD23 is set out in the main draft determination report. The estimates of capital expenditure in this annex contribute to the determination of tariffs for GD23.

Contents

Executive Summary

This Annex to the GD23 draft determination sets out the Utility Regulator's proposals on how work necessary to promote and secure new connections to the gas network will be funded in GD23.

Our proposals distinguish between domestic owner occupied (OO) connections and all other types of connections including domestic new build, social housing and industrial and commercial connections collectively referred to as non-OO connections.

If these proposals are implemented:

- Lump sum allowances would be provided for advertising, marketing and development (AMD) related to non-OO connections based on a review and challenge of historical costs.
- GDNs would continue to be funded to make new connections so that consumers do not pay for these connections at the time they are made. The costs of new connections will continue to be recovered through revenues from all consumers over the long term.
- In GD23, a cost to serve model would be introduced which will allow GDNs to respond to OO connection request and support consumers through the connection process. This would replace the connection incentive used in GD17. It will result in lower levels of activity undertaken to actively promote OO connections.

The concept of 'cost to serve' is to cover GDNs reasonable costs of responding to contacts and supporting consumers through the connection process, including the cost of energy advisers. Our proposals include a fixed sum to support some advertising and marketing and a variable unit rate to cover the cost of staff who support consumers through the connection process.

We have proposed to move from an incentive mechanism to a cost serve approach for funding the promotion of OO connections because a combination of declining levels of connections and stable or increasing estimates of the cost of securing connections is driving up the average cost of actively promoting connections to the point that it is becoming uneconomic.

1. Introduction

1.1 In previous price controls we have included allowances and incentive mechanisms to promote connections through advertising, marketing and development (AMD).

1.2 In GD17 we distinguished between the methods of funding to support domestic Owner Occupied (OO) connections and all other types of connections including new build domestic, NIHE domestic and all industrial and commercial connections (referred to collectively as Non-OO):

- An allowance was provided for AMD in respect of Non-OO connections. These allowances were based on historical levels of expenditure which are reviewed and challenged at each price control. They are not dependent on the numbers of new connections or additional consumption delivered.

- A connection incentive mechanism was included to support AMD for Owner Occupied connections. The revenue generated under this mechanism was dependent on the number of OO connections delivered. The incentive rate was calculated at an economic level which ensures that the marginal benefit of additional revenue from new connections is shared between the cost of AMD to secure connections and existing consumers.

1.3 In addition to supporting AMD, our GD17 determination continued to ensure that individual consumers did not pay for a new connection at the time the connection was made. The GDNs were funded to make connections and the investment is recovered through revenues from all consumers over the long term.

1.4 In GD23 we propose to continue to include allowances for advertising, marketing and development for Non-OO connections based on a review and challenge of historical costs.

1.5 In GD23 we propose to continue to fund GDNs to make new connections so that consumers do not pay for these connections at the time they are made. The costs of new connections will continue to be recovered through revenues from all consumers over the long term.

1.6 In GD23, we propose to transition from the OO connection incentive mechanism in GD17 to a cost to serve model which will allow GDNs to respond to OO connection request and support consumers through the connection process, but will reduce the level of activity undertaken to actively promote connections.

1.7 In the subsequent sections of this Annex we set out the background to the OO connection incentive mechanism and our reasons for proposing to change this approach and move to a cost to serve model in GD23.

2. GD17 Owner Occupied connection incentive mechanism

2.1 GD17 included a connection incentive mechanism to support AMD for Owner Occupied connections. The revenue generated under this mechanism was dependent on the number of OO connections delivered. The incentive rate was calculated at an economic level which ensures that the marginal benefit of additional revenue from new connections is shared between the cost of AMD to secure connections and existing consumers. The key characteristics of this mechanism are:

- The incentive rate was calculated from the net present value of the additional revenue generated by each OO connection over a 15 year period, net of the direct costs of the new service pipe and meter. A further amount was deducted to represent investment already made in the network, ensuring that new consumers continue to make a contribution to investment made to develop the network.

- In GD17, in response to feedback from the GDNs, we included an additional amount in the incentive rate as a 'new areas' allowance. The new areas allowance recognised the fact that all three GDNs had significant expansions planned in GD17, and that GD17 was likely to be the last price control where such expansions are considered. We concluded that there was a case to be made for an additional allowance to drive awareness of gas and ultimately lead to increased momentum in connection rates. Given the uniqueness of the extent of the extensions in GD17 we noted that this additional allowance would only be applied in the GD17 period and we did not anticipate further new areas allowances in GD23 and beyond.

- The OO connection incentive in GD17 was subject to non-additionality. Non-additionality is an estimate of the number of connections which would be delivered if the incentive mechanism did not exist. In principle, it is only economic to apply the connection incentive rate to properties connected in excess of this. For GD17, non-additionality was set at a percentage of the OO connection target with percentages of 25%, 33% and 0% applied to FE, PNGL and SGN respectively.

- As well as direct costs associated with AMD, the incentive mechanism covers an allocation of general corporate overheads.

- In GD17, payments under the OO incentive mechanism were restricted if a GDN underperformed the annual connection target by more than 50%. In these circumstances, the incentive rate was reduced to 25% of the determined value.

- The mechanism does not define or prescribe the investment GDNs make in AMD or the type of activities they undertake. GDNs are incentivised to identify efficient and effective means of promoting connections. Both the GDNs and consumers benefit when GDNs out-perform their connection targets. Lower more efficient costs revealed in one price control would be captured in subsequent price controls.

2.2 The resulting OO connection incentive rates for the last year of GD17 is include in Table 2.1. The data is presented in 2020 prices. The estimated revenue for 2022 is based on the GDNs' estimated number of OO connections in 2022. The figures are presented in the relevant price base of each company. Figures for FE and PNGL are adjusted for the GD17 frontier shift. An estimate of the revenue which would be generated through the incentive mechanism is provided based on the estimates of the number of OO connections in 2022 included in the GDN's Business Plans.

	Economic incentive rate £ per property	New Areas Allowance rate £ per property	Connection incentive rate £ per property	Non-additionality	Estimate of 2022 connections £m	Estimate of 2022 connection incentive revenue £m
FE	457	163	620	25%	3961	1.84
PNGL	459	66	524	33%	4700	2.00
SGN	512	637	1150	0%	811	0.93

Note 1: All costs are in 2020 price consistent with the relevant GDN price base.

Table 2.1: GD17 OO connection incentive rates and estimated revenue for 2022

3. GDNs proposals for GD23

3.1 The GDNs all proposed a higher rates of the connection incentive in GD23:

- FE did not calculate an economic rate for the OO connection incentive in GD23. Instead, the company proposed increasing the incentive rate from £465 in 2022 to £509 in GD23. The increased rate would allow a material increase in advertising and marketing. The company proposed a rate that would not be subject to non-additionality having already adjusted the 2022 rate from £620 to £465, reducing it by 25% to reflect the effect of applying non-additionality. If non-additionality is applied at 25% in GD23, the equivalent incentive rate would increase to £679 to deliver the same revenue.

- PNGL did not calculate an economic rate for an OO connection incentive. Instead, it proposed an incentive rate of £508. This was taken from a bottom up assessment of expenditure excluding corporate overheads subject to a 33% non-additionality. Including corporate overheads in AMD, consistent with GD17, this gives an equivalent incentive rate of £680 per connection for GD23. PNGL proposes to maintain the level of AMD expenditure in GD23 while delivering lower numbers of connections.

- SGN set out its calculation of an economic rate for the OO connection incentive of £1134. This included £189 as a continuation of the new areas allowance linked to infill still to be completed in GD23. The company proposed that non-additionally should remain at zero.

3.2 The number of OO connections which each GDN proposed to deliver in GD23 is shown in Table 3.1 below. Both FE and PNGL expect the number of connections delivered in GD23 to decline while SGN expects the number of connections to be delivered in GD23 to remain broadly constant.

OO connections	2023	2024	2025	2026	2027	2028	Total
FE	3961	3852	3685	3524	3371	3224	20,740
PNGL	4522	4159	3727	3612	3502	3396	22,918
SGN	623	593	599	652	643	640	3,750

Table 3.1: OO connections proposed by GDNs for GD23

3.3 This trend of declining connections is expected to continue beyond GD23. Two key factors contribute to this decline. Both are linked to the fact that no further network extension are envisaged:

- Connection rates are higher in an area for the first few years following the construction of gas mains. These higher rates of connections in the early years are likely to be driven by a combination of pent up demand and the awareness generated by construction activity itself.

- As connections are made, the number of properties available to connect declines and the number of consumers deciding to connect in any year is expected to reduce in parallel.

3.4 All GDNs have recognised this effect in their submissions, suggesting that securing connections will become more difficult over time. In light of this, the GDNs have proposed either maintaining or increasing expenditure as connection numbers decline. It is likely that this effect will continue beyond GD23 driving an ever increasing AMD cost per connection secured.

4. GDN views on the OO incentive mechanism

4.1 In addition to setting out their plans for OO AMD in GD23 we asked the GDNs to provide feedback on the OO connection mechanism under three broad headings:

- The approach and activities used to develop connections;
- The relationship between expenditure and the number of connections delivered; and
- The structure of the connection incentive and the incentive values.

4.2 Each GDN provided a substantive response to the questions posed. We have provided a brief synopsis of those response below.

The approach and activities used to develop connections

4.3 We asked each GDN to describe the approach and activities used to acquire OO connections. The GDNs provided information on the wide range of work undertaken to promote OO connections including marketing and advertising supported by survey work and analysis of consumer feedback to understand consumer awareness, attitudes to gas and barriers to uptake. The GDNs demonstrated how a range of channels and techniques had been used for marketing and set out how these had developed over time to target specific audiences and issues. The submissions demonstrated the thought and effort which had gone into the development of structured and targeted marketing to promote OO connections.

The relationship between expenditure and the number of connections delivered

4.4 We asked each GDN set out their understanding of the relationship between expenditure on AMD and the number of connections delivered. The GDNs generally considered that current levels of expenditure on OO AMD were optimal and that any reduction in expenditure would be detrimental to the number of connections delivered. The GDNs went on to propose either maintaining or increasing the level of investment in AMD in GD23. However, GDNs were generally unable to provide quantitative evidence on how varying the level of investment in AMD generally or on individual activities would increase or decrease the number of connections delivered over GD23. Continued investment in AMD at the same or higher levels than in GD17 was considered essential to maintain awareness of gas to ensure that it remained

front of mind when consumers were considering changing their heating system.

The structure of the connection incentive and the incentive values.

4.5 As part of their submission each GDN provided feedback on the methodology we had used to calculate the economic incentive rate for GD17. A number of common themes were drawn out in these responses:

- GDNs suggested that that the 15 year limit applied when assessing the benefit of additional revenues for each connection was not justified. Longer durations were suggested such as 20 years (consistent with the life of a meter) or 40 years (consistent with the depreciation period of the mains). The value of the incentive rate is sensitive to the duration of the analysis with longer durations leading to a higher incentive rate.

- GDNs disagreed with the application of non-additionality in the connection incentive, arguing that the incentive rate should be applied to all connections. They noted that all properties which connect will have been exposed to AMD at some stage and are likely to have been influenced by it.

- FE challenged the deduction of a contribution for existing mains. The company argued that as no material expansion of the network is planned most connections will be made to existing mains and the cost of mains has become a sunk cost.

- PNGL challenged the allocation of an element of corporate overheads to AMD expenditure, arguing that these costs are fixed and should not be attached to a variable incentive mechanism. The company also argued that most AMD expenditure was fixed and suggested that only direct incentive payments to consumers was truly variable in proportion to the number of connections made.

- SGN suggested that the cap and collar mechanism should be removed because it could unduly penalize GDNs which failed to deliver 50% of their connection targets due to external factors. This was informed in part by the company's experience in GD17 where delays to the completion of High Pressure mains under the Gas to the West High Pressure license limited SGN's ability to make connections during the early stages of GD17.

5. UR proposals for GD23

Introduction

5.1 In GD23 we propose to continue to include allowances for advertising, marketing and development for Non-OO connections based on a review and challenge of historical costs.

5.2 In GD23 we propose to continue to fund GDNs to make new connections so that consumers do not pay for these connections at the time they are made. The costs of new connections will continue to be recovered through revenues from all consumers over the long term.

5.3 In GD23, we propose to transition from the OO connection incentive mechanism in GD17 to a cost to serve model which will allow GDNs to respond to connection request and support consumers through the connection process but will reduce the level of activity undertaken to actively promote connections.

New Areas Allowance

5.4 In GD17, we increased the economic incentive rate to include an additional 'new areas' allowance. This was in recognition of the level of infill and extensions included GD17. It was provided to drive awareness of gas in new areas and lead to increased momentum in connection rates. Given the uniqueness of the extent of the extensions in GD17 we noted that this additional allowance would only be applied in the GD17 period and we did not anticipate further new areas allowances in GD23 and beyond.

5.5 The additional 'new areas' allowance in GD17 was linked to the expansion of the network and increased levels of infill in the GD17 period. This work has largely come to an end with more infill investment completed in GD17 than expected. As a result, and as signalled in our GD17 decisions, we have concluded that a 'new area' allowance is no longer justified.

Review of an economic incentive rate

5.6 We have considered the option of continuing the current economic incentive mechanism, reviewing the issues raised by the GDNs in respect of the calculation of the incentive rate (see section above beginning at paragraph 4.5), and reviewing the calculation of the incentive rate to reflect determined values for GD23.

- We have continued to apply a 15 year limit when assessing the benefit of additional revenues for each connection. We recognise that the value of the incentive rate is sensitive to the duration of the analysis with longer durations leading to a higher incentive rate. However, we consider this an appropriate limit which shares the benefit of additional connections between the cost of marketing and reducing tariffs for additional consumers.

- We consider the application of non-additionality is appropriate as the network develops and awareness of gas as an option becomes more widely embedded. The application of a non-additionality figure does not imply that some of those who connect were not aware of AMD. Instead it reflects the fact that a proportion of those who do connect would have done so in any event. Therefore there is no benefit from these non-additional connections which would justify an incentive payment on an economic basis.

- We considered the continued deduction of a contribution to existing mains in the calculation of the incentive rate to be appropriate. We believe that new connections should contribute to the costs of the infill mains which allowed them to connect. Otherwise existing consumers would bear the full costs of mains used by others through AMD incentive contributions.

- We consider the continued allocation of an element of corporate overheads to revenue recovered through a connection incentive to be appropriate. Corporate overheads contribute to all work undertaken by the GDNs and we consider it reasonable that each revenue recovery mechanism bears it fair share of these costs. Nor was it our intention to make the recovery mechanism strictly cost reflective. In particular, the unit rate approach does not match the level of fixed and variable costs which might be incurred and requires GDNs to make decisions on both when deciding on their AMD strategy.

- We continue to believe that our approach to limiting the incentive rate to 25% of the determined rate when performance falls below a fixed amount of the target is reasonable. But we will consider this further for the final determination.

5.7 Based on our conclusions for GD23 we have recalculated a connection incentive rate for GD23 as follows. This uses representative values for GD23 which we may consider refining to specific values for each GDN for the final determination. We have also updated the calculations to include the impact of the energy efficiency profile post GD23 and operational maintenance costs.

		GD17	GD23
Domestic consumption	therms/yr	380	400
Recovery period	years	15	15
Conveyance tariff	p/therm	46	45
Rate of return	%	4	2.75
NPV of revenue	£	2105	2034
NPV of additional opex including maintenance	£	not used	(199)
Dom service value	£	(1012)	(957)
Domestic meter value	£	(228)	(252)
Infill reduction	£	(387)	(417)
Connection incentive rate	£	478	410
Connection incentive rate at 2022 post frontier shift	£	459	

Note 1: All costs are in 2020 price consistent with the relevant GDN price base.

Table 5.1: Calculation of an economic incentive rate for GD23

5.8 The calculation remains sensitives to the inputs. For example, reducing the tariff to 40 pence per therm would reduce the economic incentive rate to £180, increasing the recovery period to 20 years would increase the economic incentive rate to £700.

5.9 The incentive rates proposed by FE, PNGL and SGN (subject to non-additionality of 25%, 33% and 0% respectively and inclusive of corporate overheads) are £680, £679 and £1134 respectively. These are in excess of the economic incentive rate calculated above. In different ways they aim to retain part or all of the 'new areas' allowance applied in GD17. The rates proposed by the GDNs either maintain or increase expenditure at a time when the number of opportunities to obtain connections will begin to decline and the GDN's believe that the effort necessary to secure connections will continue to increase.

5.10 In view of this, we have concluded that the use of a connection incentive to deliver OO connections is reaching the end of its useful life. We had signalled our intention to scale down the connection incentive in the past. We had considered this in GD17, but decided not to make that adjustment at that time. Instead we introduced the 'new areas' allowance which increased the incentive rate. In view of our assessment of future connections and the appropriate economic level of a connection incentive rate in GD23, we have concluded that GD23 is the right time to both remove the 'new area' allowance and to scale down the connection incentive rate. In doing so, we recognise the risk that a cycle of reducing expenditure on AMD could lead to lower rate of connections which reduces the revenue recovered by the

GDNs. Therefore, we have concluded that, if we scale down funding for OO connections, it would be right to reduce the risk which GDNs are exposed to under the incentive regime. This includes: moving away from connection targets to connection projections and making other adjustments to the payment mechanism.

6. GD23 – cost to serve approach

6.1 After considering the current mechanism and the comments made by the GDN's, and taking regard on the stage of development for each Network Operator, we have decided to scale down and replace the existing economic incentive mechanism for OO connections in GD23.

6.2 We propose to replace the existing incentive mechanism with a 'Cost to Serve' allowance. The concept of cost to serve is to cover the GDNs reasonable costs of responding to contacts and supporting consumers through the connection process, including the cost of energy advisers.

6.3 We are proposing a glide path down from the existing incentive rates in 2022, having first deducted the new area allowance introduced for GD17 and adjusted for non-additionality, to what we consider to be a reasonable cost to serve allowance by 2028 for each GDN.

6.4 In response to a query in respect of cost to serve, one GDN noted that the marketing and development activity funded from the Connection Incentive also supported wider awareness of the gas industry for the public, customers, stakeholders, community and elected representatives, ensuring that they are suitably informed, understand the emergency response, non-routine and asset maintenance activities general adverting etc. The GDN's made the point that this was necessary as part of their core responsibilities as a network operator and suggested a minimum allowance of £150k pa to deal with these type of issues. We have concluded that it is reasonable to provide a fixed allowance for all GDN's to support and aid the understanding of wider gas issues that may be lost as marketing and advertising activities funded through the connection incentive are wound down. This allowance would be for the wider promotion and awareness of the gas industry which may prompt connection requests. We propose a fixed allowance of £150k for FE and PNGL and £125k for SGN to reflect its smaller scale of operation. We would encourage GDNs to work together to maximise the benefits of these allowances.

6.5 Since this 'fixed' allowance is already included in the advertising and marketing costs allocated to OO connections incentive rate, the glide path rate from GD17 incentive rate to Cost to serve must be adjusted in the early years to deduct the fixed allowance for advertising and marketing in the embedded rate. This flattens the glide path for the variable rate.

6.6 Because we have moved to a cost to serve as opposed to a connection incentive mechanism we have made the following adjustments which de-risk this revenue stream consistent with a cost to serve approach:

a) while the estimates of revenue are based on connection projections, connection targets have not been set;

b) the unit rate will apply in all circumstances and will not be adjusted if connections delivered are higher or lower than projected levels;

c) non-additionally will not apply and every connection qualifies for the same allowance; and,

d) the Corporate Overhead Costs that were previously recovered through the OO incentive mechanism are not covered in the cost to serve rates and have been included in the general opex allowances.

6.7 The fixed and variable rates used in the cost to serve revenue mechanism are shown in Table 6.1 below. The variable rate will be applied per connection. Cost of advertising and marketing will be recovered as actual costs per annum up to the lump sum allowance.

	Lump sum £k/a	Variable rate £/connection					
		2023	2024	2025	2026	2027	2028
FE	150	274	242	210	187	180	173
PNGL	150	244	211	179	146	130	130
SGN	125	400	400	400	400	400	400

Table 6.1: OO connections cost to serve rates for GD23