



GD23 - Gas Distribution Price Control 2023-2028

Final Determination Annex H
Incentives and Innovation
October 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 forms part of the Final Determination for the GD23 Gas Distribution Price Control. It provides a review of incentives and innovation and how best the Utility Regulator (UR) can support innovation within its current vires. It also details the related approach, business plan requests, and UR assessment of these requests as well as the resulting UR decisions for GD23.

Audience

Industry, consumers and statutory bodies.

Consumer impact

A framework has been provided to enable GDNs to avail of incentives and innovation during the price control period, with the view to improve services and reduce costs in the long term for consumers.



Contents

Executive Summary	1
1. Introduction	3
Purpose of this document	3
Changes from Draft Determination to Final Determination	3
Structure of this document.....	3
2. The Approach used in GD17	5
Incentives	5
Innovation.....	5
3. GDNs Submissions	7
FE.....	7
PNGL.....	7
SGN.....	7
Draft Determination Consultation Response.....	8
4. Approach to Innovation	9
5. UR Decisions	10
Incentives	10
Innovation.....	10

Executive Summary

Incentives are an important part of the regulatory framework and are used to aid and promote efficient and economic development of the gas industry. The main available incentives are reviewed and are discussed fully in the appropriate areas of the price control as follows; properties passed incentive (Annex F - Capital Investment), connection incentives (Annex Q - Promoting Connections), cost of debt mechanism (Main Document- Chapter 10) and SGN's Price Cap (Annex C -Connections and Volumes).

Innovation that would be considered to contribute to the Energy Strategy is discussed in Annex G. With "other" innovation in mind, we expect the GDNs to deliver innovation as a "Business as Usual" activity. The cost risk sharing mechanism, within the price control framework, allows a proportion of capital and opex cost savings to be retained by the GDNs. This provides a strong incentive for the GDNs to invest in innovation to deliver costs savings and improve outputs. Consumers will benefit in the long run from improved services and lower prices.

We consider that this approach should remain the principal mechanism for delivering innovation. It provides maximum flexibility to the GDNs to make innovation decisions, aligns the benefits for consumers and GDNs and avoids the risk of a regulator being asked to pick winners from a list of potential innovation projects.

We are conscious that in some cases funding of innovations through increased prices may be appropriate, and should a GDN identify this funding need, they must apply through the submission of a business case, before any funding will be approved. Applications are subject to the materiality threshold and should comply with the innovation funding principles outlined below to ensure proper consideration is given to the risks and rewards, though valid explanations around any of the principles will be considered.

- Quantified and robust cost benefit analysis.
- Detailed and robust project plan for the innovation project.
- Credible and binding commitments from any project partners to participate in/contribute to funding the project, as well as proposed contingency arrangements in case any of the project partners should fall short of their obligations.
- Justification of why funding through the overall price control package is considered not appropriate/sufficient and why funding through specific innovation allowances and increased prices is requested.
- Explanation of how the GDN has arrived at its chosen bid for innovation and how this interacts with other innovation investments planned under the normal price control regime.

- Explanation of how the innovation bid was identified/prioritised and justified in consultation with consumers and other stakeholders.
- Explanation of why there exists a barrier towards innovation which requires some form of regulator action to progress, and the consequences of the innovation not happening.
- Details on what deliverables/benefits may be expected for local consumers from the research/development/trials.
- Detailed risk assessment as well as details on and justification of proposed treatment of risk and reward.
- Description of how the innovation, if successful, could be efficiently rolled out within the GDN and/or other Northern Ireland or Great Britain GDNs.
- Justification of how the proposed innovation is different to anything that has occurred previously, whether within the GDN, another Northern Ireland or Great Britain GDN or within the wider industry.

1. Introduction

Purpose of this document

1.1 This document forms part of the final determination (FD) for the GD23 price control. This is the price control for the three gas distribution network operators (GDNs) in Northern Ireland (NI):

- Firmus energy (Distribution) Ltd (FE)
- Phoenix Natural Gas Ltd (PNGL)
- SGN Natural Gas Ltd (SGN)

1.2 The price control covers the 6-year period from 1 January 2023 onwards.

1.3 More specifically, this document is an annex to the main GD23 final determination document. It provides a background to the development of Incentives and Innovations approach for the last price control GD17 and makes reference to the GD23 Approach document. It also details the business plan requests made by the GDNs and key comments, and Utility Regulator (UR) assessment of these as well as the resulting UR decisions for GD23.

Changes from Draft Determination to Final Determination

1.4 We have updated this annex following on from the GD23 draft determination and due consideration of the responses received. Key changes made in this context include:

- Clarification that the materiality threshold applies to funding applications for innovation projects that are not deemed to contribute to the Energy Strategy.

1.5 Any changes for incentives are detailed in their respective price control areas identified in chapter 5 of this document.

Structure of this document

1.6 This document is structured in a number of chapters as follows:

- a) Chapter 1, Introduction, provides an overview of the purpose and structure of the document, as well as outlining the changes made from the draft determination to the final determination.

- b) Chapter 2, The Approach used in GD17, provides background information on how this area has previously been developed, with a forward look on the approach for the next price control.
- c) Chapter 3, GDNs Submissions, summarises each of the requests and key comments made by the GDNs in their business plan submissions.
- d) Chapter 4, Approach to Innovation, sets out our approach and position at Final Determination and our resulting assessment of the requests.
- e) Chapter 5, UR Decisions, sets out our Final Determination for the GD23 price control.

2. The Approach used in GD17

Incentives

- 2.1 Incentives are an important part of the Regulatory framework.
- 2.2 A number of incentives were used in GD17 to aid and promote efficient and economic development of the gas industry. The GD17 price control included the following main/key incentives:
- a) Connection Incentive including a "new areas allowance" to maximise the number of connections added to the network, which recognises that a lot properties that are readily connectable have yet to convert over to natural gas.
 - b) Properties Passed Incentive, which sets a framework to focus the laying of pipes in the most densely populated areas or where major gas loads exist.
 - c) Debt Mechanism as referred in the Rate of Return, to secure the most cost effective financing possible.
 - d) Price Caps, which only applies to SGN, to incentivise out performance on the gas volume targets set, which is appropriate at the early development stage of the network.
- 2.3 These incentives will be reviewed and are discussed further in the appropriate areas of the price control, which follows Opex, Capital Investment or Rate of Return areas.

Innovation

- 2.4 One of our key statutory objectives is to "Promote the development and maintenance of an economic and coordinated natural gas industry."¹
- 2.5 As such our approach to innovation will follow the innovation principles outlined in GD17.
- 2.6 In our GD17 Final Determination we indicated "we welcome innovation initiatives from the GDNs, where reasonable and economically efficient."²

¹ <https://www.uregni.gov.uk/what-we-do>

² https://www.uregni.gov.uk/files/uregni/media-files/2016-09-15_GD17_Final_Determination_-_final_0.pdf

2.7 To date we have not received any submissions from any of the GDNs with regard to innovation during GD17. We would like to reiterate that we welcome innovation initiatives from the GDNs, where reasonable and economically viable.

3. GDNs Submissions

FE

- 3.1 In their business plan FE cited concerns around the existing GD17 funding process for innovation and it potentially creating a funding gap for innovation development activities and project facilitation, particularly in connection to the Energy Strategy.
- 3.2 FE suggested that we maintain the existing innovation funding principles but provide clearer guidance on their application and also suggested including a new specific use-it-or-lose-it innovation allowance to fund early stage innovation activities.
- 3.3 FE proposed that the new use-it-or-lose-it innovation allowance be set at 1% of baseline allowances noting that this would align with the recent RIIO-GD2 decision were GDNs received a Network Innovation Allowance of up to 0.97% of baseline allowances.

PNGL

- 3.4 With some overlap with Energy Strategy, PNGL suggested that under the current regulatory framework a Gas Networks Innovation Fund is established.
- 3.5 PNGL highlighted the desire for a review of our legislative remit to provide a better gauge for the innovation submission.
- 3.6 In PNGL's innovation business plan, the potential of a closed gas network to bring gas to rural housing that is not connected to the main gas network was cited. They suggested, in time, and depending on Energy Strategy developments, hydrogen could be used to feed this system.

SGN

- 3.7 SGN suggested that if the Traffic Management Act (TMA) did not come into force in the GD23 price control period that some or all of the allowances here could potentially be allocated to an innovation fund.
- 3.8 SGN believes there are 2 distinct strands to innovation being operational innovation and addressing decarbonisation. SGN suggest operational would include methods of working, support functions, tools, equipment, IT systems and approach to digitisation. Decarbonisation would be innovation to help meet the challenges of the Energy Strategy.

- 3.9 Specific funding amounts were not presented in the paper as SGN cited they were aware of our vires but welcomed opportunities to discuss further.

Draft Determination Consultation Response

- 3.10 Following on from our draft determination we received consultation responses on our proposals for incentives, particularly on our proposed changes to the owner occupied connection incentive. Full detail of the responses can be found in the published consultation responses Annex R. Our assessment of the most substantive responses and our decisions for the main incentives, is detailed in the respective price control areas identified in Chapter 5 of this document.
- 3.11 We didn't receive any consultation responses from the GDNs on the innovation addressed in this annex and our proposals for it, their innovation responses related to Energy Strategy innovation dealt with in Annex G. CCNI did make some suggestions on additional principles and highlighted the reducing incentive to innovate as a price control period progresses. Full detail of the responses can be found in the published consultation responses Annex R, and our assessment of submissions and responses, approach and decisions for GD23 innovation are discussed in the following chapters.

4. Approach to Innovation

- 4.1 We note that Innovations and the Energy Strategy are closely linked, but we make a distinction between the projects which relate to:
- The Energy Strategy (i.e. focus on a reduction in carbon emissions and a phasing out of fossil fuels.)
 - Innovation (i.e. Projects or innovative activities not related to the Energy Strategy that may require investment in the business, over and above normal activities e.g. Metering Issues).
- 4.2 We agree that the Energy Strategy will present challenges and that re-openers should be in place to address any policy decisions that need funding. We are implementing the use of the ring-fenced uncertainty mechanism with an accessible fund which is discussed in more detail in Annex G.
- 4.3 We are also aware that the Energy Strategy may eventually lead to a change in our legislative remit, even with regard to innovation not related to the Energy Strategy, but currently in this final determination we must act within its vires.
- 4.4 We note PNG's innovative thinking around the possibilities of a closed gas network, however this is still being developed.
- 4.5 We do not agree with SGN's suggested reallocation of Traffic Management Act (TMA) allowance. Whilst there is merit to this suggestion, the TMA principles were clearly identified in GD17 in how it would work and it is inappropriate to allocate funds from this area to another area without clear signalling. The TMA allowance will remain ring-fenced for GD23.
- 4.6 We agree with SGN's view on operational innovation, where innovation on business as usual activities can lead to shared benefits and we have expanded on this viewpoint in our determinations in the following chapter.

5. UR Decisions

Incentives

- 5.1 Incentives are an important part of the regulatory framework to ensure that the GDNs continue to develop the network, in the most efficient manner possible. We are continuing with the key incentive that allows the GDNs to offer owner occupied consumers wishing to connect a free connection (subject to additional charges for reinstatement of high cost surfacing or particular requests in respect of location). This offers a strong incentive for customers to connect as in most cases these costs are in the region of £1500 per new connection made.
- 5.2 Our review and final determination for a selection of the main existing incentives is detailed in the appropriate areas of the price control as follows:
- a) The properties passed mechanism to incentivise the GDNs to continue to extend their networks. More detail on this is contained in Annex F – Capital Investment Detail.
 - b) The cost of debt mechanism, to secure the most cost effective financing possible. More information on cost of debt is contained within Chapter 10 of the main document.
 - c) A price cap incentive for SGN, to offer incentive to outperform on gas volumes set, when network is still in a developing stage. More detail on this is contained in Annex C – Connections and Volumes.
 - d) The connection incentive mechanisms to support advertising, marketing and development for connections. Full detail published in Annex Q - Promoting Connections.

Innovation

- 5.3 We have carefully considered the innovation submissions and responses in light of our current vires. As a result, it is our determination that we expect, in the first instance, the GDNs to deliver innovation as a “Business as Usual” activity. The cost risk sharing mechanism, within the price control framework, allows a proportion of capital and opex cost savings to be retained by the GDNs. This provides a strong incentive for the GDNs to invest in innovation to deliver costs savings and improve outputs. Consumers will benefit in the long run from improved services and lower prices.

- 5.4 Though the incentive to innovate reduces as the price control period nears the end, we consider that this approach should remain the principal mechanism for delivering innovation. It provides maximum flexibility to the GDNs to make innovation decisions, aligns the benefits for consumers and GDNs and avoids the risk of a regulator being asked to pick winners from a list of potential innovation projects.
- 5.5 We are conscious that in some cases funding of innovations through increased prices may be appropriate, e.g. in the case of major innovation projects that require significant upfront investment and where the payback period for the project is relatively long, perhaps spanning future price control periods. Innovation projects of this type will be considered on case by case basis but must be demonstrated to be economically efficient.
- 5.6 Applications for innovation funding are subject to the materiality threshold.
- 5.7 As determined in GD17, and in the approach document to GD23, any new innovation projects would be expected to comply with the "Innovation Funding Principles", as described below:
- a) Quantified and robust cost benefit analysis.
 - b) Detailed and robust project plan for the innovation project.
 - c) Credible and binding commitments from any project partners to participate in/contribute to funding the project, as well as proposed contingency arrangements in case any of the project partners should fall short of their obligations.
 - d) Justification of why funding through the overall price control package is considered not appropriate/sufficient and why funding through specific innovation allowances and increased prices is requested.
 - e) Explanation of how the GDN has arrived at its chosen bid for innovation and how this interacts with other innovation investments planned under the normal price control regime.
 - f) Explanation of how the innovation bid was identified/prioritised and justified in consultation with consumers and other stakeholders.
 - g) Explanation of why there exists a barrier towards innovation which requires some form of regulator action to progress, and the consequences of the innovation not happening.
 - h) Details on what deliverables/benefits may be expected for local consumers from the research/development/trials.

- i) Detailed risk assessment as well as details on and justification of proposed treatment of risk and reward.
- j) Description of how the innovation, if successful, could be efficiently rolled out within the GDN and/or other Northern Ireland or Great Britain GDNs.
- k) Justification of how the proposed innovation is different to anything that has occurred previously, whether within the GDN, another Northern Ireland or Great Britain GDN or within the wider industry.

5.8 We are aware that robust assessment criteria for funding of innovation projects may impact on the time and resources GDNs need to invest if they wish to request funding. However, we consider that this is appropriate, proportionate and necessary to provide protection to consumers who would bear the risk and cost of such innovation projects. We also note that our assessment criteria do not exclude or restrict innovation measures to address problems specific to Northern Ireland's network areas or to create opportunities for natural gas connections. Nor do they preclude the submission and consideration of higher risk projects with higher cost saving potentials. That said, we consider that the riskier a proposed innovation project is and the higher the associated costs consumers will be asked to bear, the more diligent and detailed the upfront assessment needs to be. The assessment of these projects will therefore include a pain gain mechanism to ensure that there is sufficient alignment between the objectives of the innovation project and how the costs associated will impact the consumers of Northern Ireland.

5.9 It is important to note that the innovation principles set out in GD23 are necessary for any innovation submission to ensure proper consideration is given to the risks and rewards around innovation projects. We however encourage all submissions and if there is valid explanations around any of the principles these will be taken into consideration.