Utility Regulator GD23 Gas Distribution Price Control 2023-2028

Draft Determination

The Consumer Council Response

25 May 2022

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1. Ambition for Consumers

The Consumer Council supported the long-term investment in, and development of, the Northern Ireland gas distribution networks (GDNs), in our response to the GD17 Draft Determination.[1] Since GD17 commenced, the energy landscape has evolved considerably with the implementation of UK Net Zero legislation and subsequent development of the Northern Ireland Energy Strategy. Additionally, the ramifications of the COVID-19 pandemic and the Russian invasion of Ukraine have had a dramatic impact on natural gas costs.

However, as described in the Northern Ireland Energy Strategy, natural gas continues to have an important role to play as *"an interim solution in meeting our longer-term objective of ensuring that energy for heating does not contain fossil fuels."*[2]

We recognise that as the GD23 process coincided with the Energy Strategy development the Utility Regulator has decided to take a 'business as usual' approach to the Price Control. Therefore, our key priorities in responding to Draft Determination consultation are:

Engagement:	Given the scale of change the Northern Ireland energy network may have to undergo to facilitate decarbonisation, it is essential that consumers are provided greater opportunity to engage in decisions affecting them. We welcome the commitment to develop new consumer focused metrics and would appreciate the opportunity to collaborate in their development and rollout.
Empowerment:	We ask that the UR reconsider its plans for the removal of the connections incentive and ensures its 'basket of works' calculations are calibrated to ensure that, at a minimum, no consumer is asked to pay for upstream connection costs.
Affordability:	The energy price crisis has served to reiterate the importance energy affordability. In this regard it is important that our GDNs focus on efficient expenditure and service delivery. We welcome that the Draft Determination proposes lower rates of return and an overall reduction in the impact on consumers' bills.
Decarbonisation:	The Consumer Council welcomes that our GDNs have been considering innovation opportunities. We believe a requirement on

1 https://www.consumercouncil.org.uk/sites/default/files/original/Consumer_Council_Response_to_UR_GD17_Draft_Determination_31_May_2016.pdf

2 https://www.economy-ni.gov.uk/sites/default/files/publications/economy/Energy-Strategy-for-Northern-Ireland-path-to-net-zero.pdf

GDNs to produce an Environmental Action Plan, in a similar guise to the stipulation in RIIO-GD2, would encourage GDNs to reduce their own environmental impact and set a great example for consumers who are seeking leadership in the field of decarbonisation.

Vulnerability: GDNs' acknowledgement of the importance of the delivery of the Best Practice Framework for Consumer Protection is welcome, particularly as the energy price crisis and energy transition are both likely to increase consumer vulnerability. In making adherence to the Framework a stipulation for the companies, we trust that the UR will ensure companies are provided the very modest allowances required to implement consumer protection best practice.

The Utility Regulator's principal statutory objective is to protect the interests of consumers. This should therefore be the key objective of the GD23 review, and how far a particular policy protects consumers should be the principal test used when deciding on the issues raised in the consultation.

The remainder of our response to the GD23 Draft Determination follows the structure of the consultation document.

2. The Consumer Council

The Consumer Council is a non-departmental public body (NDPB) established through the General Consumer Council (Northern Ireland) Order 1984. Our principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland.

The Consumer Council has specific statutory duties in relation to energy, postal services, transport, water and sewerage, food accessibility and financial services.

We are an insight-led evidence based organisation:

- Providing consumers with expert advice and confidential guidance.
- Engaging with government, regulators and companies to influence public policy.
- Empowering consumers with the information and tools to build confidence and knowledge.
- Investigating and resolving consumer complaints under statutory and non-statutory functions.
- Undertaking best practice research to identify and quantify emerging risks to consumers.
- Campaigning for market reform as an advocate for consumer choice and protection.

Consumer Principles

Eight consumer principles, shown in Figure 1, help assess regulatory decisions from a consumer perspective. They provide a framework to consider service design and delivery, consumer impact and how services should look and feel to the consumer.

Figure 1: Consumer Principles

Review of the Utility Regulator's GD23 Draft Determination

Common Issues

Duration of GD23 Price Control

The proposal to have a six year control seems reasonable and would allow material from Ofgem's RIIO GD3 control (the price control for GB distribution companies after the current control ends in 2026) to be taken into account in the next price control. However, it is important that reopeners, particularly those relating to innovation, are calibrated in such a way that ensures consumers do not miss out on advantages that may arise from Energy Strategy actions.

Price Base

It would be easier for comparisons between gas networks to use a consistent price base, but we agree that the difference between the price bases used for the different companies is likely to be minor.

Form of Price Control

We agree that FE and PNGL should be subject to a revenue cap.

Given the UR's assessment that "*we are at, or close to, the limit of the economic extension of the gas network*" we note that SGN are moving towards a situation where a revenue cap may become more appropriate. However, given a price cap provides strong incentive to expand the number of customers served and few customers have been connected to the West Network we agree that SGN should remain on a price cap for the GD23 Price Control period.

Adjusting for Inflation

We agree that a move from using RPI to using CPIH as the measure of inflation is appropriate for the reasons given in the Draft Determination. However, using the CPIH means that tariffs will be higher in the short term than using the RPI (although lower in the long term), given the major concerns about energy price rises and the affordability of energy prices in the short term, this move will exacerbate those pressures particularly for vulnerable customers. We therefore recommend that the UR should look at the impact of this change on vulnerable customers and consider ways to mitigate its impact. For example, by reprofiling the TRV across the control period.

When using the CPIH as a measure of inflation for the price control, UR should also take account of the fact that consumer prices in Northern Ireland tend to be around 2.3% lower than those for the UK as a whole[3] and that therefore inflating company costs by CPIH measured for the UK may over-estimate the expected cost inflation for Northern Ireland. It

[3] https://www.ons.gov.uk/economy/inflationandpriceindices/articles/relativeregionalconsumerpricelevelsuk/2016#:~:text=The%20main%20difference%20compared%20with,CPI%20measures%20the%20difference%20in

may therefore be appropriate to include an offset to the CPIH indexation to recognise this systematic difference.

The Consumer Council is embarking on a joint project with the Office of National Statistics regarding the development of a consumer price index for Northern Ireland that could provide more accurate information assist future Utility Regulator calculations.

Future of Domestic Owner-Occupied Connection Incentive

The Consumer Council do not support the move from an incentive mechanism to a cost to serve approach at this time.

We acknowledge that taking a cost to serve approach would mean that as the cost of connections increases and the number of connections declines, existing consumers will not be faced with higher bills to fund uneconomic connections.

However, it is worth noting that penetration rates (the number of properties connected to the gas network as a proportion of those passed by the network) in the Ten Towns Network Area are c. 20%, lower still in the West Network Area, and in the Greater Belfast Network Area penetration rates are at similar levels to the beginning of GD17, primarily due to network growth facilitated by the gas to East Down project. As a result, the rate of gas network connections may not decline during the GD23 period.

Of course, the rate of connections is dependent on a wide range of factors, notably consumers' disposable income, the companies' advertising and marketing spend, the price of natural gas vis-à-vis home heating oil, and Government prioritisation of natural gas.

While the Energy Strategy continues to prioritise natural gas as an interim solution in meeting our longer-term objective of decarbonisation, the increased price of natural gas vis-à-vis home heating oil and a likely reduction in consumers' disposable income due to the cost-of-living crisis indicate that continued incentivisation is required to encourage consumers to connect to gas.

Further, given existing consumers' investment in network rollout to date, it is in their interests that we ensure further connections to the network thereby reducing their share of future network costs.

While it is difficult to quantify the effectiveness of advertising and marketing spend it is likely that this spend adds to the awareness of the natural gas network thereby increasing connection rates.

If provision for advertising and marketing spend is retained the Consumer Council suggest it is stipulated that advertising spend is used to provide energy efficiency education, promote Government support schemes and the company's own vulnerable customer support measures only. Such advertising would have direct consumer benefits while also serving to maintain the company's brand awareness.

NI Executive Energy Strategy

We agree that it is too early to anticipate the future costs associated with the decarbonisation agenda, but that a small amount of funding should be provided for each GDN to hire an extra member of staff to work on the impacts of the Energy Strategy.

Future Metering Solutions

We would welcome early and comprehensive engagement with the Utility Regulator and the GDNs regarding future metering solutions if, as proposed, they are dealt with outside of the GD23 review process.

FE distribution / supply separation

We agree that any costs associated with separation of GDN's supply and distribution activities should be dealt with outside of the GD23 review process as set out in the DD.

We note that the energy price crisis has had a detrimental impact on the firmus energy brand which could negatively impact upon distribution connection numbers in the medium to long term, even if, as we propose, the Connections Incentive is retained.

Therefore, it could be in the interest of both firmus energy Distribution Ltd and the consumer if separation were taken forward by firmus energy at no cost to the consumer, particularly if, as we propose, the Connections Incentive is retained.

Without separation Connection Incentive advertising spend could be a sunk cost due to the damage that has occurred to the firmus energy brand.

Price Control Submissions and Current Performance

We note that while FE and PNGL outperformed their GD17 allowances, and SGN underperformed their allowances. SGN spending was £2.1m (68%) more than FD allowances, and connections, properties passed, and volumes were all below GD17 allowances.

Volume and Connections

Adjustments to connections and consumption volumes

The adjustments to connections and consumption volumes appear reasonable, although it is not clear how the UR have determined the 25% and 33% reduction in I&C connection targets for SGN for small/medium and large I&Cs respectively.

Energy efficiency adjustment

It is unclear why the energy efficiencies that were assumed in GD17 to apply from the start of GD23 are not included in the GD23 assumptions. The Draft Determination suggests that this is pending the introduction of wider support for energy efficiency measures, but such support would not have been apparent in GD17 and many improvements to the energy efficiency of appliances and buildings are likely to occur without any particular support measures; not least due to the general pressures on all companies to introduce energy efficiencies to meet Net Zero targets. Therefore, we would recommend that the 25%, 25% and 30% energy efficiency adjustments are applied to FE, PNGL and SGN respectively, but that they are applied starting from 2023 rather than 2029 or 2030.

Environmental Action Plan

The GDNs have demonstrated a clear willingness to become involved in innovation opportunities and to market natural gas as a solution to carbon reduction, for example, firmus energy now use the marketing tag line "transitioning to net zero carbon". This proactivity is welcome and our research demonstrates that consumers believe companies have a responsibility to take ownership of, and show leadership in, carbon reduction and environmental protection.

Therefore, we would strongly welcome the introduction of a requirement for the GDNs to produce, and report annually against, Environmental Action Plans. These plans, should demonstrate the GDNs progress in decarbonising their business operations including shrinkage, direct emissions, contractor emissions, and supply chain (scope 3) emissions.

The plans could also require GDNs to consider how they deal with waste and excavation spoil, their water use, and their impact on biodiversity.

Finally, these environmental action plans could provide an opportunity for the companies to consider their role in facilitating energy system transition.

Operational Expenditure

We note that a large part of the adjustment for each GDN relates to the move from the Connection Incentive to a Cost to Serve allowance and if these are excluded, as we propose, then the actual level of adjustment would be reduced from 20% (FE), 18% (PNGL) and 42% (SGN) to 13%, 16% and 22% respectively.

Capital Investment

The UR has made some significant reductions to the capital investment proposed by the GDNs. Some of these may still be carried out during GD23 through the uncertainty mechanism if the need for the work is confirmed following consideration of a stand-alone economic case.

We trust that these reductions will not restrict economically efficient reinforcement and network resilience works that would have a beneficial safety impact and/or serve to reduce network outages.

We recognise the importance of appropriate calibration of the "basket of works" and forecasting of inflation to ensure the GDNs are provided appropriate cost allowances and we accept that the current economic climate may lead to modest increases in the GDNs capital allowances at Final Determination. In this regard, it is of particular importance that downward pressure on costs does not cause GDNs to move away from the common practice that consumers are not charged for the costs of a network connection.

Energy Strategy, Innovation & Incentives

Energy Strategy

The UR proposes a ring-fenced uncertainty mechanism to achieve the ambitions in the DfE's Energy Strategy. They propose that any project that requires funding will require a business case submission and meet three core principles (demonstrate that the project will contribute to new zero carbon; illustrate a reduction on fossil fuel usage; and alignment with core aims of the energy strategy). We suggest a fourth core principle should also be required for all projects that require funding from the uncertainty mechanism:

- Demonstrate support from consumers

This will ensure that proposed projects are aligned with customer values and have the minimum possible negative impact on consumers (or alternatively provide the maximum possible positive impact).

Innovation

We agree that the principles outlined are sound, create transparency, and that successful innovation can be driven under an appropriate price control framework.

We would add some key principles to those suggested by the UR:

- it is important to be transparent about the share of the benefits generated that accrue to the GDNs and their shareholders and the share that accrues to consumers, both overall and over time.
- It is also important that the framework is designed so that incentives to innovate are not dependent on when in the control period the innovation is made (i.e., stronger incentives at the start of the period when the company has longer to retain the benefits and weaker incentives at the end of the control period).
- It is important that innovation projects are structured so that companies gain when consumers gain (e.g., from higher quality outputs), but also that consumers gain when companies gain (e.g., from sharing lower costs and greater efficiencies).
- The sharing of gains should be based on the actual outcomes achieved rather than the forecasts when the projects are planned.

However, given the relatively high bar set by these innovation principles and the small proportion of the Northern Ireland population served by the existing gas networks, it may be more beneficial to the consumer if innovation funding opportunities were established without gas network price controls, funded by the Department for the Economy (DfE) and administered by either DfE or the UR.

Incentives

We agree with the main incentives outlines by the UR. We propose that extra spending allowed through the uncertainty mechanism should be on a fixed-cost basis (once a good estimate of the costs is known) to give the greatest incentive to outturn efficiency, rather than on an emerging-cost basis; projects that do not have sufficient cost certainty to be undertaken on a fixed-cost basis should not be allowed in the uncertainty mechanism.

Stakeholder and Customer/Consumer Engagement

We agree that protecting and supporting consumers should be at the core of GDNs' delivery priorities and that this can only be achieved through effective consumer engagement and by reflecting consumer priorities in GDN delivery plans.

We believe that to achieve this the GDNs must sign up to the principle of reflecting consumer priorities in their plans and transparently show how they have done so. This must include the introduction of measures to enhance support and provision for vulnerable consumers now and in the future.

We welcome the UR commitment to develop new consumer focused metrics, KPIs and targets by the end of 2024. This work should be undertaken collaboratively to ensure comparable data and must result in specific actions for implementation during the remainder of the GD23 period. This work should lead to improve customer service standards.

The Consumer Council has a statutory duty to engage with stakeholders and consumers; evidence of our proven track record in this role includes the retention of BS: 18477 inclusive service provision. We would welcome the opportunity to work closely with the GDNs and the UR to assist in the further development of their consumer engagement plans for implementation during 2025.

The benefit to GDNs of our involvement includes that any consumer research findings relating to consumer preferences for natural gas as a heating product will have a level of independence and veracity not afforded to industry surveys.

We trust that the UR will ensure companies are provided the very modest allowances required to implement consumer protection best practice and undertake consumer engagement.

Uncertainty Mechanisms

We support the general principle of using uncertainty mechanisms to recover the costs of activities that cannot be included in the fixed-price regulatory base-settlement. However, we believe that it is important that the companies show that (like the base-settlement activities) the activities that are rewarded through the uncertainty mechanisms are properly supported by customer engagement and reflect appropriate customer priorities. When making the business case to UR for inclusion of uncertainty adjustments, the company should include clear evidence of customer support for the activity and the UR should not accept adjustments that do not have this customer support.

Rate of Return and Financeability

The energy price crisis has served to reiterate the importance energy affordability for consumers and the rate of return afforded to the companies is one of the most significant elements of the price control with regard to its final impact on consumer tariffs.

We agree with the finding of the First Economics report regarding the ranges for the GDN's cost of capital and agree that is appropriate to use a figure at the low end of the range, so that the Vanilla WACCs would be 2.03%, 2.25% and 2.76% for PNGL, FE and SGN respectively.

For the assessment of company financeability, we agree with the approach of using key financial ratios to assess whether the company can finance its activities. However, we believe that this should be supported by sensitivity analysis to see how reasonable shocks to either costs and/or revenues impact on the ratios and the companies' ability to maintain a BBB rating. We recognise that acceptable levels of the financial ratios are set with some level of contingency. However, it can be that particular events or developments can have a 'tipping point' impact on a company's cashflows which mean that while on a central modelling basis the company is financeable, there is a real risk of default in different circumstances or states of the world.

Outputs, Outcomes and Allowances

Risk sharing mechanism

We support the proposal for the Capex Roller Incentive to share 35% of outperformance or underperformance for all companies. However, this is dependent on the capex targets being set at a challenging level and outturn performance being subject to regulatory scrutiny to ensure the costs and revenues are appropriately ring-fenced from the company's other activities.

Impacts on Customer Bills

We welcome the reduction in domestic customer bills compared to GD17 tariffs of £37, £31 and almost £4 for FE, PNGL and SGN respectively. We believe that at a time of rising costs and pressure on real wages, this will provide an important benefit for customers.

However, we note that some of our proposals in this response could have influence the final calculation of consumer bills and that any decrease resultant from the Final Determination will be small when compared to increase in the price of natural gas in the last year.

Business Plan Assessments

We support the UR's approach to business plan assessment, which appears to follow best regulatory practice. However, we recommend that the questions on quality of engagement asked regarding Area 4 (engaging customers, consumers and other stakeholders) include a recognition of the need to specifically engage with vulnerable customers and incorporate their needs into the company's ongoing activities.

The fact that all three GDNs rated every area of their respective plan as 'Exceptional', while the UR rated their plans as 'Good' (with one area for PNGL rated 'Exceptional' and one area for SGN rated 'Meeting Basic Expectations') suggests that the current approach to self-assessment is not particularly effective. We would suggest that in future, rather than using an absolute assessment level (Excellent, Good, etc), the GDN's are asked to self-assess and compare the relative quality of the different areas of their own business plans (so if they mark one area as particularly strong then this implies that other areas are relatively weaker).

Next Steps

Change in Ownership Structure

In the possible situation that any GDNs end up under common ownership, it will be important that the UR use the opportunity to ensure that consumers share properly in the cost efficiencies and synergies expected.

Lessons Learnt

We agree that the UR should engage with stakeholders to understand the lessons learnt from the GD23 price control process. We also believe that they should transparently set out how they have taken account of the lessons learnt from the GD17 price control process.

Further Engagement

The UR has indicated that it will continue to engage with key stakeholders between June and September 2022. We strongly welcome this indication and look forward to further engagement with the UR and GDNs prior to the Final Determination.

6. Contact Information

This consultation response was developed with expertise from SLG Economics.

To discuss our response in more detail, please contact:

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The Consumer Council consents to this response being published.