



FE 02 GD23 DRAFT DETERMINATION CONSULTATION RESPONSE

MAY 26, 2022

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Part 1. Executive Summary

firmus energy welcomes the opportunity to respond to the consultation on the Utility Regulator's GD23 Price Control Draft Determination and looks forward to productive dialogue in advance of the Utility Regulator's Final Determination, due to be published in September 2022.

firmus energy's Business Plan for the GD23 period was developed with customers front and centre of our objectives for the six- year review period and with the Northern Ireland Executive's new Energy Strategy and strategy for Green Growth very much setting the strategic policy direction context. Our plan sets ambitious targets to continue making connections to our network whilst supporting the efficient operation and maintenance of our assets and recognising the significant contribution to be played by firmus energy in Northern Ireland's journey to net zero carbon.

As we embark upon the GD23 review period, the Utility Regulator's primary objective for the gas industry in Northern Ireland remains:

"to promote the development and maintenance of an efficient, economic and coordinated gas industry in Northern Ireland¹".

firmus energy's Business Plan for GD23 proposed challenging but deliverable targets which support the Utility Regulator's primary objective and the goals of Northern Ireland's Energy Strategy. We have provided well-evidenced support for efficient expenditure during the six- year period, whilst also identifying particular market challenges for firmus energy over this horizon. Our proposals presented an 11% real tariff reduction for current and future customers using our network, and we demonstrated our continued commitment to deliver value for money. In seeking to further develop the gas network so as to achieve greater economies of scale and lower network usage charges we are also committed to developing biomethane and hydrogen as sustainable alternatives to natural gas, thus further reducing carbon emissions and providing greater energy security, and further reducing overall energy costs by better utilising food/agricultural waste and curtailed wind in Northern Ireland.

In the Utility Regulator's Final Approach document for GD23, one of their *"aims for the GD23 is that GDNs should produce high quality, well evidenced business plans..."*². In order to evaluate the GDN's Business Plan submissions, the Utility Regulator introduced a Business Plan Assessment at

¹ Utility Regulator's GD23 Draft Determination, Para 1.7

² Utility Regulators Final Approach document for GD23, para 6.35

GD23 to “*assess how each has performed against each Test area*”³. Our plan, and the associated evidence, was adjudged to be “*Good*” by the Utility Regulator in their GD23 Draft Determination, with recognition that our submission was a “*Good plan*” with “*excellent responses in some test areas*”. This gave us confidence that our proposals resonated with the Utility Regulator’s expectations and that they were well evidenced.

firmus energy has always sought to rise to the challenges set within each of our previous price controls. Since award of our licence in 2005, we have demonstrated our ability to deliver value for money and our commitment to continuous improvement, whilst safely developing and operating our network. The context to this price control period will not be ‘business as usual’, with a particular focus upon reducing CO₂ emissions and promoting the green economy in Northern Ireland.

Regrettably, we do not believe the practical implications of the Utility Regulator’s GD23 Draft Determination will deliver the best outcomes for consumers in the short, medium or longer term, with opportunities to optimise investment already made in our network and contribution to Northern Ireland’s energy transition being materially and irreparably impacted. In particular, we are focussed upon the Owner Occupied Connection Incentive, our contractor unit rates, WACC, and allowances to support the delivery of the new Northern Ireland Energy Strategy.

Across the Draft Determination, the Utility Regulator has consistently taken a ‘lowest common denominator’ approach which provides the lowest allowances in individual areas, including removing incentivisation, removing allowances for us to undertake crucial works to protect the network and proposing the lowest ever cost of capital applied to a gas distribution network in the United Kingdom.

The strategic direction of the Utility Regulator’s proposals for the GD23 period is perhaps best illustrated by the move towards a ‘cost to serve’ for Owner Occupied connections. firmus energy has been granted allowances, and customers continue to pay for the development of our network to c.135,000 Owner Occupied properties. As we embark upon GD23, only c.27,000 Owner Occupied households have been connected to the network. At c.20% Owner Occupied penetration, it is difficult to comprehend the timing of the Utility Regulator’s ambitions to move to a cost to serve model. As the term suggests, firmus energy will be granted allowances to serve a very small number of the potential Owner Occupied properties who might otherwise be persuaded to connect to our network. Allowances, including capital allowances for domestic services, have been proposed which would significantly curtail any further ability to promote and deliver connections to the network. No further Owner Occupied connections in GD23 would place

³ Utility Regulators Final Approach document for GD23, para 6.39

upward pressure on network tariffs for all customers of c.7%. Such a policy shift is in our view, ill-judged and premature.

The reduction to the Owner Occupied connection incentive proposed by the Utility Regulator will, in the Utility Regulator's own words "*reduce the level of activity undertaken to actively promote connections*"⁴.

Our analysis indicates that the extra revenue, net of costs which result from incentive driven connections, is economically beneficial for the network and ultimately results in lower tariffs for customers. In addition, connecting customers to our network from an existing oil system also gives customers the ability to reduce their carbon emissions by up to 52%. Based on our analysis, it is difficult to understand why the Utility Regulator would seek to deny consumers that benefit particularly with natural gas being formally recognised in the Northern Ireland Energy Strategy as a key bridge to decarbonisation. This is further compounded when considered in line with increased network costs to support renewable generation, and electrification of end uses including heating, projected to cost hundreds of million pounds before 2030 under different scenarios according to NIE analysis.⁵

For the GD23 Draft Determination, the Utility Regulator chose to use a rate of return at the lowest point of the range established by their consultant, First Economics. This aiming down is out of line with typical regulatory practice.

The choice of this lowest point estimate of WACC has had knock-on implications within the Utility Regulator's financeability modelling, producing interest cover ratios that are below investment grade metrics. Publication of the GD23 Draft Determination prompted both Fitch Rating's and Moody's Investors Service to change their outlook for Phoenix Natural Gas Limited (PNGL) from stable to negative^{6 7}.

Contractor unit rates proposed by the Utility Regulator are unrealistic, likely undeliverable and based on a retrospective approach which is inappropriate, given the level of beyond inflationary

⁴ Utility Regulator's GD23 Draft Determination, Para 2.26

⁵ <https://www.nienetworks.co.uk/documents/future-networks/networks-for-zero-net.aspx>

⁶ <https://www.fitchratings.com/research/corporate-finance/fitch-revises-phoenix-natural-gas-limited-outlook-to-negative-affirms-ratings-12-04-2022>

⁷ <https://finance.yahoo.com/news/phoenix-natural-gas-limited-moodys-122606159.html>

cost pressures being experienced presently and forecast for the GD23 period. [REDACTED]

[REDACTED] In a rapidly changing economic and social landscape, historic cost trends alone do not provide a sufficient basis to assess the changes taking place in cost inflation. Capital allowances currently being proposed will stifle future network development and the ability to sustain construction expertise to support Northern Ireland's journey to net zero carbon.

The Utility Regulatory has assessed our plan as 'Good'. Given this, we are concerned by the apparent dismissal of evidence presented in firmus energy's Business Plan and the apparent failure by the Utility Regulator to provide counter-evidence in support of its position. Further, the GD23 price control contains none of the scope for outperformance or incentive arrangements enjoyed by our peers in GB, resulting in a price control package which we believe to be unduly and significantly weighted to the downside.

At each step it appears that the Utility Regulator has made proposals which do not support the continued development of an economic and co-ordinated gas network in Northern Ireland. The GD23 Draft Determination presents an approach which does not appear aligned with the Utility Regulator's stated aims for GD23 or the Utility Regulator's statutory obligations. We also consider the overall approach to be misaligned with the recent Northern Ireland Energy Strategy which states, *inter alia*, that "*we will continue to encourage people with access to the gas network to connect to it*".⁸

In addition to the above challenges, our confidence in the Utility Regulator's assessment of a coherent overall package was further undermined by the Utility Regulator releasing a statement seven weeks after the publication of the Draft Determination to acknowledge that the Utility Regulator had "*identified an error in the calculations of a technical financial metric relating to the interest cover for GDNs*".⁹ In correcting the error and restating the updated (and adverse) impacts to the assessment of financeability, the Utility Regulator chose not to revise the conclusions reached within their Draft Determination, which further supported a 'lowest common denominator' approach and placed more downside pressure to the price control proposals.

⁸ [DfE's Energy Strategy "The Path to Net Zero Energy", December 2021](#)

⁹ [gd23-dd-financeability-addendum.pdf](#)

As a gas distribution network operator, we have always striven to create an efficient gas network which delivers for our current and new customers and supports Northern Ireland in delivery of its climate change ambitions. The combined adjustments proposed by the Utility Regulator in its Draft Determination will significantly and adversely impact our ability to continue to deliver for energy customers in Northern Ireland. Given the level of challenge applied, it is very possible that the Draft Determination leads us towards a position in which firmus energy, and other parties, will struggle to attract the investment (both equity and debt financing) necessary to fulfil our ambitions, as well as the ambitions of the Northern Ireland Energy Strategy in achieving net zero carbon by 2050. Customers will be adversely impacted in both the short and the longer term.

In our response to the Utility Regulator's GD23 Draft Determination consultation, not only have we provided a detailed assessment and response to the Utility Regulators proposals, we have worked to present practical recommendations for remedy.

Part 2. Customer Connections

What we're asking for

We are asking the Utility Regulator to:

- reset (i.e. increase) our connections targets to the level we have submitted within our GD23 Business Plan
- maintain the customer connections incentive
- provide an allowance equivalent to £506 per connection for the GD23 period

Why we're asking for it

We believe that the Utility Regulator should continue to incentivise connections to our gas network in line with its principal objective and general duties, and in support of the new Northern Ireland Energy Strategy.

As a result of reduced connections, due to the Utility Regulator's Draft Determination proposals, existing customers will be faced with potentially higher bills for using the network, new customers will lose networked gas as a viable fuel option, and Northern Ireland will face greater challenges in delivering against its climate change ambitions.

2.1 Summary

2.1.1 History of Customer Connection Incentive

At the end of GD17 we will have completed the majority of the mains works planned as part of the development of our network. We are now moving into a period of maximising the efficiency of the network for existing and future customers through increasing the number of connections, improving our operational performance and supporting Northern Ireland's transition to net zero carbon.

Through GD14 and GD17, the Utility Regulator provided an allowance to encourage customers to connect to the gas network. *"The connection incentive is a per connection allowance to encourage the connection of domestic owner occupied (OO) properties. This is unique to NI and was created due to initial difficulties in driving gas connections... It is up to the GDN's how they spend the*

allowance but it tends to cover the sales teams, advertising and marketing, direct customer incentives and associated overheads.”¹⁰

This has been an important mechanism in supporting customers with around 66% of our customers using one of the available incentives as part of their switch to gas. On average, the incentive enabled customers to receive £180 towards their connection through a range of the following mechanisms including 0% finance, free controls, NISEP contribution, £150 cash back, Boiler replacement enhancement by £200, hotel vouchers, free shower, competitions e.g. garden makeover. Overall c.24% of the connection incentive allowance from 2017 to end of 2020 (c.£300k pa) supported customer connection incentives.

The incentive mechanism has been a fundamental aspect of our ability to increase connections to the network. In our submission for GD23 we outlined our position for the need to maintain the mechanism as per GD17 and slightly increase the allowance. We provided further evidence to support our position in the GD23 Business Plan supplementary paper FE 08 Connection Incentive Review.

In our GD17 Final Determination, the Utility Regulator set out its intention to review the connection incentive in advance of GD23;

“We consider that it is important that we review the rationale for the connection incentive as well as the performance of each of the GDN’s in connecting owner occupied properties. We consider that a mid-point review, during GD17 would be appropriate point to do this in 2020. We consider that this review would assist in developing our approach for consideration for the rationale for any connection incentive for the GD23 price control period¹¹.”

This review did not happen.

2.1.2 The Utility Regulator’s Position for GD23

For GD23, the Utility Regulator is minded to materially reduce our ability to promote our network to customers:

“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

¹⁰ Utility Regulator’s GD17 Final Determination, Para 6.311

¹¹ Utility Regulator’s GD17 Final Determination, Para 13.15

through the connection process but will reduce the level of activity undertaken to actively promote connections.”¹²

The impact of the change in approach is a reduction in the Owner Occupied (OO) connections targets submitted by firmus energy, with the Utility Regulator’s Draft Determination proposing 2,518 connections below our ambitions for the GD23 period and 1,178 below the target set for GD17.

At GD14 and GD17, the Utility Regulator provided an allowance based on a bottom-up calculation which included:

- 1) Staff costs: To provide for energy advisors to actively promote the network and to help customers through the process of switching to the gas network
- 2) Overheads: Limited allowance for directly relevant costs of doing business
- 3) Advertising costs: To enable firmus energy to be able to raise awareness and understanding of the gas network
- 4) Customer incentive: To enable firmus energy to provide customers with financial support to support their switch

The allowance provided, based on the above aspects, was compared by the Utility Regulator to the economic value associated with adding a new connection to the network. As the allowance was below the calculated economic value, the allowance resulted in an improved economic outcome for all current and future customers on our network.

In preparing our GD23 Business Plan submission firmus energy used the Utility Regulator’s GD17 economic evaluation methodology to test that our requested allowance met the Utility Regulator’s economic test. Our requested allowance of £506 per connection resided well within what the Utility Regulator had previously determined as economic.

For the final three years of GD23 (2026 - 2028) the Utility Regulator’s proposed position is that we should be provided an allowance per connection which covers only staff costs. In addition, the Utility Regulator has provided a limited allowance of £150k p.a. for advertising costs.

For the non-advertising costs in GD23, the Utility Regulator has profiled a straight line glidepath between our 2022 determined allowance per connection and the determined 2028 “cost to serve” allowance.

We have been provided with limited information to support the Utility Regulator’s calculation of the allowance provided for 2028. Having been given a spreadsheet detailing the Utility Regulator’s

¹² Utility Regulator’s GD23 Draft Determination, Para 2.26

workings, the number used for our allowance in 2028 was a hard-coded number not associated with any of the preceding calculations.

The following table shows a comparison of the allowance per connection at the end of GD17, and through the GD23 period in average 2020 prices (firmus energy's analysis of Utility Regulator's Draft Determination):

£2020	GD23 Draft Determination							
	Closing GD17 Allowance	2022	2023	2024	2025	2026	2027	2028
Year		2022	2023	2024	2025	2026	2027	2028
Staff		215	208	201	194	187	180	173
Advertising and marketing		80	41	44	47	52	57	63
Incentives		120	66	41	16	0	0	0
Corporate overheads		50	0	0	0	0	0	0
Total		465	314	286	258	239	237	236

TABLE 2.1 COMPARISON OF THE ALLOWANCE PER CONNECTION

2.1.3 Our Challenges with the Utility Regulator Proposal

We have 4 core challenges with the Utility Regulator's Draft Determination proposal on the Customer Connection Incentive, as follows:

1. We believe that the Utility Regulator's proposal is misaligned to:
 - a. its principal objective and general duties *"to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland¹³"*
 - b. its overarching aim of GD23, and the recent Northern Ireland Energy Strategy which states that *"we will continue to encourage people with access to the gas network to connect to it¹⁴"*
2. We believe that the Utility Regulator's proposal has not considered the dramatic changes in the energy sector in the last 12 months.
3. We believe that the Utility Regulator's proposal will result in poor outcomes for many of our key stakeholders, including, customers who are facing dramatic increases in their

¹³ The Utility Regulator's principal objective is set out in Article 14 of the Energy (Northern Ireland) Order 2003

¹⁴ DfE's Energy Strategy "The Path to Net Zero Energy", December 2021

energy bills who will lose networked gas as a viable fuel option in Northern Ireland, no longer recognise the benefits of connecting to our network, forgo the opportunity to benefit from renewable gas, and existing customers who will experience upward pressure in network usage costs due to curtailed growth in connections, as well as adverse impacts on our industrial partners and Northern Ireland’s ability to deliver its net zero ambitions. It misses the opportunity to encourage investment and create jobs, both of which would add value to the Northern Ireland economy as a whole.

4. We believe the Utility Regulator has made a number of process-related errors, including how it reached its conclusion that *“a connection incentive to deliver OO connections is reaching the end of its useful life¹⁵”* and the inconsistent application of its proposed changes.

In addition to the above challenges, we have been unable to make a properly informed representation on the level of allowance set by the Utility Regulator in the absence of transparent calculations. This goes directly against the statement from the CMA at GD17 that *“It is good regulatory practice to share the underlying data and workings of top-down benchmarking analysis with the firms in question in order to ensure that they have the opportunity to make properly informed representations¹⁶.”*

2.1.4 Our Proposal

We believe that the Utility Regulator should continue to incentivise connections to our gas network in line with its principal objective and general duties. As such, we propose the Utility Regulator:

1. reset (i.e. increase) our connections targets to the level we have submitted within our GD23 Business Plan
2. maintain the customer connections incentive
3. provide us with an allowance of £430¹⁷ per connection for the GD23 period

¹⁵ Utility Regulator’s GD23 Draft Determination, annex-q-promoting-connections, para 5.10

¹⁶ CMA 4.235

¹⁷ Acknowledging Utility Regulator’s change in approach to providing for overheads through this mechanism this is equivalent to our ask of £506 in our Business Plan Submission

2.2 Supporting Information

2.2.1 We believe that the Utility Regulator's proposal is misaligned to its principal objective and general duties

We do not believe the approach taken by the Utility Regulator to reduce allowances for incentivising customers to connect to the gas network to be appropriate.

The Utility Regulator fully acknowledges in the Draft Determination that the approach “*will reduce the level of activity undertaken to actively promote connections.*”¹⁸ We believe this statement describes the complete mis-alignment of the Utility Regulator's proposal with its principal objective and general duties, ignores the reality of where gas is likely to be positioned in customer's priorities and is inconsistent with the aims of the new Northern Ireland Energy Strategy. It also risks undermining the value for money proposition that underpins the development of the gas network.

We note that the Utility Regulator has cut our connections targets accordingly, although the 60% haircut applied to our assumptions appears to be an arbitrary adjustment in the absence of transparency and evidence from the Utility Regulator.

On this basis alone, the proposed reduction in allowance should be removed by the Utility Regulator. Our specific challenges in this regard are as follows:

2.2.2 The Utility Regulator's principal objective and general duties

We believe the position taken by the Utility Regulator is at odds with its principal objective and general duties.

“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 Ireland¹⁹”

The decision to move towards reactive-only connections means the Utility Regulator is no longer promoting the development of the gas industry, while at only c.20% of Owner Occupied customers connected, we have not yet reached a level of maturity such that we can truly be efficient for our customers.

¹⁸ Utility Regulator's GD23 Draft Determination, Para 2.26

¹⁹ The Utility Regulator's principal objective is set out in Article 14 of the Energy (Northern Ireland) Order 2003

We note that through multiple price controls the Utility Regulator has continued to support PNGL with its customer connections, despite it having a significantly higher customer penetration and a more “*mature*” network and established presence..

As the CMA set out in *firmus energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation: Final Determination* (bold by firmus energy):

“setting the correct connection incentive is a matter that is covered by the Utility Regulator’s principal objective to promote the development and maintenance of an efficient, economic and coordinated gas industry in NI; having regard to the need to secure that licence holders are able to finance their activities. It is also a matter covered by the Utility Regulator’s statutory duty to promote the efficient use of gas and efficiency and economy in the conveyance, storage or supply of gas; and it is also covered by the stated effect of the licence modifications to ‘incentivise the GDNs to further grow the industry in an economic and co-ordinated manner’ and ‘allow the GDNs to charge tariffs consistent with the maintenance and operation of a growing gas network whilst financing its activities’.”²⁰

Whilst we share the Utility Regulator’s view that the Energy Strategy for Northern Ireland may result in “*Potential legislative changes with respect to the role and vires of the Utility Regulator as driver for decision taking, including with respect to regulatory allowances, price control targets and changes to the regulatory framework*”²¹, we believe it is reasonable to expect that the Draft Determination position would align with the existing vires rather than based on an expectation of how the vires could evolve.

On this basis, we strongly urge the Utility Regulator to change its stated ambition away from reducing the level of activity undertaken to actively promote connections.

2.2.3 Future Energy Policy - The new Energy Strategy

firmus energy does not consider the Utility Regulator’s proposals for future connections to be appropriately aligned with the new Energy Strategy for Northern Ireland.

While we were in the process of developing our business plan, we were collaborating with the Department for the Economy to support the development of the new energy strategy for Northern Ireland, “*Energy Strategy - Path to Net Zero Energy*”.

The new Energy Strategy was published on 16 December 2021 – after our GD23 Business Plan was submitted, but before the Utility Regulator published its GD23 Draft Determination. We

²⁰ CMA Findings, 5.152

²¹ Utility Regulator’s GD23 Draft Determination, annex g- energy strategy, 2.11 f

developed our Business Plan based on our best understanding of what the Energy Strategy would contain. We anticipated the Utility Regulator's proposals to better reflect the Energy Strategy within the Utility Regulator's GD23 Draft Determination.

The Energy Strategy states that *"we will continue to encourage people with access to the gas network to connect to it"*²². Rather than encouraging customers to connect to the gas network, the Utility Regulator has stated that its proposed Draft Determination position will move us away from promoting connections for customers. In effect, the Utility Regulator is no longer enabling firmus energy to encourage connections and is instead promoting an approach whereby we are only able to respond to inbound requests.

The Utility Regulator has indicated the potential for a ringfenced uncertainty mechanism to help achieve ambitions within the Energy Strategy. The mechanism would enable DNOs to seek allowances for projects which meet the following criteria:

- Demonstrate how the project will contribute to the achievement of net zero carbon.
- Illustrate how the proposal incorporates a reduction in fossil fuel usage.
- Demonstrate how the project aligns with the core aims detailed in the energy strategy.

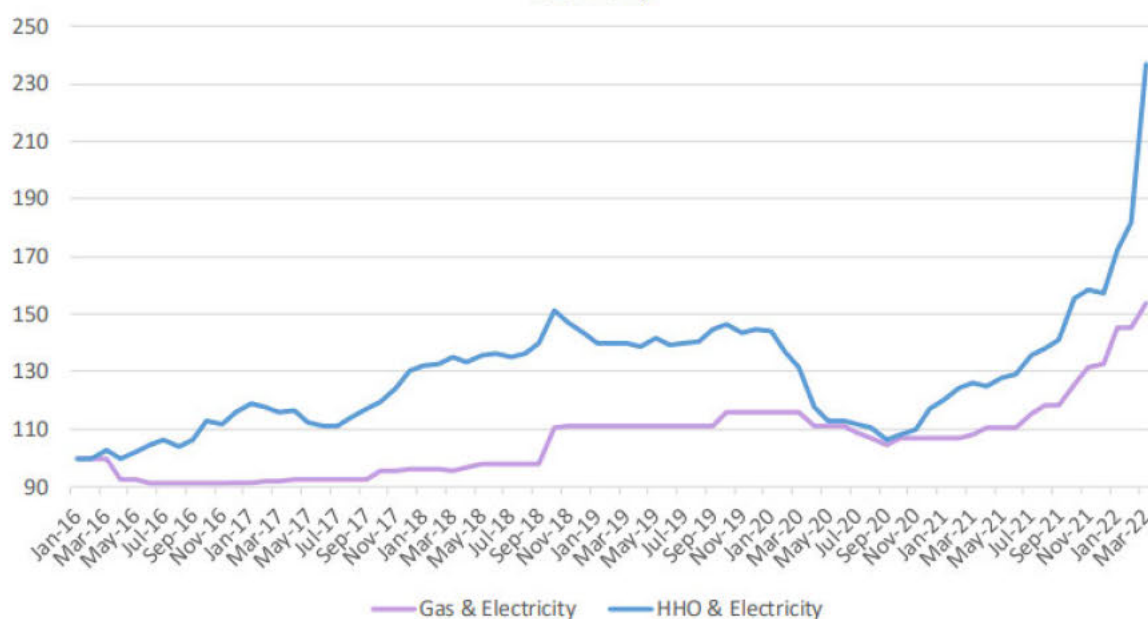
Connecting more customers to our network explicitly delivers on all three of these requirements, however the Utility Regulator's approach to promoting connections appears to be at odds with the criteria for capital projects which support the Energy Strategy for Northern Ireland.

2.2.4 We believe that the Utility Regulator's Proposal has not taken into account the dramatic changes in the energy sector in the last 12 months.

In recent months, we have seen dramatic increases in the prices which customers across Northern Ireland are having to pay for their energy.

²² DfE's Energy Strategy "The Path To Net Zero Energy", December 2021

Figure 2: Home Energy Index for (a) Electricity and Gas and (b) Electricity and Home Heating Oil for Northern Ireland (January 2016 – March 2022).



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Unfortunately, this is not anticipated to be a short-term change and our customers, and potential future customers, are likely to continue to experience continued high prices for their energy. This has been acknowledged by multiple sources including national media, the OBR and even the CEO of the Utility Regulator, John French, indicating that it will be many years before customers are seeing prices which we had experienced before 2021. In fact, both the OBR and Cornwall Insight expect that prices will remain above pre-2021 levels for many years to come – indicating a step-change in the average price our customers will likely have to pay for their energy.

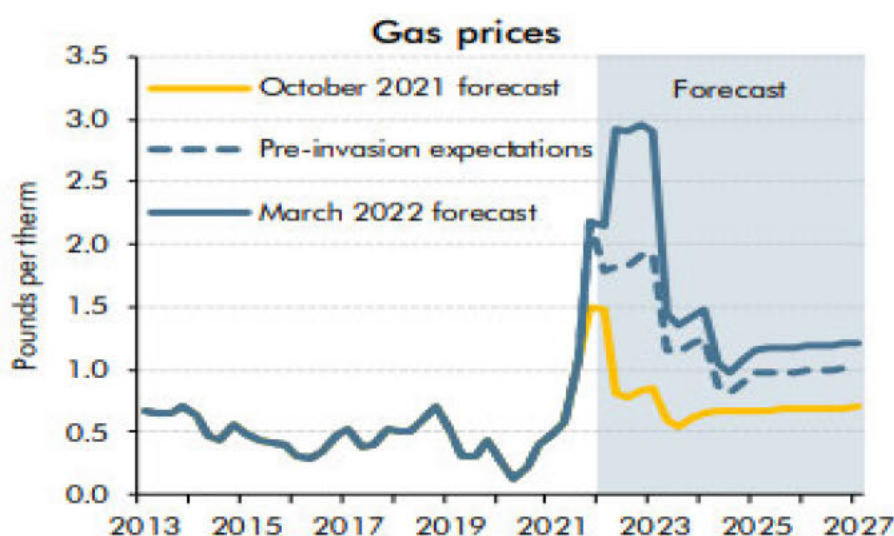
“Current market sentiment is that we’re in this for three years and some people are even saying it could be five years of high prices” – John French, Head of Utility Regulator²⁴

The OBR states in its March 2022 Economic and Fiscal outlook that their forecasts *“imply significantly higher prices in the short term than pre-invasion and even more so relative to our October forecast. They also imply gas and oil prices fall back in 2023 but settle higher in the medium term than in our October forecast”²⁵*

²³ The Consumer Council’s Home Energy Index March 2022

²⁴ Belfast Telegraph, 19th April 2022

²⁵ Office for Budget Responsibility, Economic and fiscal outlook, March 2022



Tom Edwards, Cornwall Insight recently stated *“While prices will reduce, our modelling shows that pre-2021 prices are not making a comeback this decade and likely beyond”*²⁶

Given the sudden and very high increase in prices, there has been an almost doubling in the number of Northern Ireland households in fuel poverty: *“National Energy Action (NEA) NI has said the number of households in fuel poverty in Northern Ireland is predicted to have doubled, from 22% to more than 40%.”*²⁷

Based on the consensus that energy prices are likely to stay high for a number of years of the GD23 period, it is highly likely that household budgets will continue to be under intense pressure for many years to come. Such customers are less likely to connect and will require greater, not less, incentive to do so.

Since we submitted our GD23 Business Plan, these price increases have provided greater challenges to connect customers, with 52% of customers who were disinterested in connecting to natural gas saying this was because *“Gas is expensive to run/can’t afford it”*, up from 3% in March 2021.²⁸

²⁶ The Times, 21st April 2022

²⁷ Belfast Telegraph, 14th April 2022

²⁸ Note- An independent telephone survey was conducted in May 2022 of 250 non-customers

-Non-gas customers were surveyed in streets where gas is live and available to them in the Ten Towns network

-Respondents had to meet the following criteria:

-Solely/jointly responsible for making decisions relating to central heating for the household at which you are interviewing

2.2.5 We believe that the Utility Regulator's proposal will result in poor outcomes for many of our key stakeholders

We believe the Utility Regulator's plan to reduce support for customer connections is not appropriate for the GD23 period as it does not support customers, industry or our net zero carbon ambitions in Northern Ireland.

In particular, as above, we note that the Utility Regulator's position does not appear to have taken into account the considerable medium-to-long term changes we have seen in the energy sector since our GD23 Business Plan was submitted.

2.2.6 Impact on customers

Customers who are off the gas grid are at a disadvantage in terms of the protections they are provided with. Gas suppliers are obligated to provide customers with debt support, a priority services register which enables support to be provided to vulnerable customers and information about energy efficiency. Reducing connections to the gas industry means that more customers will continue to be without these crucial support systems.

The incentive for customers has been used extensively to make the switch across from oil to gas. From 2017 to 2020 (4 years), we have paid £1.25 million to support 6,765 customers in connecting to our network, representing an average payment of £185 to each customer connecting. Over the same period 66% of customers have used the incentive to support their transition to gas. The incentive enables us to support 0% finance, NISEP, Boiler Replacement scheme etc. as these schemes require this financial assistance to encourage connection.

The Utility Regulator is proposing to remove this financial support for switching to the gas network at a time when customers are facing significant cost of living challenges. In effect, removing the support for customers will result in many customers no longer having a genuine alternative to their existing higher carbon energy fuels. We note that since our GD23 Business Plan submission, customers' perceptions of the benefits of shifting to gas have almost all been adversely impacted over the last 12 months.

2.2.7 Impact on installers

During our growth as a network, we have built an ecosystem of installers – with 42 qualified gas safe registered installer companies currently supporting customers in our areas in connecting to firmus energy's gas network whilst supporting local plumbing and heating merchants, boiler manufacturers, promoting energy efficiency and providing employment via technical colleges for students to have a future in the energy transition.

In order to maintain this network of highly trained installers, we need to be able to provide comfort that there will continue to be a sustained flow of new connections to the network. We have already seen that installers are considering moving away from the market at current levels of installation. Limiting the growth in connections by reducing firmus energy's ability to proactively attract new customers will result in greater numbers of installers changing their focus away from gas conversions (or resulting in them ceasing to trade).

We note further that the development and maintenance of this network of installers is important not just for GD23 but also into the future. If the gas network is to play a role in Northern Ireland's net zero future as we move towards a low carbon grid, it will be essential to maintain the expertise and supply chain necessary to maximise the use of the network as a means for customers to benefit from low carbon energy.

2.2.8 Impact on the environment

We are acutely aware of the role the gas network is playing, and will play, in the move towards a low-carbon energy network in Northern Ireland. Reducing accessibility of the network to customers will actively damage Northern Ireland's ability to deliver on its climate ambitions.

We believe the Utility Regulator has a pivotal role to play in this regard.

"... the Department and the Authority shall carry out their respective gas functions in the manner which it considers is best calculated ... to secure a diverse, viable and environmentally sustainable long-term energy supply...[where] environmental sustainability includes the need to guard against climate change"²⁹

Switching to natural gas from oil gives customers the ability to reduce their carbon emissions by 52%. The actual amount of carbon dioxide saved from going into the atmosphere equates to c. 2.2 tonnes per Owner Occupied household per annum.³⁰

Based on our average Owner-Occupier consumption and using UK Government information on the societal cost of carbon emissions, each connection from a customer previously on oil is worth

²⁹ The Energy (Northern Ireland) Order 2003

³⁰ These figures assume the switch from a 15-year-old inefficient Sedbuk F rated oil boiler without controls to a Sedbuk A rated gas condensing boiler with controls (which form the majority of our conversions). Multiplying this through our Owner Occupied customer numbers to date would equate to over 56,000 less tonnes of CO₂ being emitted each year.

£530 per year (£2020)³¹. This value has not been considered in the Utility Regulator's contemplation of appropriate connection allowances during the GD23 period.

Despite the carbon savings for the environment, we have more to do to educate our potential customers of these benefits. A recent survey showed that only half (49%) agreed natural gas is more environmentally friendly than oil, revealing a downturn on 2021 trends (56%). Almost a fifth of respondents (18%) were unsure³².

If we start to introduce biomethane into the network and look to fully decarbonise the gas we use, these carbon savings will increase further, although only for customers who have made the transition to the gas network. We also have more to do to make customers aware of this future potential – with only 34% of those recently surveyed recognised the potential for green gas to be conveyed in our network in the future³³.

The ambition to use the gas grid to support Northern Ireland's net zero carbon ambitions is directly supported by the Energy Strategy which outlines *"the plan to fully decarbonise the gas used in the network"*³⁴.

In order to be able to deliver these benefits for the wider environment, it is essential that we are able to advertise the benefits of the gas network to our customers and to encourage and support them with making the transition to gas.

2.2.9 The allowance provided will not support the targets proposed

Based on the allowances provided by the Utility Regulator in the Draft Determination we anticipate a material reduction in the connections which can be achieved during GD23 when compared to GD17.

We believe the Owner Occupied connections which can be achieved will be significantly less than the level assumed by the Utility Regulator, which is already 12% lower than what firmus energy proposed within its GD23 Business Plan.

The connection incentive allowances that we requested for GD23 have been reduced by 37% (on a like-for-like connection basis and removing corporate overheads) at a time when we believe it

³¹ Using Government Carbon values in £2020 prices per tonne of CO₂ of £241 and c.2.2 tonnes CO₂ per customer per year - <https://www.gov.uk/government/publications/valuing-greenhouse-gas-emissions-in-policy-appraisal/valuation-of-greenhouse-gas-emissions-for-policy-appraisal-and-evaluation>

³² Note- An independent telephone survey was conducted in May 2022 of 250 non-customers
-Non-gas customers were surveyed in streets where gas is live and available to them in the Ten Towns network
-Respondents had to meet the following criteria:

-Solely/jointly responsible for making decisions relating to central heating for the household at which you are interviewing

³³ Note- An independent telephone survey was conducted in May 2022 of 250 non-customers

³⁴ [DfE's Energy Strategy "The Path To Net Zero Energy", December 2021](#)

will be necessary to increase the allowance if we are to deliver the growth in connections to support the Northern Ireland Energy Strategy.

Since our GD23 Business Plan submission, against the backdrop of rising energy prices and the wider cost of living crises, we have seen a considerable drop in interest to connect to our network. We measure connectable sales enquiries (Residential Domestic Sales Enquiries, RDSEs) into the business. Prior to COVID and pre retail tariff increases in September 2021 RDSEs into the business averaged c.400 per month. Since September 2021, monthly RDSEs have significantly dropped with January, February, March and April 2022 averaging c.125 RDSEs per month while the first three weeks in May 2022 had fewer than 78 leads in total.

Given it is likely that energy prices will stay high for a number of years (as explored in section 3.2.2) we believe that the £430 we have requested per connection (based on our submitted figure of £506 less overheads which the Utility Regulator has determined separately for GD23) is likely to be the absolute minimum required to deliver suitable connections to support the continued growth of connections to our network.

Based on our analysis it is clear that the Utility Regulator's allowance will result in a significant reduction in total connections to the gas network during GD23 compared to the GD17 period. We note that if no Owner Occupied connections were to be made to our network from 2023, and all associated investment to support any further Owner Occupied connections was removed from our cost base, customers would be subject to a 7% (real) increase in network tariffs. The impact of costs required to support further connections to our network (as outlined in our GD23 Business Plan, which delivered a 11% decrease in network tariffs) significantly outweighs the potential cost of being unable to attract any further customers to the Ten Towns gas network.

2.2.10 We believe the Utility Regulator has made a number of process-related errors

Challenges with the analysis underpinning the Utility Regulator's approach

The Utility Regulator set out its reasoning for the change in approach based on its calculation of the economic value of a connection.

"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

...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...

...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 life³⁵.”

firmus energy does not consider the Utility Regulator’s calculation of the economic incentive rates to be fit for purpose.

In GD17 the Utility Regulator calculated an economic connection incentive value of £420 (Dec-14 prices) as follows³⁶:

Revenue per Connection

6.125 A reminder of the formula:

*Revenue per connection = Average consumption X Conveyance tariff,
Discounted over the defined Recovery period*

Connection Incentive Assumptions - GD17		
Domestic Consumption	tpa	380
Recovery Period	yrs	15
Conveyance Tariff	ppt	40
RoR Post 2016	%	4.0
Dom Service Value	£	889
Dom Meter Value	£	200
Infill Reduction	£	340
Connection Incentive Value	£ / add. conn	420

Table 29: GD17 Connection Incentive Assumptions

³⁵ Utility Regulator’s GD23 Draft Determination, annex-q-promoting-connections, para 5.7-5.9

³⁶ Utility Regulator’s GD17 Final Determination, para 6.125

Updating these assumptions, based on GD23 Draft Determination values and in average 2020 prices, would provide a connection incentive value of £658:

Connection Incentive Assumptions - GD23 Update		
Domestic Consumption	tpa	418
Recover Period	yrs	15
Conveyance Tariff	ppt	40
RoR Post 2022	%	2.81%
Dom Service Value	£	957
Dom Meter Value	£	203
Infill Reduction	£	390
Connection Incentive Value	£ / add. conn	658

TABLE 2.3 CONNECTION INCENTIVE ASSUMPTIONS GD23

Further, there is an argument to remove the infill reduction as all the mains are built-out and any further Owner Occupied connections will not require additional mains.

The current conveyance cost for existing users already factors in the cost of infill mains so any additional connections would provide an incremental benefit. This would increase the connection incentive value to £1,048.

We have set out in Table 2.4 the potential range of economic incentive rates based on different approaches including maintaining the GD17 approach and removing the infill reduction. As can be seen from the table, the Utility Regulator has taken the lowest potential economic incentive rate from the options.³⁷

Were the Utility Regulator to have an approach to its calculation of the economic incentive rate which aligned with our understanding of what this calculation is seeking to determine, it is difficult to understand the conclusion reached by the Utility Regulator.

³⁷ In addition, we note that the Utility Regulator GD23 Approach connection incentive rate doesn't agree to their published table (it looks like the £199 for opex has been excluded)

		UR GD17 Approach	UR GD23 Approach	GD23 based on GD17 Approach	GD23 based on GD17 Approach (no infill)
Domestic consumption	therms/yr	380	400	418	418
Recovery period	years	15	15	15	15
Conveyance tariff	p/therm	46	45	40	40
Rate of return	%	4.00	2.75	2.81	2.81
NPV of revenue	£	2,105	2,034	2,208	2,208
NPV of additional opex including maintenance	£	not used	(199)	not used	not used
Domestic service value	£	(1,012)	(957)	(957)	(957)
Domestic meter value	£	(228)	(252)	(203)	(203)
Infill reduction	£	(387)	(417)	(390)	not used
Connection incentive rate	£	478	410 ³⁸	658	1,048

TABLE 2.4 RANGE OF ECONOMIC INCENTIVE RATES

Finally, based on the Utility Regulator's calculation, the economic incentive rate is only 14% below the level which supported the GD17 determination. We note this is a limited change for such a significant conclusion.

	GD17	GD23	Decrease
Connection incentive rate	£478	£410	£68 (14%)

TABLE 2.5 CHANGE IN UTILITY REGULATOR CALCULATED ECONOMIC INCENTIVE RATE

³⁸ £410 was the figure published in Table 5.1 however the sum of the figures quoted gives a rate of £209

Challenges in application of approach

Even if the Utility Regulator were to retain its calculation of the economic incentive rate to determine the move away from the Owner Occupied customer connection incentive, there are a number of further matters which require consideration.

Calculation of allowance

The Utility Regulator has stated its intention to take a “cost-to-serve” approach and is using the GD23 period to transition to this new mechanism. We note that the approach used in GD23 is analogous to that used in the GD17 Final Determination based on a connection target driver with the allowance subject to an Uncertainty Mechanism.

The level calculated for 2028 (and into GD29) has been set at £173 per connection. The Utility Regulator has provided the following information to explain the calculation in response to an information request made by firmus energy during the Draft Determination consultation period:

“The final allowance was set, after reviewing, existing costs and reviewing suitable benchmarks.”³⁹

It appears that our GD23 staff allowance has then been calculated based on a glidepath between our current allowance per connection and a future allowance to be provided from 2028.

Overall, based on the Utility Regulator’s Draft Determination position, we will experience a 49% decrease in allowance by 2026 (against 2022) before flattening. This means that while our staff costs decrease linearly, our overall allowance reduction is not linear, but front ended in GD23 when our Owner Occupied penetration (in 2026) will still be only c.30%.

Unfortunately, we have been unable to assess the reasonableness of this target level based on the limited information provided by the Utility Regulator.

Consistency in application

We also note that the Utility Regulator has not consistently followed its own guidance for all DNOs in the Draft Determination.

³⁹ IR FE-037

“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 GDN⁴⁰.”

Despite this statement, the Utility Regulator has determined no such glide path for SGN, appearing to maintain a steady incentive rather than adopting a glide path to a cost to serve allowance by 2028.

	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

Based on the Utility Regulator’s Draft Determination position on SGN for GD23, it follows that the Utility Regulator has decided that the current maturity of the network impacts the type of incentive a network should be provided with to support customer connections to its network.

The connection incentive was introduced for PNGL in 2007, when their form of regulation moved from a price cap to a revenue cap. In 2007 PNGL had approximately 25% Owner Occupied penetration of their network. By GD23, PNGL will have reached 55% Owner Occupied penetration. PNGL will have received connection incentives for over 20 years to help grow their penetration rate from 25% to 55%. By comparison, firmus energy is currently at 20% Owner Occupied penetration. While we accept that PNGL were the first to enter the market, we would like to understand the lack of consistency in the Utility Regulator’s approach and would seek to be treated on an equal basis.

The reduction of the incentive does not consider firmus energy’s low penetration rate

We have previously acknowledged, and continue to agree with the Utility Regulator, that there will be a point in time at which the need for an incentive to support connections to the gas network will begin to taper. At c.20% Owner Occupied penetration of our network, the critical mass of customers converting to our network has not yet been reached. By way of comparison, PNGL Owner Occupied penetration in 2017 was 50%, however allowances for PNGL in this year

⁴⁰ Utility Regulator’s GD23 Draft Determination annex-q-promoting-connections, para 6.3

were £465. This is £151 (or 48%) per connection higher than those proposed for firmus energy at the beginning of the GD23 period.

The timing of this reduction is not suitable for firmus energy based on the current Owner Occupied penetration of our network. At c.20% penetration there is significantly more work we need to do to expand our reach and achieve the scale necessary to operate an efficient gas network.

2.2.11 Our Proposal

We believe it is imperative that the regulatory framework continues to incentivise connections to our gas network in line with its principal objective and general duties. In line with this, we would propose that the Utility Regulator:

- resets our GD23 Owner Occupied connections target to the level submitted within our GD23 BP submission
- maintains the customer connections incentive
- provides us with an allowance of £430⁴¹ per connection for the GD23 period

As noted above if no Owner Occupied connections were to be made to our network from 2023, and all associated investment to support any further Owner Occupied connections was removed from cost base, customers would be subject to a 7% (real) increase in network tariffs. The impact of costs required to support further connections to our network (as outlined in our GD23 Business Plan, which delivered a 11% decrease in network tariffs) significantly outweighs the potential cost of being unable to attract any further customers to the Ten Towns gas network.

⁴¹ Acknowledging Utility Regulator's change in approach to providing for overheads through this mechanism this is equivalent to our ask of £506 in our Business Plan submission

Part 3. WACC and Financeability

What we're asking for

We are seeking a consistent approach by the Utility Regulator, particularly to gearing and the asset beta and to review the overall level of WACC having regard to the price control package and financeability outputs.

Why we're asking for it

The Utility Regulator has proposed a WACC which is one of the lowest for any UK regulated utility.

We want to do more and invest more than the Draft Determination proposes but the level of WACC proposed will discourage investment.

The 'lowest point of the range' level of WACC included in the Draft Determination, coupled with a similar approach to opex and capex, will present considerable challenges for our financeability and curtail investment at a time when Northern Ireland needs it most.

3.1 WACC

In setting the rate of return for the GD23 Draft Determination, the Utility Regulator has taken the advice from consultants First Economics.

We have commissioned Frontier Economics to review the Utility Regulator's Cost of Capital Draft Determination.

In their paper (*FE 03_Rate of Return Appendix*) Frontier Economics acknowledge and agree with First Economics' approach to draw on regulatory precedent, especially given the Utility Regulator considered other contemporary determinations in its GD17 decision, particularly from the CMA.

However, they highlight several significant areas that would warrant further consideration by the Utility Regulator. Most notably, the inconsistent approach to gearing and the asset beta that is not supported by robust analysis.

First Economics has relied on GB precedent to set all cost of equity parameters yet has selected an asset beta and a gearing level below the GB level. The gearing level and asset beta both reflect

the level of risk for firmus energy and the specific values First Economics has selected for these two parameters are inconsistent.

There are several additional areas which we believe should be given further consideration:

- The Total Market Return (TMR) is set at the bottom of the range of recent precedent and relies solely on Ofgem’s determination, despite First Economics recognising the “*extensive review*” undertaken by the CMA which resulted in a higher range.
- In adjusting the cost of debt using an iBoxx benchmark, we do not believe it is appropriate to use a spot rate as a benchmark given this reflects rates from a specific day only.
- The Draft Determination has excluded an illiquidity premium, a decision that deviates from the Utility Regulator’s own previous determination. Evidence suggests that companies issuing a relatively smaller amount of debt would be subject to an illiquidity premium.
- First Economics has chosen to aim down on the overall WACC. This is out of line with typical regulatory practice, which generally suggests aiming up is advisable, given the potential risks associated with underestimating the WACC.

In setting the Draft Determination at the lowest value of First Economics’ proposed WACC range, the Utility Regulator compounds the impacts of also setting very challenging operating cost and capital cost allowances. The overall Draft Determination ‘package’ provides a minimum level of revenue in the GD23 period thereby discouraging any additional investment and accentuating any underperformance, challenging financeability as outlined in section 3.2.

Combining the above adjustments, we would propose a revised CPIH-based Rate of Return of **3.63%** as set out in the table below (and in *FE 03_Rate of Return Appendix*).

Parameter	First Economics' analysis	firmus energy revision	Reasoning
Notional gearing	55%	60%	All evidence suggests a level of 60%
CPI Inflation	2.10%	2.25%	Updated for March 2022 OBR forecasts
Risk-free rate	-1.10%	-1.10%	The Utility Regulator follows the same approach and this estimate relies on more recent data
TMR	6.50%	6.60%	We have narrowed our range following the CMA's RIIO-2 appeal decision
Equity risk premium	7.60%	7.70%	<i>Calculated</i>
Asset beta	0.33 - 0.37	0.37	There is clear evidence that the asset beta should not be at the bottom of the GB range
Equity beta	0.64 - 0.73	0.80	<i>Calculated</i>
Post-tax cost of equity	3.78% - 4.45%	5.08%	<i>Calculated</i>
Pre-tax cost of equity	5.02% - 5.92%	6.75%	<i>Calculated</i>

Real Cost of Debt	1.00%	1.33%	Updated for March 2022 market rates and illiquidity premium
Taxation	24.75%	24.75%	As per the Utility Regulator's observation on UK tax rates
WACC (pre-tax)	2.81% - 3.21%*	3.63%	Consistent with our GD23 WACC Submission, we aim up 25 basis points on the cost of equity only

TABLE 3.1 REVISED CPIH-BASED RATE OF RETURN ADJUSTMENTS

* For the Draft Determination the Utility Regulator chose to use a return at the lowest point of the range, i.e. 2.81%.

3.2 Financeability

3.2.1 Background on Financeability

In the Draft Determination the Utility Regulator outlines their responsibility with regards financeability, whereby the price control “... ought to be set at a level which would allow an efficient network company to finance its licensed activities”.⁴²

The Draft Determination reported the following ratios, when considering borrowing and the ability of firmus energy to maintain investment-grade credit quality:

⁴² Utility Regulator's GD23 Draft Determination, para 10.14

	2023	2024	2025	2026	2027	2028	Average
FFO Interest Cover	3.3	3.4	3.6	3.7	3.9	4.0	3.6
PMICR	1.8	1.7	1.6	1.5	1.5	1.4	1.6
Nominal PMICR	3.0	2.9	2.8	2.8	2.7	2.6	2.8
FFO / Net Debt	7.0%	7.4%	8.0%	8.5%	8.9%	9.4%	8.2%
Gearing	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%

Table 10.3: FE Modelling

Based on these ratios, the Utility Regulator concluded that firmus energy should be capable of maintaining access to debt finance and be capable of financing its activities during the GD23 period.

Following the publication of the Draft Determination, the Utility Regulator acknowledged an error in their calculations of financeability ratios. On 28th April 2022, (7 weeks following publication of the Draft Determination), the Utility Regulator published an addendum to the GD23 Draft Determination⁴³, noting, “*The error is material and affects the conclusions that we reached about financeability in paragraphs 10.13 to 10.23 chapter 10 of the draft determination.*”

The following table of revised financeability metrics was included in the Utility Regulator’s addendum:

	2023	2024	2025	2026	2027	2028	Average
FFO Interest Cover	3.3	3.4	3.6	3.7	3.9	4.0	3.6
PMICR	1.6	1.5	1.4	1.3	1.3	1.2	1.4
Nominal PMICR	2.8	2.7	2.6	2.6	2.5	2.5	2.6
FFO/Net Debt	7.0%	7.4%	8.0%	8.5%	8.9%	9.4%	8.2%
Gearing	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%

TABLE 3.2 REVISED FINANCEABILITY METRICS

⁴³ [gd23-dd-financeability-addendum.pdf](#)

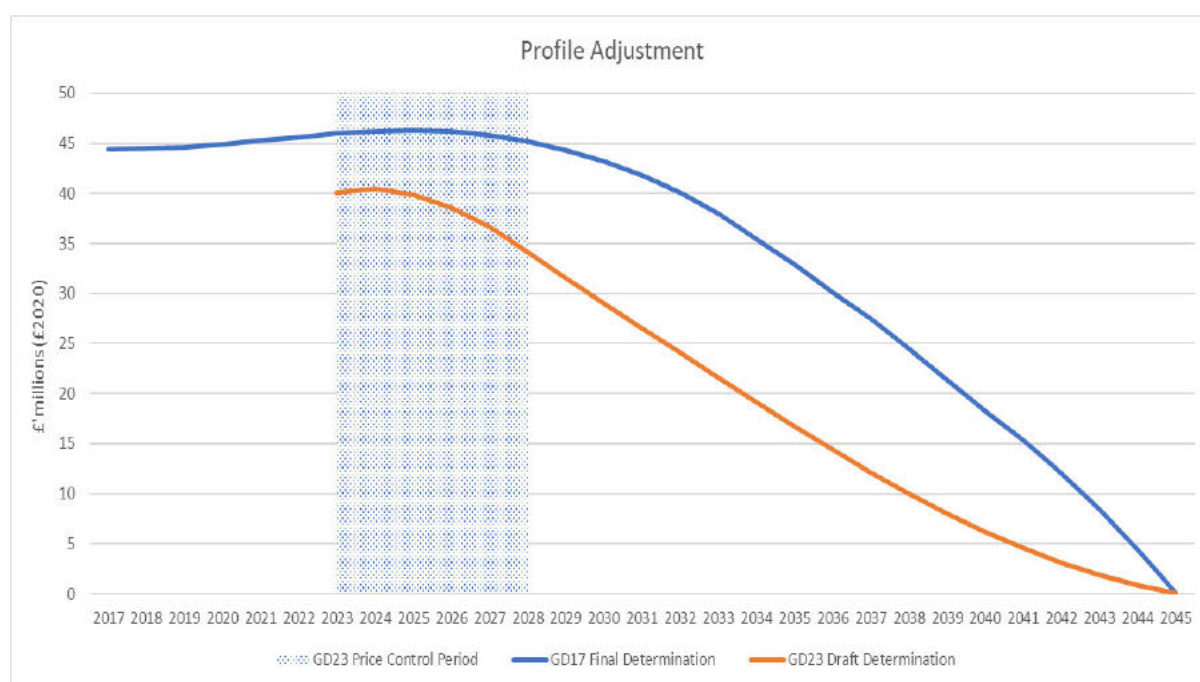
The revised calculations result in reduced PMICR ratios through the GD23 period, and the ratio continues to fall when extending the metrics beyond the GD23 Price Control period.

The Utility Regulator notes that “...this weakness in PMICR could conceivably create challenges for ... FE during the rating process.”

3.2.2 Total Regulatory Value (TRV) and Profile Adjustment

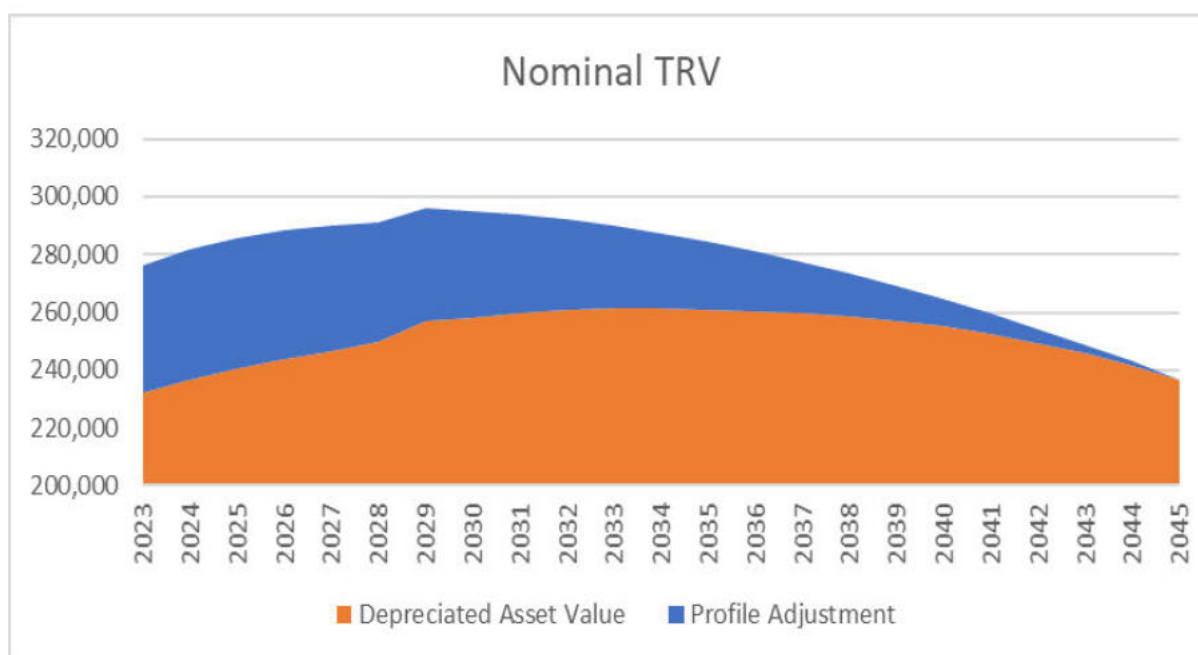
The GD23 Draft Determination produces a change in the movement in the profile adjustment compared to the GD17 Price Control Period and when compared to the annual movement of the TRV in the period.

The graph below illustrates how the profile adjustment will reach a peak within the GD23 period (2024) and thereafter reduce until it is fully unwound by the end of the recovery period (2045).



GRAPH 3.1 PROFILE ADJUSTMENT

When comparing the movement in the profile adjustment to the movement in the overall TRV (i.e. profile adjustment plus depreciated asset value (DAV)), the profile adjustment starts to reduce in the period whilst the overall TRV continues to rise, and only starts to fall after the end of the period (2029).



GRAPH 3.2 NOMINAL TRV

These differing profiles present additional financing considerations, in particular, the impact on and implications for financial ratios.

3.2.3 PMICR Ratio

The Utility Regulator stated in GD17, *“The PMICR measure that we put most focus on is the one we have used in GD14 and is based on the metrics provided by the credit rating agencies. After responses to the Draft Determination we had further discussions with the credit rating agencies on their view of the PMICR and they re-iterated that they were comfortable with its application and use in our analysis⁴⁴.”*

Following the publication of the GD23 Draft Determination, Moody’s changed their outlook on PNLG from stable to negative, citing, amongst other factors, the achievement of an adjusted interest coverage ratio of at least 1.4x.⁴⁵

⁴⁴ Utility Regulator’s GD17 Final Determination, para 10.70

⁴⁵ [Ratings.Moodys.com/ratings-news](https://www.moodys.com/ratings-news)

Rating Action: Moody's changes outlook on Phoenix Natural Gas to negative; affirms Baa2 rating

29 Mar 2022

London, March 29, 2022 -- Moody's Investors Service (Moody's) today affirmed the Baa2 long-term corporate family rating of Phoenix Natural Gas Limited (PNG) and changed the outlook to negative from stable. This rating action follows the publication on 9 March 2022 of the Utility Regulator's (UREGNI) draft determination for the 2023-28 regulatory period, known as GD23[1].

RATINGS RATIONALE

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook reflects the likelihood that PNG's credit metrics over the GD23 period will fall below guidance for the current rating, absent significant measures to strengthen the balance sheet, if the final determination is in line with the draft determination.

Specifically, the negative outlook takes into account the proposed cut in real allowed returns to 2.59% at the start of the new regulatory period, compared with 4.26% in the period from 2017 to 2022, with revenues and regulated assets linked to the CPIH measure of inflation rather than the structurally higher RPI measure. On a like-for-like basis, this represents a reduction of more than 60% in allowed returns. The negative outlook also takes into consideration cost allowances that are lower than proposed by the company.

The negative outlook also reflects PNG's exposure to further increases in interest rates. All of PNG's debt matures in August 2024, creating significant exposure to market conditions at that time. If bond yields continue to rise in line with current market expectations, PNG's borrowing costs over GD23 are likely to be significantly above the amount allowed in the draft determination. Although a proposed true-up mechanism will allow PNG to recover most of these costs starting in 2029, it would not alleviate pressure on cash flow-based credit metrics during the GD23 period.

RATIONALE FOR RATING AFFIRMATION

Affirmation of the Baa2 rating reflects Moody's view that the proposals, which are in a consultation phase, could be significantly modified in the final determinations expected in December 2022, and that PNG has the option to appeal its final determination the Competition and Markets Authority. Management also has time to adopt financial policies that bolster financial flexibility. Affirmation of the rating also reflects PNG's sound business risk profile as a monopoly provider of gas services.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

The outlook could be stabilised if UREGNI's final determination for GD23 appears likely to support financial metrics that meet the rating agency's guidance for the current rating, in the context of plausible scenarios for future borrowing costs. In particular, the ratio could be stabilized if Moody's expects the company to achieve an adjusted interest coverage ratio of at least 1.4x and leverage not exceeding the low-70s in percentage terms (net debt/TRV), taking into account any mitigating actions taken by the company.

Conversely, the rating could be downgraded if, taking into account such measures as management and shareholders may implement, it appears that PNG will likely have insufficient financial flexibility to accommodate the expected reduction in allowed returns and more challenging efficiency targets in GD23.

Whilst referencing previous correspondence with rating agencies there does not appear to be any correspondence between the Utility Regulator and rating agencies regarding the GD23 Draft Determination or the subsequent financeability addendum and it is therefore unclear what position the rating agencies would adopt in light of publication of the revised PMICR figures.

3.2.4 Mix of debt and equity financing (gearing)

A mitigation to the PMICR weakness propounded by the Utility Regulation is that firmus energy could reduce its borrowings and hence the level of gearing, thereby improving the PMICR ratio.

The Utility Regulator comments, ‘... PNLG’s and FE’s existing borrowings mature in mid-2024 and mid-2025 respectively, affording the GDNs an opportunity to alter the scale of their borrowings and/or the way in which they borrow (e.g. the utilisation of index-linked debt).’⁴⁶

An important point to note when considering the level of gearing is that the Utility Regulator’s modelling is based on a **notional** assumption of 55%.

This assumption is based on regulatory precedents for conducting price control reviews and cost of capital modelling.

The actual level of gearing for regulated companies is generally higher than this assumption and in firmus energy’s case the actual level of gearing is c.70%.

For firmus energy to reduce its gearing to 55%, or even 45%, would require equity injections of £40m to £65m respectively.

The practicalities and costs associated with such a level of debt reduction do not appear to be considered in the Utility Regulator’s analysis.

3.2.5 GD17 Financeability Considerations

The GD17 Final Determination⁴⁷ pointed to two considerations that would mitigate the lower financeability ratios being modelled:

- a. additional revenue firmus energy would receive in the period from under-recoveries which had been built up historically - c.£15m (Av £2014)
- b. the actual post-refinancing cost of debt being lower than the allowed cost

firmus energy’s historic under-recoveries were fully unwound (i.e. recovered) in GD17 and this consideration is therefore not applicable to GD23.

Whilst the cost of debt mechanism remains for GD23, due to lower interest rates (actual and those contained in the Draft Determined cost of debt), any possible scope for outperformance is materially reduced.

Taking both these factors into account significantly reduces the level of financeability headroom that firmus energy will have in the GD23 period.

⁴⁶ [gd23-dd-financeability-addendum.pdf](#)

⁴⁷ Utility Regulator’s GD17 Final Determination, Para 10.73

3.2.6 Sensitivity Analysis

As part of the GD17 Price Control Determination, the Utility Regulator carried out additional financeability sensitivity analysis, looking at a downside scenario with underperformance (15%) in capex and opex compared to determined values.

We note that no similar sensitivity analysis has been published for the GD23 Draft Determination or within the Utility Regulator's subsequent addendum.

When modelling any under-performance, whilst it is reasonable to assume that not all under-performance would be financed through debt issuance, it would also be unreasonable to assume that no under-performance would be financed through debt issuance.

Any under-performance that requires additional debt finance will reduce the financeability ratios further.

3.3 Price Control Package

When assessing the financeability of the GD23 Price Control, much as the way the rating agencies look at more than just leverage and interest cover ratios, we need to consider it as a package that considers the potential for under or out-performance and the various incentives offered to encourage out-performance.

In the Utility Regulator's GD23 Draft Determination⁴⁸ for firmus energy:

- 1) GD23 WACC submission has been reduced by 31%
- 2) GD23 period capex submission has been reduced by 36%
- 3) GD23 period opex submission has been reduced by 21%
- 4) The main GD17 incentive mechanism (customer connection incentive) has been replaced with a 'Cost to Serve' allowance
- 5) Lower interest rates will reduce any potential outperformance from the cost of debt mechanism

These factors present:

⁴⁸ Utility Regulator's GD23 Draft Determination

- a risk of material underperformance in both capex and opex
- a risk of financeability issues and/or substantially reduced equity returns
- an inability to respond to emergencies and/or carry out essential maintenance
- insufficient allowances and/or incentives to connect customers
- reduced gas conveyance volumes
- higher than determined conveyance charges

We believe it is incumbent upon the Utility Regulator to reassess the financeability of firmus energy for the GD23 period, in the appropriate context of all other aspects the Price Control package, to ensure a fair and equitable outcome that aligns with the Utility Regulators duties to:

1. secure the most cost-efficient outcome for the protection of consumers and the promotion of the gas industry in Northern Ireland;
2. ensure the gas distribution network operators can continue to finance the activities which are the subject of obligations placed on them; and
3. have due regard to all relevant factors.⁴⁹

⁴⁹ Utility Regulator's GD23 Draft Determination, para 1.12

Part 4. Energy Strategy Alignment

What we're asking for

We are asking the Utility Regulator to provide allowances and mechanisms which will enable the gas industry in Northern Ireland to contribute as intended to Northern Ireland's ambitions on climate change.

Energy Strategy Reopener – that the Utility Regulator:

- consider the wording of the criteria as stated to ensure they are not unnecessarily or inappropriately restrictive
- allow funding for Hydrogen-related energy sector projects
- provide suitable funding for staff to undertake the associated works (covered in Manpower section)

Innovation Mechanism – that the Utility Regulator:

- reconsiders its position on the use-it-or-lose-it innovation allowance

Why we're asking for it

The gas network is already playing an important role in delivering carbon savings in Northern Ireland, and this role will become more significant over the GD23 period, as renewable gas (e.g. biomethane) is injected into the grid. These changes are necessary to support our ability to invest appropriately in developing our network and the wider gas industry and we believe that the Utility Regulator's current position has potential to be a blocker to innovation in the industry.

4.1 Energy Strategy Reopener Mechanism

4.1.1 Overview

firmus energy welcomes the Utility Regulator's proposal of a ring-fenced uncertainty mechanism to help achieve the ambitions of Northern Ireland's Energy Strategy, with allowances considered as the need is identified. Furthermore, we welcome the exclusion of a materiality threshold within this mechanism.

The Draft Determination confirms that any business case brought to the Utility Regulator for approval must focus on a reduction in carbon emissions and include the phasing out of fossil fuels. firmus energy recognises the uncertainty inherent in delivering aspects of the Energy Strategy and

are broadly supportive of the use of a simple reopener mechanism to deliver this aim. However, there must also be a recognition of the need for greater clarity and certainty from both the Utility Regulator and the Department for the Economy in order to drive new investment. This includes ongoing support within GD23 for the new connections which will maximise existing consumer investment in the network and support a more efficient network.

“We will consider the annual submissions the GDNs make in respect of additional costs relating to the implementation to the Energy Strategy and the decarbonisation of gas and make provision for costs we determine to be necessary and efficient through the GD23 Uncertainty Mechanism.”⁵⁰

“We expect the GDNs to continue to work together on these issues, optimising the use of resources and collaborating on innovation projects and studies to maximise benefits for consumers. This would include developing a plan of activities a year ahead for additional work necessary to support decarbonisation of gas. This plan should take account of opportunities for external sources of funding for innovation and development work.”⁵¹

Innovation is a critical component in the journey to decarbonise Northern Ireland’s energy sector, and energy networks can play a pivotal role in driving such innovation. The importance of gas networks, alongside a move towards renewable sources of electricity and electrification more generally, is already reflected in the decarbonisation strategies in many other European countries, as well as the rest of the UK. For example, low carbon gas is an integral feature of energy strategies in the Netherlands, France, Belgium, Germany and Denmark.

In its Draft Determination, the Utility Regulator sets out the principles that must be met for the Energy Strategy reopener mechanism to be considered as and when the need is identified. These principles are as follows:

- Demonstrate how the project will contribute to the achievement of net zero carbon.
- Illustrate how the proposal incorporates a reduction in fossil fuel usage.
- Demonstrate how the project aligns with the core aims detailed in the energy strategy.

firmus energy is poised and eager to expedite Northern Ireland’s journey to net zero carbon, through the GD23 period working alongside the other GDNs. firmus energy has reviewed the 5 potential decarbonisation projects included within our GD23 Business Plan submission, supplementary paper (*FE 06 Innovation Business Plan*) against the criteria defined for the Energy Strategy reopener within the Draft Determination. We are satisfied that our proposed projects meet the Utility Regulator’s criteria.

⁵⁰ Utility Regulator’s GD23 Draft Determination, para 2.34

⁵¹ Utility Regulator’s GD23 Draft Determination, para 2.33

It is imperative that the process to apply for allowances through the reopener be as streamlined as practical, minimising costs and time for both GDN's and the Utility Regulator. The sooner this is clarified by the Utility Regulator the quicker we can begin implementation.

As such, we would welcome the opportunity to discuss progression of the projects outlined within firmus energy's GD23 Business Plan and will seek engagement with the Utility Regulator as early as practicable in the GD23 period, if not beforehand.

4.1.2 Hydrogen

The DfE's Energy Strategy recognises the important long-term role that Northern Ireland's gas networks must play in achieving net zero carbon emissions, as well as the role which hydrogen transported through the gas network could play in delivering this aim.

In requests for information made to the Utility Regulator during the GD23 Draft Determination consultation period, firmus energy asked the Utility Regulator to confirm if hydrogen projects would be considered ahead of an amendment to their statutory duties, as referred to in Annex G, paragraph 5.4 of the Draft Determination document.

The Utility Regulator's response to our query stated;

"It would be unlikely, given that Hydrogen does not sit within current viries presently⁵²."

firmus energy does not believe the consideration of hydrogen (or the blending of hydrogen) within the natural gas network to be a matter which resides outside the Utility Regulator's current vires.

The Utility Regulator noted within its GD23 Draft Determination that *"We are also aware that our statutory duties may be amended as a result of the energy strategy as it stated, "As the Utility Regulator is a critical policy enabler we will develop an appropriate mandate to support a net zero carbon future, including reviews of licencing and regulatory regimes." We will monitor any changes to our statutory duty and this will be taken into account for any of the energy strategy submissions we receive from [Gas Distribution Networks] GDNs.⁵³"*

⁵² IR FE-026

⁵³ Utility Regulator's GD23 Draft Determination, annex-g-energy-strategy, para 5.4

firmus energy is concerned that this viewpoint could form a barrier to the important progress which is needed in the short to medium term to ensure that the Energy Strategy goals, and ultimately the climate imperative, can be met.

It should be noted that the current ongoing work in relation to biomethane in Northern Ireland has been initiated, progressed, and included in the Utility Regulator's Forward Work Plan in the absence of specific vires for the Utility Regulator. Other examples where new approaches have been successfully initiated in advance of full regulatory regime development include the original offshore transmission connections in GB in the early-mid 2000's, which were instrumental in accelerating the huge growth in offshore renewable generation.

firmus energy notes the core principles that any energy strategy projects should meet, as set out by the Utility Regulator at paragraph 5.8 of GD23 Draft Determination Annex G 'Energy Strategy':

- a) Demonstrate how the project will contribute to the achievement of net zero carbon.
- b) Illustrate how the proposal incorporates a reduction in fossil fuel usage.
- c) Demonstrate how the project aligns with the core aims detailed in the energy strategy.

Hydrogen-related energy sector projects in general should be aligned with the core aims of the energy strategy, contribute to the achievement of net zero carbon and enable fossil fuel use to be reduced or avoided. Therefore, firmus energy takes the view that the Utility Regulator's own criteria should be intended to permit that hydrogen projects would be capable of being approved for ring-fenced uncertainty mechanism funding, subject to an otherwise acceptable business case without any specific changes to the regulatory mandate.

However, firmus energy has the following observations in relation to the specific criteria as stated:

- The 'core aims' in the energy strategy reopener mechanism are not given as a single list and are many and varied across the different areas of focus of the strategy. Any single hydrogen project with which a GDN might be logically involved may not be capable of aligning with all of the 'core aims' of the Energy Strategy Reopener Mechanism. Nonetheless it is a reasonable expectation that hydrogen projects should be aligned with the general intention of the Energy Strategy Reopener Mechanism or, at minimum, particular aspects of it.
- Hydrogen projects calling for GDN involvement may not necessarily incorporate a reduction in fossil fuel usage relative to the existing position but may still be important in facilitating a future avoidance or minimisation of fossil fuel usage. firmus energy would therefore suggest the wording of the second criterion should be reviewed with this in mind.
- Joint project submissions with the other GDNs [(as invited at paragraph 5.9)] may be appropriate in certain circumstances, but the geographically specific nature of hydrogen projects may also mean that the GDNs need to work together with other non-network

company partners going forwards to deliver joint projects. The nature of such projects means that all the parties in a supply chain – hydrogen producers, technical/engineering equipment providers, network operators, suppliers and, potentially, users/consumers will generally need to step forward together to deliver a project, for it to be viable overall.

In any event, firmus energy would look to share any learning points from such projects with the other GDNs and interested stakeholders even if they were not direct project partners.

Development and (energy strategy-related) innovation projects may either inform policy development or be a response to it. The concept of trials and pilot schemes clearly forms part of the Energy Strategy as a means of informing local policy development, and the network operators need to be able to play their part in delivering such schemes and trials within Northern Ireland.

There are several trials, and indeed now larger scale hydrogen-related initiatives, underway in GB and firmus energy will continue to engage with the GB GDNs as far as possible, to assist in its own learning from those projects.

However Northern Ireland has its own policy and local governance landscape, including local funding mechanisms, such as City Deal arrangements. It also has its own distinct distribution network code arrangements and relationships between distribution and supply, and between suppliers and consumers. This means, for example, that charging, metering and billing systems and arrangements are all specific to Northern Ireland. Lessons learned in GB in terms of the commercial and regulatory frameworks may not necessarily ‘read across’ directly to the Northern Ireland regime and so it is not necessarily reasonable to rely on trials ongoing elsewhere to determine what is best for Northern Ireland.

It is also worth noting the significant learning value to be gained by direct participation in local initiatives. For example, the experience of developing the biomethane arrangements has been valuable for all the GDNs. The lessons learned from the development process alone are valuable across many facets of the business and will make the GDNs better equipped to tackle future challenges even more effectively, even if efficiency or productivity gains cannot be directly quantified.

Consequently, opportunities for the Northern Ireland GDNs to support, participate in, and learn from local trials and projects involving hydrogen will be very important to best enable and accelerate the transition for the Northern Ireland jurisdiction.

The application of the Utility Regulator’s criteria for project approval should reflect this situation and the Utility Regulator should ensure it does not become a barrier to local projects making progress.

For example, as noted above, the need for all partners in new hydrogen supply chains to step forward together means that by not approving GDN participation in a project, the Utility Regulator

could directly delay or completely block progress which would otherwise enable other local entities to gain competitive advantage and important organisational and collaborative learning in developing and delivering technology/skills/jobs/renewable gas use, which would otherwise be contributing to both the green economy targets and the replacement of fossil fuels ambitions in the Energy Strategy as well as accelerating the energy transition.

It is vitally important that the GB Government's delay in making a specific decision concerning hydrogen for heating should not present a blanket prohibition on hydrogen projects in Northern Ireland going ahead.

The Energy Strategy states explicitly that low-regret pathways should remain open⁵⁴. Maintaining these low-regret pathways in the context of domestic heat may involve some trials and demonstrations ahead of a GB and/or Northern Ireland decision on heat policy.

It is also important to note that not all hydrogen projects may be concerned exclusively with heating, and some may have joint industrial and domestic objectives. It may be the case that sizing of systems to serve both heating and industrial needs would be the most economic and efficient decision over the medium to longer term for a particular locality. The Utility Regulator therefore needs to be acutely cognisant of the risk that their decisions could lead directly to otherwise avoidable costs falling to future consumers.

In such cases, regulatory failure to approve parts of, or indeed entire, projects could become a serious barrier to making any progress as a community at all and would be inconsistent with the stated principles of the Energy Strategy.

Summary

If the Utility Regulator were to adopt such an unduly simplistic view of hydrogen projects, as indicated in its short reply to our query, the Utility Regulator would run the risk of itself becoming a clear barrier to reaching net zero and potentially being the direct cause of inefficient investment. In addition, the Utility Regulator's position risks missing opportunities related to hydrogen supporting reductions in electricity wind curtailment costs and thus benefitting end consumers.

firmus energy would therefore request the Utility Regulator consider the wording of the criteria as stated to ensure they are not unnecessarily or inappropriately restrictive. It could also consider adding or incorporating a criterion reflecting the benefits of supporting local initiatives and collaborations, providing learning opportunities and informing local policy.

⁵⁴ DfE's Energy Strategy "The Path To Net Zero Energy", December 2021

It would further propose that the Utility Regulator should take a case-by-case approach to evaluating projects, considering them reasonably and flexibly against the criteria with a view to actively encouraging the maintenance of low-regret pathways and (energy-strategy focused) innovation and developments.

Issues such as the value of learning to the GDNs (technological, commercial and regulatory) and the significance of GDN participation in the wider developing supply chains of the future energy systems of Northern Ireland, energy system resilience, long term cost efficiency, and the ultimate cost/risk to the future consumer should all be carefully considered.

In any event, it is important that the Utility Regulator acts as an enabler, and not as a barrier, to the delivery of the objectives of the Energy Strategy and the transition to net zero.

4.2 Innovation Mechanism

We welcome the Utility Regulator retaining the current (GD17) innovation mechanism and ‘funding principles’, although we had hoped to be provided with further clarity on how the funding principles will be applied. In addition, we believe that there continues to be a funding gap for innovation development activities and project facilitation.

We note that the Utility Regulator states that it is “*difficult to suggest how each of the funding principles will be applied to each individual project*”⁵⁵. While this may be a reasonable challenge, we note that the Utility Regulator has not provided any detailed assessment of the projects submitted by firmus energy, which would have given greater clarity on how the principles are likely to be applied.

In our GD23 submission we proposed a specific use-it-or-lose-it innovation allowance to overcome this challenge.

This request has not been allowed by the Utility Regulator without any explanation provided. firmus energy continue to believe that this funding is necessary to enable the industry to deliver much needed innovation through the innovation mechanism. Without such funding, there is a considerable risk of a very limited (and inefficient) level of innovation taking place during GD23.

Our conclusion is therefore that the lack of clarity and certainty from the Utility Regulator risks acting as a disincentive to innovation and investment for the future and is contrary to the clear direction of travel from Government.

⁵⁵ Utility Regulator’s GD23 Draft Determination, annex-h-incentives and innovation, para 4.1

We request that Utility Regulator reconsiders its position on the use-it-or-lose-it innovation allowance to further support necessary innovation during the GD23 period.

Part 5. Manpower

What we're asking for

We are asking the Utility Regulator to review their proposed manpower allowances for both FTEs and costs, in order to better reflect salaries in the Northern Ireland market and resourcing required to deliver GD23 outcomes.

Why we're asking for it

firmus energy is committed to continuing its investment in the Northern Ireland economy and in particular by developing its local workforce. To maintain our outstanding level of service and ensure our staff are fairly remunerated, we need to be able to pay them in line with the market.

Sustaining and, in some areas, growing our employee base is necessary for maintaining an aging network and servicing a growing customer base. Without the necessary allowances, we will struggle to retain staff, attract new staff and ultimately deliver our outcomes for customers within the Ten Towns network.

firmus energy's GD23 Business Plan submission proposed to employ an average of 73 FTEs per annum and invest £24.8m in its local workforce over the six-year period.

The Utility Regulator's Draft Determination lowers the allowed number of FTEs to an average of 69 FTEs per annum (a 5% reduction in FTEs) and proposes a reduction in manpower costs to £21.7m (a 13% reduction in costs)⁵⁶, over the six year period.

Whilst a proportion of these reductions correspond to lower levels of outputs (e.g. connection targets and maintenance and metering activity), most of the reductions proposed are based on reducing costs and FTEs to the actual levels in 2020.

Overall, in terms of manpower, the GD23 Draft Determination is anticipating considerably more outputs without providing the appropriate resources or costs necessary to meet this need.

⁵⁶ figures calculated by firmus energy based on the Utility Regulator's supporting workings to the Draft Determination

Coupled with the implications of the Draft Determination on WACC it seems the Utility Regulator is pursuing an approach which could be described as a short-term drive towards the lowest common denominator. This is simply not realistic.

The table below highlights the relative size and scale of firmus energy, comparing 2020 (the base year used by the Utility Regulator) to 2028 (the final year of the GD23 Price Control Period):

		2020	2028	% change
Volumes	mTherms	63,869	85,905	35%
Cumulative connections	No.	54,553	99,103	82%
Mains length	km	1,762	2,239	27%
Properties Passed	No.	158,516	201,474	27%
Age of network	Yrs	14	22	57%

TABLE 5.1 RELATIVE SIZE AND SCALE OF NORTHERN IRELAND

Despite increases in these metrics – serving more customers, maintaining a longer, older network (maintaining the assets and ensuring safety and security of supply) and conveying more volume, the Draft Determination has provided for fewer staff (FTEs) and less manpower costs to carry out these activities:

		2020 Actuals	2028 Allowance	% change
FTEs	No.	70.3	67.9	-3%
Staff costs	£'000 (2020)	3,639	3,584	-1%

TABLE 5.2 DRAFT DETERMINATION FTEs AND MANPOWER ALLOWANCES

5.1 Utility Regulator’s Approach

In the main document, the approach for the GD23 Draft manpower Determination has followed the approach for GD17.

In relation to determining operating expenditure, the Utility Regulator observes *“To provide structure to our assessment, we collect and analyse opex under 23 cost categories ... Under each of these cost categories we consider a further breakdown by activities such as staff, materials, professional and legal fees, etc. to inform our decisions.”⁵⁷*

The Utility Regulator also remarks, *“In common with GD17, we have not set explicit FTE allowances for the individual cost categories, since manpower forms part of most of the cost categories within the Annual Cost Reporting Template, rather than being an individual cost category. We consider that it is the choice of the GDN to decide where to allocate its resources, as business needs develop.”⁵⁸*, and,

the *“... price control does not make a general cost allowance for manpower, i.e. there is no cost line associated with it. Instead, the manpower requirements for each of the activities represented by the individual cost lines in the ACRT were considered by the Utility Regulator as part of its bottom-up assessment of the needs of FE in respect of each activity.”⁵⁹*

Having noted the Utility Regulator’s remarks in making its Draft Determination for GD23, the Utility Regulator’s methodology appears to be significantly at odds with its stated intention, as it does not take the approach of assessing the needs of firmus energy for each activity, with the exception of the Work Execution opex activities and the Owner Occupied Advertising and Market Development, where a separate assessment was carried out.

Rather than look at the total operational costs for an activity, costs were assessed line by line, with comparisons made to 2020’s actual costs and the costs included in firmus energy’s GD23 submission.

This ‘mix-and-match’ approach can be illustrated by observing the first opex activity code – Asset Management. The table below shows the 2020 actual figures, firmus energy’s submission for 2023 and the Utility Regulator’s 2023 Draft Determination:

⁵⁷ Utility Regulator’s GD23 Draft Determination, para 5.2

⁵⁸ Utility Regulator’s GD23 Draft Determination, annex d – opex, para 4.11

⁵⁹ para 8.5 CMA Appeal Utility Regulator Representations and Observations

Asset Management	2020 Actuals	FE 2023 submission	Utility Regulator 2023 Draft Determination
Staff Cost - Gross	155,744	216,408	155,744
Capitalisation	(70,257)	(123,382)	(88,795)
Staff Cost - Net	85,486	93,025	66,948
Capitalisation %	45%	57%	57%
Professional and legal fees	35,987	18,928	18,928
Total activity costs	121,473	111,953	85,876

TABLE 5.3 2020 ACTUAL FIGURES, FIRMUS ENERGY'S SUBMISSION FOR 2023 AND THE UTILITY REGULATOR'S 2023 DRAFT DETERMINATION

As can be seen from these figures, the Utility Regulator has not compared the total activity costs but has based its determination on individual line items and selected figures from either actuals or submission (as highlighted) to determine an overall activity allowance that is much lower than either the 2020 actuals or firmus energy's submission.

In this example, the Utility Regulator Draft Determination for 2023 is 29% less than firmus energy 2020 actual costs.

This methodology was applied throughout all activities to determine the operational cost and underlying manpower allowances.

We would note that, whilst GD17 historical actual costs and FTEs for 2017, 2018, 2019 and 2020 were provided to the Utility Regulator as part of Annual Cost Reporting, only the 2020 actuals were used to derive GD23 allowances.

The Utility Regulator, unlike in other opex areas, chose not to utilise any formal benchmarking of FTEs or costs in determining the GD23 manpower allowances.

The 'mix and match' approach is not limited to Asset Management. Table 5.4 sets out the Utility Regulator's approach to determining manpower allowances across all operational cost items:

	2020 Actuals	FE 2028 submission	Utility Regulator 2028 Draft Determination
Asset Management	1.90	3.19	1.90
Operations Management	12.97	13.29	13.29
Customer Management	11.44	10.09	10.09
System Control	3.55	4.15	3.55
Other Direct Activities	0.04	0.02	0.04
IT & Telecoms	1.17	1.20	1.17
Property Mgt (including rates)	1.00	1.00	1.00
HR & non-ops training	1.30	1.20	1.20
Audit, Finance & Regulation	8.20	9.50	8.20
Procurement	0.30	0.30	0.30
CEO & group management	1.20	1.20	1.20
Stores & Logistics	0.00	0.65	0.00
Advert. & Market Dev. (non-OO)	5.74	4.85	5.85 ⁶⁰
Trainees and Apprentices	1.03	1.00	1.03
	49.83	51.65	48.82

TABLE 5.4 UTILITY REGULATOR'S APPROACH TO DETERMINING MANPOWER ALLOWANCES ACROSS ALL OPERATIONAL COST ITEMS

Table 5.4 shows that by choosing between 2020's actuals and firmus energy's submitted figures, an allowance of two FTEs less than 2020's actuals is realised (after accounting for the additional

⁶⁰ Draft Determination includes an additional new FTE for a decarbonisation analyst

new FTE for a decarbonisation analyst included under Advert. & Market Dev. (non-OO)), i.e. 47.82 (2028) vs. 49.83 (2020).

5.2 Specific FTE Draft Determination adjustments

Regulatory Analyst (0.5 FTEs)

As noted in our GD23 Business Plan submission, firmus energy's Regulatory Affairs team is a corporate service which provides support for both firmus energy (Distribution) Limited and firmus energy (Supply) Limited.

This team, currently comprising 1 manager and 1 analyst, is responsible for managing a suite of activities within both our Distribution and Supply businesses.

In our GD23 submission we requested an additional 0.5 FTE to secure delivery of our Business Plan and to support the Utility Regulator in delivering projects identified within its Corporate Work Plan. We provided evidence for this marginal uplift in resourcing with reference to the increased activities (projects and engagements) required to support the Utility Regulator's work within the industry.

By determining FTEs and costs based on 2020's actuals (under the Audit, Finance and Regulation activity) and retaining these throughout the GD23 period, the Utility Regulator is not acknowledging any uplift in regulatory activities from 2020 to 2028, despite, for example, the introduction of additional responsibilities under its Consumer Protection Programme (CPP), current and future workstreams around new metering solutions and meter reading responsibilities and the regulatory resources required to support Northern Ireland's energy transition to net zero carbon.

We would also note that PNL allowance in this area is greater by 4 FTEs (c.50%), suggesting an implied efficiency already being achieved by firmus energy based on the relative size, scale and activity workload of the organisations.

Stores & Logistics (0.65 FTEs)

The Draft Determination states, “We note that PNGL (which has been in existence longer than FE) and which also has asset management accreditation does not employ FTEs for this area ⁶¹.”

Once again we feel that the Utility Regulator is inconsistent in its treatment of firmus energy and PNGL. Whilst PNGL do not attribute FTEs to this area, they do however incur other costs in relation to managing the activity of stores & logistics. firmus energy has not been granted any costs under this activity heading.

The Draft Determination includes a capex allowance for the expansion of firmus energy’s stores, workshops and recycling areas (to reflect the step change in stock activity levels) which is inconsistent with the absence of opex allowances under this activity.

Decarbonisation Analyst (1.0 FTEs)

The Draft Determination includes an allowance of 1.0 FTE for a new decarbonisation analyst.

firmus energy welcomes this recognition of the need to support the Energy Strategy but a single analyst could only provide limited support.

In allowing for the decarbonisation analyst, the Utility Regulator has included an additional FTE under the Advertising & Market Development (Non Owner Occupied) activity.

However, whilst including the gross FTE under this activity, the Utility Regulator has capitalised 41% of the costs of this analyst. The analysis and support that this FTE would provide would not be an activity subject to capitalisation.

Furthermore, we believe the strategic assessment, governance, management and delivery of work associated to sustaining our network, supporting Northern Ireland’s Energy Strategy and transition to net zero carbon warrants a greater investment than that being proposed within the Draft Determination.

⁶¹ Utility Regulator’s GD23 Draft Determination -annex-d-opex-detail, para 4.110

5.3 Proposed elements to review for the GD23 Final Determination

In relation to the manpower allowances proposed for GD23, firmus energy would request that the Utility Regulator reviews the following areas and reconsiders the calculation of operational cost allowances accordingly:

1. Review the inconsistent approach to assessing operational cost allowances, specifically the allowances for FTEs and average staff costs.
Rather than basing the allowances on an inconsistent mixture of 2020 actuals and submitted figures at a cost line item level, use the approach noted in GD17, whereby allowances are based on an assessment of the needs of firmus energy in respect of each activity.
2. Reconsider the disallowance of 1.15 FTEs for a regulatory analyst (0.5 FTE) and stores person (0.65 FTE)
3. Reconsider the seniority of the FTE allowed to support decarbonisation and firmus energy's role in supporting Northern Ireland's journey to net zero carbon and remove capitalisation of associated cost.

Part 6. Efficiencies

What we're asking for

We are asking the Utility Regulator to update their frontier shift calculations to reflect recent market changes and, in particular, to better reflect input price inflation for materials and the impact of the COVID-19 pandemic on the potential for productivity growth.

Why we're asking for it

Subsequent to the publication of the Draft Determination, there have been significant upward pressures to input prices and inflation and the economy is still suffering from the impact of COVID-19.

We have always demonstrated continuous improvement and efficiency of operations, however, we believe the proposed productivity improvements and actual real price effects are unduly onerous and are likely to result in cost allowances which are insufficient to cover actual costs.

The Utility Regulator proposes a cumulative frontier shift of c.1.8%⁶² for opex and capex over the GD23 period. The Utility Regulator's calculation takes account of both of the following components:

- the real price effects that reflect changes in the price of GDNs' inputs that differ from changes in the general inflation measure; and
- the productivity trends that capture improvements in companies' efficiency over time.

We discuss the Utility Regulator's approach to each component in turn below.

⁶² Utility Regulator's GD23 Draft Determination, annex e- frontier shift, para 4.2

6.1 Real Price Effects

Overall, we welcome the fact that the approach proposed by Utility Regulator to estimating input inflation for the GD23 period is generally consistent with recent regulatory precedent and firmus energy's own submission to the Utility Regulator on RPEs.

However, we note that the Utility Regulator has departed from Ofgem's RIIO-GD2 precedent in relation to one key aspect – assessing input price inflation for materials.

The Utility Regulator forecasts materials inflation over the GD23 period by creating an unweighted composite materials index based on the long-term average annual inflation measured across four underlying indices. For two of these indices (BIS FOCOS and BIS NOCOS), the time horizon in the long-term average stretches back to 1986. For a third index (BCIS Structural Steelwork – Materials), the long-term average includes observations dating back to 1991.

The time horizon the Utility Regulator uses in calculating its average materials inflation forecast departs from Ofgem's final determination on RPEs at RIIO-GD2, in which long-term average annual growth rates include data from 2000 onwards. Further, the Utility Regulator has not provided an explanation of the grounds for this divergence. We consider that the Utility Regulator's approach risks putting undue weight on older observations which is not best practice, particularly given the forward-looking nature of how input price inflation is factored into the frontier shift calculation for GD23.

In addition, since our original submission, the cost pressures facing the gas sector and wider industries in Northern Ireland, and more widely, have changed markedly. This is particularly true for the cost of Materials, as detailed further in Part 8. Qualitative evidence suggests that growth in the cost of materials will continue to outstrip inflation at higher rates than seen previously. Some of the European construction sector's largest players are currently reporting that Europe is facing shortages of building materials as a result of surging energy costs and EU policies. In turn, this has already led to bankruptcies amongst construction businesses. In our view, the backwards looking nature of the Utility Regulator's input inflation estimate for materials fails to account for these more recent trends and is therefore likely to be very conservative for the GD23 period.

6.2 Ongoing Productivity

The Utility Regulator proposes to apply a 1%⁶³ annual productivity adjustment for GD23. The Utility Regulator's conclusions are informed by two sources of evidence:

- Ofgem EU KLEMS productivity growth data analysis (from RIIO-2); and
- wider regulatory precedent from Northern Ireland and GB across the Energy and Water sectors.

These support an ongoing productivity adjustment of 0.7% to 1.2% for opex and 0.5% to 1.0% for capex.

We agree that these are two important sources of evidence to inform the ongoing productivity challenge that could be applied for GD23. However, we are disappointed that the Utility Regulator has not explicitly taken account of wider factors when setting its proposed ongoing productivity targets from within these ranges. In particular, we consider that the Utility Regulator should take account of the following factors:

- a structural productivity slowdown in the UK since 2008, and
- the impact of the COVID-19 pandemic on the potential for productivity growth.

Taken in the round, we consider that the Utility Regulator's proposal on ongoing productivity adjustment is likely to be beyond the top end of the achievable range over the GD23 period, with wider evidence to support a more conservative adjustment. When this proposal is combined with the other challenging targets throughout the GD23 Draft Determination, we consider that it places firmus energy in a very difficult position.

⁶³ Utility Regulator's GD23 Draft Determination, annex d- opex detail, para 3.14

Part 7. Security of Supply

What we're asking for

We are asking the Utility Regulator to:

- review its position to disallow all resilience projects and allow for capital expenditure of £3.6m to construct our requested resilience projects.
- set an appropriate allowance for project SOS-016, allow for project SOS-005 within the GD23 period and allow for all necessary projects to deliver the Portstewart reinforcement

Why we're asking for it

We have examined our network in its entirety and have identified 40 projects to support security of supply. We are asking for funding to allow us to help protect customers and future customer growth from 2023 to 2045.

7.1 Background

Since 2005, firmus energy has been building out our network in line with our regulatory settlements and in line with gas industry best practice. This has been set out in detail in our Business Plan submission document *FE 24 Security of Supply*.

We have largely completed our core mains network, apart from c.30km of mains to be constructed in GD23. The build-out of the network has been the focus of our work, particularly in GD14 and GD17 and we have significantly accelerated this roll-out compared to initial expectations.

As part of our GD23 Business Plan submission, firmus energy has proposed 40 projects to support our security of supply. We have examined our network in its entirety, and these are the only additional security of supply mains identified to help protect customers and future customer growth from 2023 to 2045.

As part of the post Business Plan submission request for information, the Utility Regulator requested that these security of supply projects be identified as having a driver of reinforcement or resilience. Based on the Utility Regulator's split of project drivers, we submitted 33 resilience projects and 7 reinforcement projects.

7.2 Resilience Projects

7.2.1 We submitted 33 projects totalling £3.6m (none greater than £450k) from 2023 to 2045

firmus energy's objective is to ensure we continue to deliver gas safely, reliably and efficiently to all our customers, both current and future, by ensuring we have a fit for purpose gas network that is resilient and is constructed and operated prudently to mitigate the risks with unplanned events such as interference damage.

Since our licence award, firmus energy has built a safe, efficient, and economic network in line with best practice and industry guidelines. In that period, firmus energy has only received and/or claimed allowances for the network it has physically built to date.

As part of our GD23 Business Plan submission, we have examined our network in its entirety, and identified a small number of areas where adding resilience to the existing network will help protect the customers/services in that area (both customers connected now and future connections to 2045) and mitigate against the risk of damage.

The projects we have identified are the only additional resilience mains necessary to help protect customers and future customer growth from 2023 to 2045.

In total, firmus energy has proposed 33 Security of Supply projects to support the resilience of our network, with none greater than £450k at a total of £3.6m from 2023 to 2045.

Our business plan submission provided information on the likely risk associated with the resilience projects proposed based on using our Security of Supply risk assessment. We included the risk assessments to show our decision-making process as part of the information request process⁶⁴.

These proposals represent the continuation of our efforts to maintain resilience within the network in line with key industry legislation and best practices set out under "The Pipeline Safety Regulations, Pressure Systems Safety Regulations, Gas Safety Management Regulations, IGEM Technical Gas Standards for Transmission and Distribution gas networks using, IGE/GL/1 Edition 3 - Planning of gas distribution systems, IGEM/TD/3 Steel and Polyethylene pipelines for gas distribution" documents.

⁶⁴ IR FE-035

7.2.2 The Utility Regulator disallowed any resilience projects

The Utility Regulator has rejected the project proposals which were identified as being driven by a need to provide increased resilience to our network, in their entirety.

*“The Utility Regulator position is therefore that the GDN's should have provided resilience where reasonably practicable in the original economic layout of the network and that any further work necessary should be completed within the current price control mechanisms”.*⁶⁵

Following a video call with the Utility Regulator on 5th May 2022, we understand that as part of the Draft Determination process that the Utility Regulator did not review the detail of our risk assessment submissions for these resilience projects.

7.2.3 We believe these projects are necessary and should be included within the Draft Determination

1) These projects are necessary to protect customers and the network

Following licence award firmus energy developed a spine mains network to connect targeted developments as approved by the Utility Regulator.

Through time it was agreed that we broaden the number as well as tenure of properties able to access our gas network. This has been very successfully achieved through the programme of infill projects which has now made gas widely available throughout the Ten Towns area and into neighbouring towns and villages.

As the number of properties passed has almost doubled from the start of GD17 to the start of GD23 and similarly the total network length has increased from c. 1,100km to c.2,100km, the risk of outage has significantly increased accordingly.

Under the Gas Safety Management Northern Ireland Regulations 1997 (GSMR), firmus energy as a Distribution Network Operator (DNO), has a duty to ensure the safe management of gas flow through its network. Gas must be supplied to, and maintained in, the network in sufficient quantity and pressure to allow it to be distributed through the network so it is delivered at the point of supply at an adequate pressure. Failure to do this may result in a drop of pressure, or a loss of supply, which could put consumers at risk. For this reason, ensuring continuity of supply lies at the heart of safe gas flow management. How continuity of supply is maintained is

⁶⁵ Utility Regulator's GD23 Draft Determination, annex f- capital investment, page 7

fundamental to the acceptance of firmus energy's safety case by The Health and Safety Executive Northern Ireland (HSENI). Failure to comply with an accepted Safety case is a breach of the Gas Safety Management regulations.

There is also a requirement to ensure security of supply, as a regulated energy service provider, and we have a legislative requirement to design systems to meet pipeline security standard such as IGE/GL/1 Edition 3 - Planning of gas distribution systems of maximum operating pressure (MOP) not exceeding 16 bar. For example, A DNO's planning strategy is to ensure that demands can met under peak 1:20 six-minute demand conditions to accommodate abnormally high demands consistent with winters experienced in the UK over a 20-year period. DNO's design and operate their network so that they can operate safely under peak high demand with due consideration also being given to the likelihood and severity abnormal operating situations for example interference damages.

Further, under the Gas Safety Management Northern Ireland Regulations 1997, firmus energy as a Distribution Network Operator (DNO), has a duty to ensure the safe management of gas flow through its network, in particular in those parts of the network supplying domestic consumers. Additionally, the Regulation places a subsequent duty on DNOs to minimise the risk of a gas supply emergency occurring. A Gas Supply Emergency could be as a result of peak demands or abnormal/emergency conditions. This can only be done if key risks having been carefully considered and appropriate controls implemented with respect to the hazards associated with abnormal/ emergency conditions that could reasonably lead to Supply Emergency situations.

We have achieved a degree of resilience in our networks throughout this project by interconnecting the initial spine mains, extending them only where necessary and achieving a series of networks which contain numerous loops and back-feeds in and around these infill areas.

Due to the geographical nature of our licence area, however, there are areas where a relatively large number of properties are supplied from a single fed pipeline which presents a vulnerability should a damage to this single feed occur. These are the projects which we have identified as being a requirement now to ensure ongoing reliable gas supply.

Whilst the direct financial repair cost of a network damage or escape will generally be borne by the party at fault (3rd party contractor or network operator), customers affected by an outage bear the costs of being without a gas supply for the length of time it takes to repair. Examples of network damages can be found within our Business Plan Submission (*FE 024 Security of Supply*), where examples are included in *Appendix 1*.

Domestic customers affected could be without heat, hot water, and cooking facilities. Industrial and Commercial businesses will suffer, particularly if their natural gas usage is part of a manufacturing process.

Customers have no recourse to the network operator for loss of earnings or other negative consequences if their gas supply is interrupted for a prolonged period.

Adding a reasonable level of resilience to the existing network, having assessed the cost/benefit of such development, will add an extra level of protection to customers and enhance their security of supply.

Unfortunately, we have first-hand experience in large pipe diameter medium pressure partial ruptures with 3rd party damages. In 2017 and 2018 in Antrim this occurred at points on our network that were single feeds. Both these partial ruptures resulted in a load shedding exercise being carried out with industrial and commercial customers requested to stop using gas for a period until the gas escape was repaired in order to protect supplies to domestic customers. The repairs were completed in a timely manner (12hrs and 18hrs respectively) without dropping the network pressure downstream of the gas pipe damage to 0mbar.

If these damages had been full ruptures or the volume or nature of release poses risk to life or property (gas clouds, tracking gas – entering properties etc.), without a back feed or second supply downstream of the damage, it would have resulted in the loss of supply to c.2,000 customers. The cost alone to complete the purge and relights to c.2,000 customers would have been c. £110k not including compensation costs and costs to firmus energy to manage the process and communicate to customers.

In the event of the resilience projects not being awarded firmus energy deems the likelihood of a gas supply emergency happening as “foreseeable” and “significant”. We believe that the risk that these projects would mitigate outweighs the marginal increase to conveyance charges. Our detailed risk analysis is provided in *FE 04_ Security of Supply Risk Assessment Appendix*.

2) firmus energy has only received and/or claimed allowances for the network it has physically built to date.

The approach the Utility Regulator has taken previously to supporting our investment in the network – providing an allowance per property passed – means that firmus energy has only received and/or claimed allowances for the network it has physically built to date.

Were we to have progressed these projects under the properties passed mechanism, we would have been required to invest in these assets without being able to obtain a reasonable return for the work we are undertaking. The Utility Regulator’s obligation to the networks in this regard is set out in its Vires:

“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;⁶⁶”

The total cost of these projects has been estimated at £3.6m (as per our submission), with a length of 28km. These projects have an average of 1 property passed per 159m (excluding the 12 projects which would pass no properties) - compared to 1 property passed per 17m in the 621 projects submitted at GD17.

Comparing this to the total capital outlay on the network to date (c.£250m - Per GD23 pi model DAV calculations), this resilience investment represents less than 1.5%.

Including the capital cost for these resilience projects in the GD23 Draft Determination conveyance charge allowance calculations would result in an increase of 0.23p/therm (0.6%).

3) There is precedent from the Utility Regulator for such projects

The Utility Regulator has previously demonstrated that it agrees in principle with the idea of resilience as an ongoing activity, in counter to its position in its Draft Determination. In providing an allowance for the resilience (and reinforcement) project at the Foyle River Crossing, the Utility Regulator demonstrated that:

- Resilience projects can be identified after the initial design of the network.
- Resilience needs to be continuously monitored by network operators and acted upon where risks become too great; and
- That the properties passed incentive approach to building out the network has not provided for firmus energy to undertake such projects

In addition to the Foyle River Crossing, many further loops / tie-ins have been completed naturally throughout the firmus energy network during role out of infill mains.

However, larger resilience and reinforcement mains have not been completed as they were not required at the early stages of firmus energy's network build based on penetration levels and the consequence of local gas supply emergencies, and therefore not requested during other price controls.

⁶⁶ <https://www.legislation.gov.uk/ukpga/2000/27/part/II/crossheading/gas/enacted>

7.2.4 Our Proposal

The Utility Regulator's Draft Determination has disallowed all resilience projects. Given the commentary above, we would ask Utility Regulator to review this position and allow for capital expenditure of £3.6m to build our requested resilience projects.

If we don't build these then this would potentially put 67,170 properties at greater risk of outage in the event of a network damage, including vulnerable customers and several high-priority services (hospital, etc).

7.3 Reinforcement

As part of our Security of Supply submission, we submitted 7 reinforcement projects as part of the Business Plan. Subsequent to submitting our Business Plan, we identified an additional project running to Portstewart which we included within IR FE-079.

Unlike for resilience projects, the Utility Regulator has *"assessed the need for reinforcement mains on a project by project basis."*⁶⁷

Within GD23, the Utility Regulator has partially allowed one project and provided a placeholder for one project based on us providing further information through this process. Further, the Utility Regulator has accepted a small number of additional projects, although these have been moved to 2029 and not allowed within this period.

Network analysis indicates that the following projects need to happen within the GD23 period:

- SOS-005
- SOS-016
- SOS-040
- SOS-043
- Portstewart reinforcement

Note: SOS-042 will be required should additional towns and large loads come onto firmus energy network as per FE-033 response.

Network analysis indicates that the following projects need to happen within the GD29 period:

⁶⁷ Utility Regulator's GD23 Draft Determination, annex f- capital investment, para 4.12

- SOS-041
- SOS-044 (related to connection of Portrush)

The following provides a short summary of the key information related to the projects required to be built during GD23.

Detailed network analysis is provided in *FE 04_Security of Supply Appendix*.

SOS-005

In our response to FE-033, firmus energy has identified through network modelling (Table 2-Antrim Network Analysis) that the pressure at Ulster Farm By-Products will be 2.073bar at December 2028. Given the length of time required to construct / lay 7,353m of network (minimum 6 months) firmus energy will need to start the construction of SOS-005 in May 2028 at the latest, i.e. within the GD23 price control period. This reinforcement is required due to pressure drop.

SOS-016

The allowance provided for by the Utility Regulator is not sufficient to allow firmus energy to undertake the necessary works.

The estimated cost of £59k includes the following: 206m x 90mm pipe (70% open cut), Railway SED Crossing, 2 x 90mm valves, 1 x district governor.

The Utility Regulator has provided allowances of £16k for the SOS-016 project and we request that the Utility Regulator increases the allowance in line with modelled costs of £59k as set out in our Business Plan submission.

Portstewart Reinforcement (including SOS-040, SOS-041, SOS-043 and SOS-044) ⁶⁸

firmus energy has modelled and studied alternative routes outside of the routes / options proposed in FE-079 Portstewart Reinforcement paper and GD23 Business Plan submission.

In order to have sufficient network pressure in the Coleraine network all reinforcements identified by firmus energy need to be built in the order below.

- Portstewart Reinforcement, Route C (amended), 4,487m x 180mm MP main to be constructed at the start of Q3 in 2023. This will prevent the network pressure dropping below 2bar in December 2023. January 2024 would be below 2bar.
- FE SOS-040, 2,482m x 250mm MP main to be constructed in Q3 2026. Note SOS-040 is required to reinforce Portstewart due to Bushmills D1 & D2 load at 2000scmh plus existing customers. This will prevent the network pressure dropping to 2bar in December 2026. January 2027 would be below 2bar.
- FE SOS-043, 3,982m x 315mm MP main to be constructed in Q3 2028. This will prevent the network pressure dropping to 2bar in December 2028. January 2029 would be below 2bar.
- FE SOS-041, 2,100m x 315mm MP main to be constructed in Q3 2030. This will prevent the network pressure dropping to 2bar in December 20230. Q1 of 2031 would be below 2bar.
- FE SOS-044, 2,936m x 250mm MP main and other small networks loops to be constructed and live by 2032 if Portrush is to connect to natural gas in 2032.

⁶⁸ Note: Following a capex meeting between firmus energy and Utility Regulator on the 05th May 2022, firmus energy can confirm that SOS-040 is required in 2026 to deal with both the Bushmills load of 2000scmh at D1 and D2 and existing customers. Not D3's load.

- a. Bushmills will be increasing their load to 3000scmh in 2026 with D3 online and this demand increase will be managed by SOS-040 being constructed.
- b. SOS-040 is vital to the Coleraine network pressure from 2026 onwards. See table 7.
- c. Portrush cannot be supplied / connected to Route "C" 180mm pipe as the pressure drops to 1.058bar in Portstewart. The Portrush feeder main must connect from SOS-040 250mm.
- d. Further, in order to allow for Portrush to connect to natural gas, all the above SOS's must be constructed.

7.3.1 Our Proposal

In advance of the Utility Regulator's GD23 Final Determination, we ask;

- That the Utility Regulator increases the allowance for SOS-016 project in line with modelled costs provided.
- That the Utility Regulator allows for all necessary projects to deliver Route C for Portrush reinforcement.
- That the Utility Regulator allows for SOS-005 within the GD23 period

Part 8. Contractor Unit Rates

What we're asking for

We have provided strong evidence to support the rates we presented in our Business Plan submission which is further supported by the evidenced presented with this response. GD17 contractor rates and those proposed by the Utility Regulator based upon retrospective modelling do not adequately account for significant and beyond inflationary cost pressures for the GD23 period.

Why we're asking for it

These rates have come under, and continue to come under, considerable upwards pressure. We are seeking allowances which recognise these increases.

When we come to retender this contract in 2023, we will not be able to achieve the rates set out by the Utility Regulator in its Draft Determination position.

8.1 Background

In the firmus energy GD23 Business Plan submission we costed activities based on two factors:

1. Actual historical rates for activities
2. Special factor adjustments that we foresee for the GD23 period, particularly the rates anticipated in the renewal of our Period Contract

With the aim of substantiating some of the special factor adjustments applied in our figures, our GD23 submission included two supplementary papers highlighting current and future cost pressures in the construction sector, '*FE 25 Maintenance, Emergency and Construction Cost Pressures in GD23*' and '*FE 26 Inflation in the NI Construction Sector*'.

Based upon our market research and the work undertaken by Construction Employers' Federation (CEF) and Oxford Economics, firmus energy took an informed, yet prudent view of cost pressures

facing our operations in the GD23 period. We applied a 5% (real) uplift to costs associated with operations undertaken by the 3rd Party Period Contractor from 2023.

This uplift was applied to contractor rates, as applicable, for both capex and opex activities. One notable exception to the 5% uplift in rates was domestic service laying capex activity. For domestic service constructions activities in GD23, we prudently forecasted a 17% (real) uplift to rates in 2023, outlining why the forecast increase in that specific rate was exceptional.

8.2 Utility Regulator position

The Utility Regulator's Draft Determination largely followed the same process as the GD17 Determination, relying heavily on historical information from firmus energy and other Gas Distribution Networks (GDNs).

No increases were applied in their workings to reflect the costs pressures flagged by us in our submission.

Whilst we appreciate that this is generally accepted best practice for Regulation and utilises the most reliable information available to a Regulator, we believe that there are certain key areas where recent cost pressures mean that historical rates are not reflective of future rates.

8.3 Cost Pressures

In developing our GD23 Business Plan, we were aware of cost pressures within our supply chain, and mindful of the impact these cost pressures were likely to have upon our engineering operations in the GD23 period (2023-2028).

In April 2021, Mark Spence, Managing Director of the Construction Employers' Federation, communicated, as follows, to industry colleagues in Northern Ireland:

"I wish to draw to your attention to the extraordinary pressures being borne by contractors in the current market conditions where there are significant material shortages and rapidly rising prices.

According to the Chartered Institute of Procurement & Supply, we are currently experiencing “the sharpest rise in cost inflation in a generation” ⁶⁹

On 4 June 2021, BBC (Northern Ireland) published an article entitled “*Global construction supply shortage pushing up costs in NI*” quoting Gavin McGuire, Director of the Federation of Master Builders, as highlighting steep price rises with steel, timber, cement and pipes, stating “*Most projects are planned maybe six months to a year ahead of time, so for you as a client, a price that a builder would like to commit to now, realistically is not going to be what it's like in six months’ time*”⁷⁰.

A February 2022 publication by the Royal Institution of Chartered Surveyors (RICS)⁷¹ forecasts that “*strong annual increases will continue over the first three quarters of 2022 in the order of 5% to 7% per annum, generally as a result of the following over 2021:*

- *contractors no longer being able to absorb the additional cost of following social distancing*
- *a number of contractors going into liquidation*
- *strong upward pressure from input costs*
- *rising demand*
- *materials and labour shortages*
- *logistics problems.”*

Figure 8.1, below, illustrates the RICS forecast that costs will rise by **14%** over the forecast period (4Q2021 to 4Q2026).

⁶⁹ IHS Markit / CIPS UK Construction PMI, April 2021

⁷⁰ BBC NI- “*Global construction supply shortage pushing up costs in NI*”

⁷¹[https://www.rics.org/uk/products/data-products/insights/bcis-five-year-forecast-building/#:~:text=The%20BCIS%20General%20Building%20Cost,period%20\(4Q2021%20to%204Q2026\)](https://www.rics.org/uk/products/data-products/insights/bcis-five-year-forecast-building/#:~:text=The%20BCIS%20General%20Building%20Cost,period%20(4Q2021%20to%204Q2026))

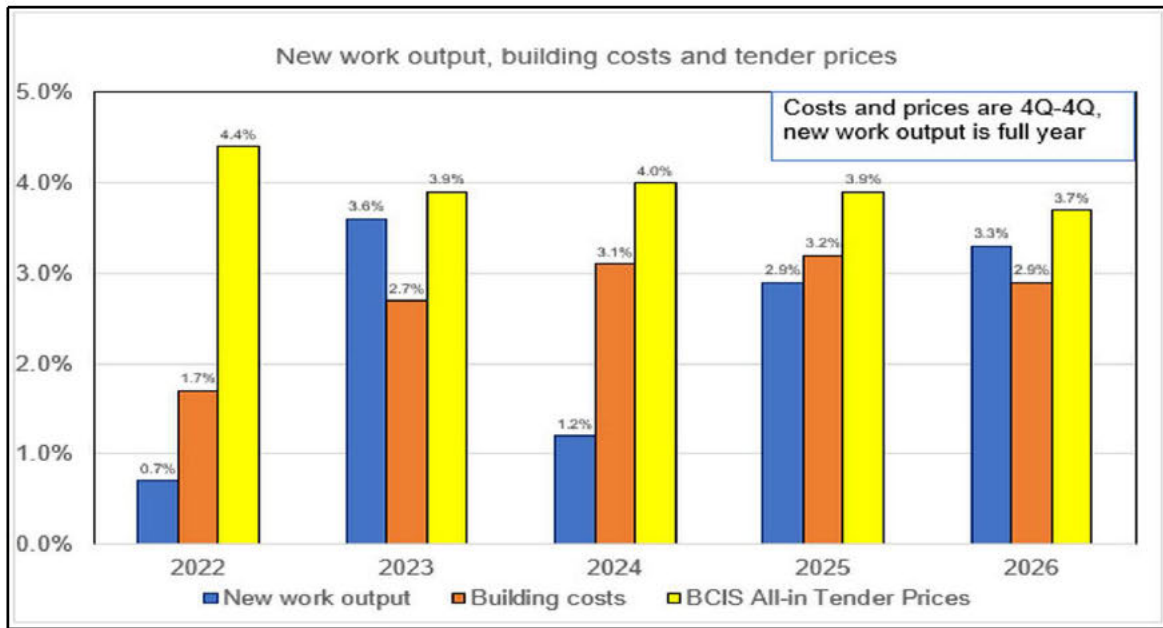


FIGURE 8.1 RICS FORECAST OF NEW WORK OUTPUT, BUILDING COSTS AND TENDER PRICES

The upward pressure on costs anticipated ahead of GD23 is also illustrated by recent data published by the Department for Business, Energy and Industrial Strategy (BEIS) in their 'Monthly Statistics of Building materials and Components', published on 4 May 2022. Figure 8.2 and Figure 8.3, below, have been extracted from their report.

They highlight that the material price index for 'All Work' increased by 24.5% in March 2022 compared to the same month the previous year.

Chart 1: Construction Material Price Indices, UK
Index, 2015 = 100



Source: Monthly Statistics of Building Materials and Components, Table 1

FIGURE 8.2 BEIS – CONSTRUCTION MATERIAL PRICE INDICES APRIL 2022

Category	Year-on-year change (March 2021 to March 2022)	Month-on-month change (February 2022 to March 2022)
New Housing	19.5%	2.1%
Other New Work	27.8%	7.3%
Repair & Maintenance	22.4%	3.6%
All work	24.5%	5.0%

FIGURE 8.3 BEIS – CONSTRUCTION MATERIAL PRICE CHANGES MARCH 2022

To corroborate market research, firmus energy engaged the support of Oxford Economics and we included their analysis and cost implications for the period 2023 to 2028 in supplementary paper 'FE 26 Inflation in the NI Construction Sector'.

Oxford Economics concluded that *“we expect construction tender price inflation to exceed general economy-wide measures of inflation. Over the period 2023 to 2028, UK construction tender price inflation will average an estimated 5.2% per year. This suggests that construction price inflation will be 3.4 percentage points higher than the CPI (1.8% per year), and 2.2 percentage points higher than the RPI (3.0% per year).”*⁷²

To supplement our response in this area we commissioned Long O Donnell, expert consultants within the energy and infrastructure sectors, to review the cost pressures facing the construction industry and the real uplifts to current rates that may be anticipated upon the retendering of our Period Contract. Their report is attached as appendix FE 06_GD23 - Construction Cost Inflation.

They conclude *“Based on the evidence provided in this report it is the view of Long O Donnell that the application of a 5% uplift over any agreed inflationary uplift, to account for recent market pressures and any delta between the mean value inflation % and the real inflation %, is a conservative and pragmatic position to take in order to provide relief and reduce the financial exposure to firmus energy and their Third Party Period Contractor”*.

8.4 Our Challenges

We outlined the challenges related to unit rates as part of our business plan submission where we flagged that utilising historic rates to forecast GD23 allowances would not be reflective of the current market environment.

When we come to retender our period contract in 2023, we will not be able to achieve the rates set out by the Utility Regulator in its Draft Determination position, with evidence already indicating a material outstripping of current contracted rates.

⁷² FE 26 ‘Inflation in the NI Construction Sector’

To further support our position, and in addition to information provided previously, we have undertaken further 3rd party research by Long O Donnell as referenced above. The report supports our views that:

- the existing contracted rates are unsustainable
- we are unlikely to be able to achieve the Utility Regulator's Draft Determination rates in our upcoming tender

8.5 Areas for further consideration by the Utility Regulator

Based on the evidence presented in our GD23 submission and in this response, we would request the Utility Regulator to review the engineering unit rates, as proposed in the Draft Determination, and make due allowance for forecast cost increases over inflation.

The provision of allowances that are reflective of actual, achievable costs is essential for delivering the outputs of the GD23 Price Control, in particular, connecting customers, responding to emergencies and carrying out essential maintenance to the network.

Part 9. Emergency, Maintenance and Metering

What we're asking for

firmus energy is seeking revised cost modelling in this area following provision of updated data and additional clarification around inputs and historic actuals.

Why we're asking for it

The proposed allowances will fall short of the necessary expenditure required to deliver forecast outcomes for the GD23 period, with particular focus upon our ability to react to emergencies resulting from adverse weather (or temperature) conditions.

firmus energy's GD23 Business Plan submission proposed to invest £20.4m in maintaining our network and responding to emergencies over the GD23 period.

As can be seen from the table below, the Utility Regulator's Draft Determination proposes to reduce these operational costs by 15% to £17.4m (pre-efficiency).

Emergency, Maintenance & Metering Activities	FE Submission £'000	Draft Determination £'000	Variance £'000
Emergency Call Centre	1,949	1,410	(539)
Emergency	6,537	5,508	(1,029)
Metering	6,821	6,186	(635)
Maintenance	5,133	4,317	(816)
Total	20,440	17,421	(3,019)

TABLE 9.1

The reductions proposed reflect a combination of reductions to activities (connections, call numbers and specific maintenance activities) and reductions to cost allowances (unit rates and manpower).

The decreases proposed as a consequence of reductions to forecast connection numbers are consistent with other areas of the Draft Determination however we would flag that, unlike in other areas, the emergency, maintenance and metering operational cost allowances are not subject to any “true-up” to reflect actual connections or call numbers.

The consequence of these fixed allowances is that firmus energy would incur additional costs if there is outperformance in connection numbers, an area where we would be keen to outperform to improve our current network penetration and help reduce carbon emissions in our network area.

9.1 Emergency Call Centre

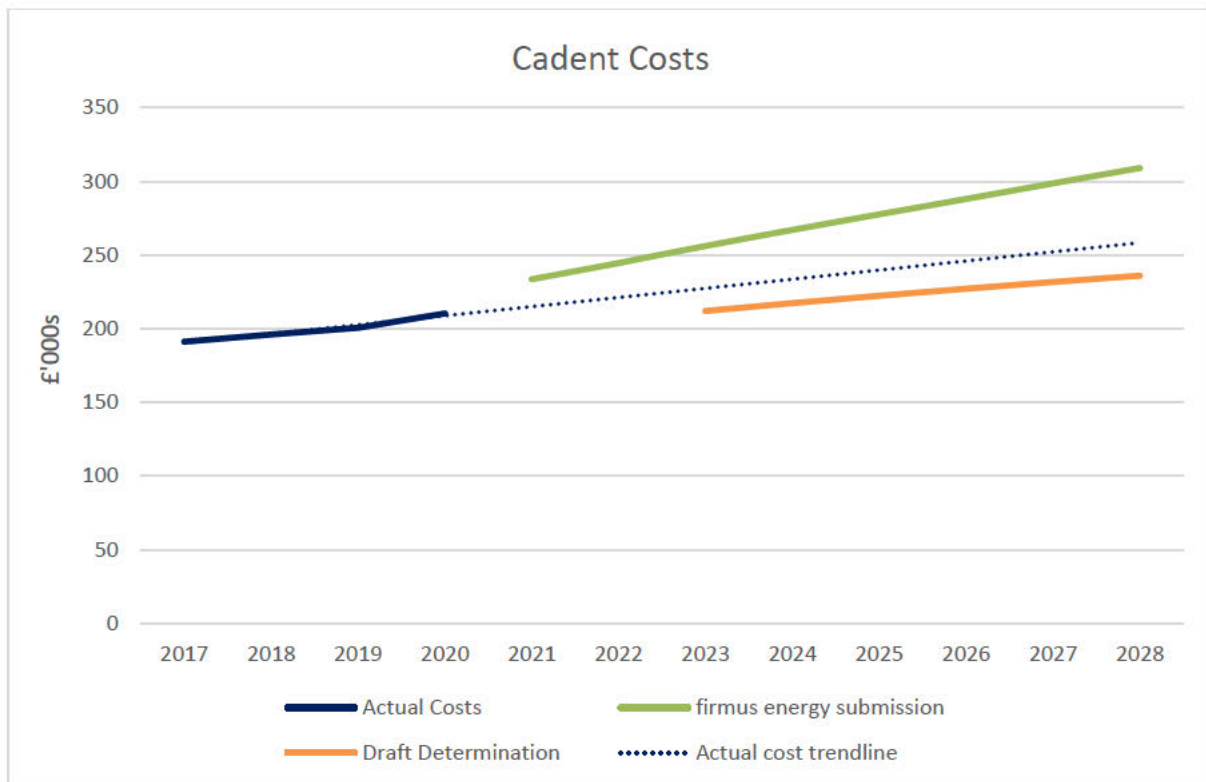
Allowances in this area represent firmus energy’s share of costs payable to Cadent for the operation of the Northern Ireland Emergency Call Centre. Cadent’s costs for Northern Ireland are shared between PNGL, SGN Natural Gas and firmus energy based on the proportion of calls attributable to their network area.

The GD23 Draft Determination proposes allowances for Cadent Emergency Call Centre costs of £1.35m compared to our GD23 Business Plan submission of £1.70m.

Our submission assumed higher connection numbers than the Draft Determination and included uplifts to reflect the increasing proportion of Northern Ireland emergency calls attributable to our network area.

In 2021 30% of Northern Ireland emergency jobs raised were attributed to firmus energy and for the first quarter of 2022 we can already see this percentage rising to 33%.

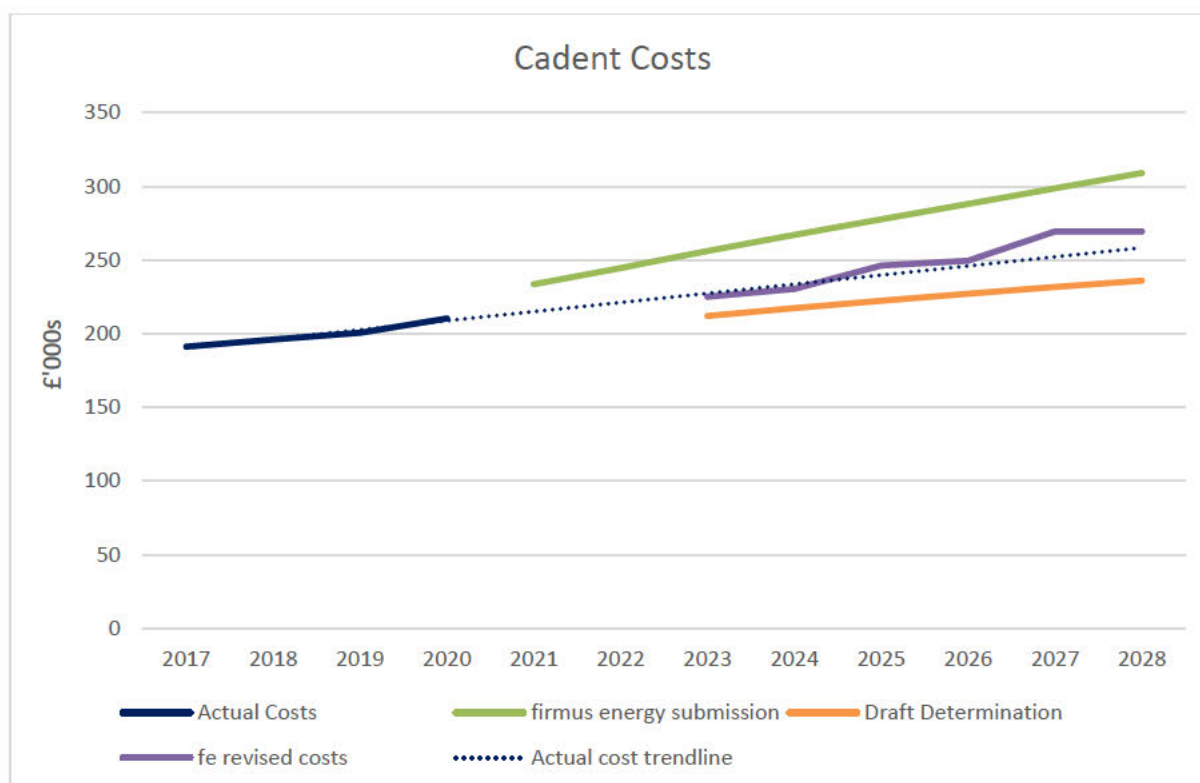
The graph below shows the historic costs for the operation of the Cadent Emergency Call Centre together with our submitted figures and the Draft Determination.



GRAPH 9.1 COSTS FOR THE OPERATION OF THE CADENT EMERGENCY CALL CENTRE

Having reviewed the Utility Regulator's calculations and reflecting the reduced connection numbers and a reduction to the number of calls received over Cadent's allowed monthly threshold, we have remodelled the forecast costs and consider that the proposed allowances will fall short of these remodelled costs.

Our revised calculations forecast costs of £1.49m in the period and as illustrated in the graph below, these costs are more in line with the trendline of historic actual costs.



GRAPH 9.2 COSTS FOR THE OPERATION OF THE CADENT EMERGENCY CALL CENTRE- REVISED COSTS

The details behind our calculation of the revised costs is attached in *FE 05_Metering, Maintenance and Emergencies Appendix*.

We would ask the Utility Regulator to review the allowances in this area and provide an uplift of c.£143k (11%) to better reflect both the trend of historic actuals and the increasing number of calls (costs) that will be attributable to firmus energy in the GD23 period.

9.2 Emergency Costs

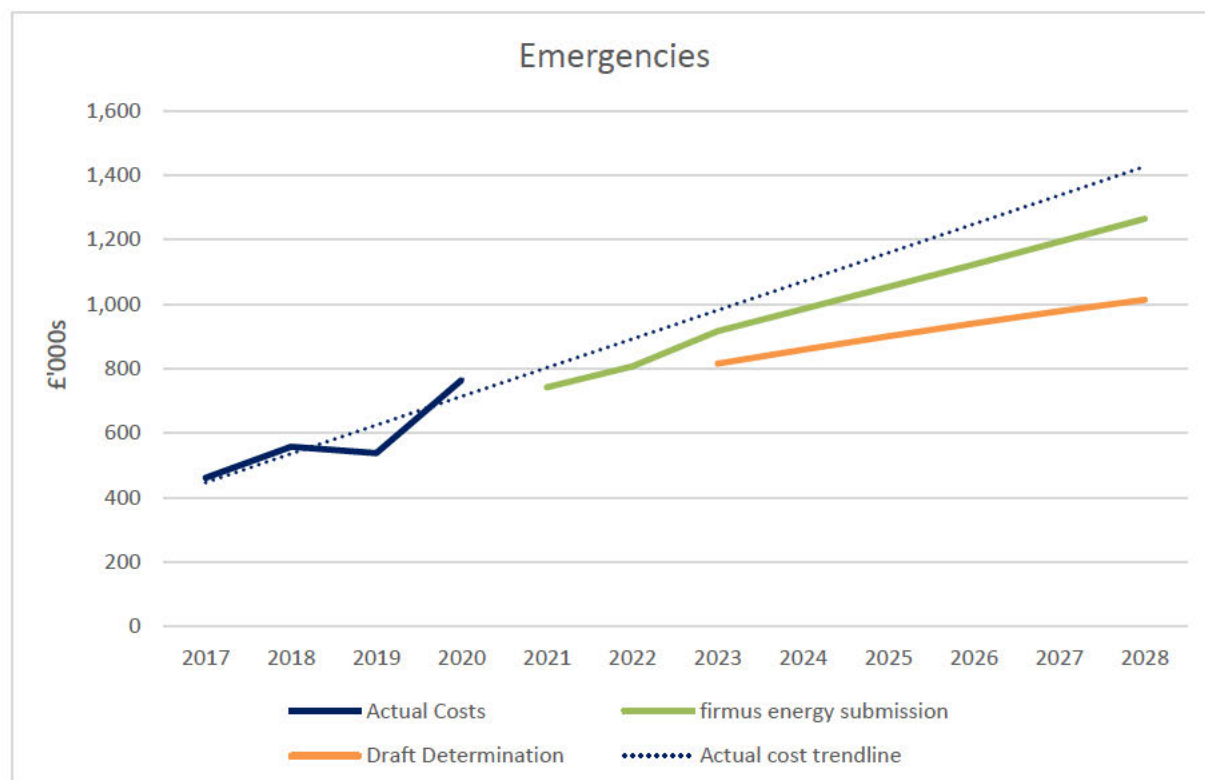
The GD23 Draft Determination proposes allowances for emergency costs of £5.5m compared to our submission of £6.5m.

Describing the differential in proposed allowances compared to our submission, the Utility Regulator noted in Annex D to the Draft Determination that three factors contributed to their reduction in estimated costs of emergency jobs:

- *“The volume of emergency jobs allowed for in the draft determination is less than that submitted by FE because we have forecast lower connection numbers for the GD23 period.*

- We have projected costs on the basis of the historic proportion of customer calls that become emergency jobs. FE had proposed an increasing proportion in GD23.
- The 5% cost pressure uplift that FE had applied to work being undertaken by its period contractor from 2023 onwards was not allowed, consistent with the approach we have adopted for capital investment.⁷³

The following graph outlines the historic emergency costs, firmus energy’s submitted costs and the proposed allowances.



GRAPH 9.3 EMERGENCY COSTS

It can be seen from this graph that both firmus energy and the Utility Regulator are forecasting costs below the trendline of historic actuals, reflecting firmus energy’s ongoing work to inform customers on the functions of, and interaction with, gas meters, gas appliances, carbon monoxide alarms and what constitutes a gas emergency.

We are somewhat apprehensive of the proposed allowances, as they are derived from the historic actuals of 2017 to 2020 which was a period of relatively mild weather, and the forecast allowances

⁷³ Utility Regulator’s GD23 Draft Determination, annex d-opex-detail, page 3

may not cover the actual costs in the case of a prolonged period of harsh weather or cold temperatures.

Adequate allowances for responding to emergencies are essential to allow firmus energy to respond quickly and safely.

9.3 Metering

The GD23 Draft Determination proposes allowances for metering of £6.0m (adjusted for non-routine adjustments) compared to our submission of £6.8m.

The key drivers for these reductions are:

- Revised forecast connection numbers for large I&C meters
- Amended methodology for calculation of routine meter maintenance based on historical information on the timing of maintenance and number of meters
- Exclusion of 5 year and 15 year inspection costs for one year (2023) for domestic and small I&C meters
- Revision of the non-routine maintenance cost per connection
- Removal of the 5% uplift applied to period contractor rates

9.3.1 Large I&C Meters

In relation to forecast connection numbers for large I&C meters, in the absence of any firm commitments to connect, firmus energy did not submit any large I&C connections in the GD23 period.

Whilst capital allowances contain an uncertainty mechanism to “true-up” allowances for actual connections made in the period, there is no equivalent uncertainty mechanism for the maintenance of these large meters.

Historic actuals (2017 to 2021) for large I&C connections, net of any disconnections, shows a net average of 11 large meter connections per annum.

We believe 11 connections per annum would represent a reasonable estimate to determine large metering maintenance allowances.

9.3.2 Routine Metering Maintenance

When the Utility Regulator was determining routine metering maintenance, due to some errors in the figures we submitted and confusion around the dates of overhauls/PSSR checks, we believe that the allowances do not reflect the true maintenance lifecycle of our metering assets.

We have included, in *FE 05_Metering, Maintenance and Emergencies Appendix*, more detailed workings clarifying the metering maintenance lifecycle of our assets, the dates of overhauls and the number of meter exchange jobs.

We would ask the Utility Regulator to review this additional information and revise their modelling accordingly, seeking further clarity from us, if required.

9.3.3 5 year and 15 year inspection costs

The Utility Regulator has disallowed the 2023 inspection costs because they believe we have applied the revised guidance from the updated British Standard one year too early.

The disallowance of this year resulted in a deduction of £350k from the submitted costs.

We accept this viewpoint with the consequence that our 5 year and 15 year inspection programme will not now commence until 2024.

9.4 Maintenance

The GD23 Draft Determination proposes allowances for maintenance of £4.3m compared to our submission of £5.1m.

The key drivers for these reductions are:

- Amended methodology for calculation of valve cover maintenance and critical valve inspection based on historical information and the cumulative length of mains (£203k)
- Reduction to governor reactive maintenance (£275k)
- Reduction to telemetry equipment maintenance due to reduction in new connections requiring telemetry (£69k)
- Removal of the 5% uplift applied to period contractor rates (£172k)

9.4.1 Valve Covers

The Utility Regulator's analysis assumes a base figure for the number of valve covers and increases this annually proportionate to the increase in the length of the network in that year.

We believe this analysis does not reflect the correct driver for valve cover maintenance and we have proposed an alternative methodology for estimating valve cover inspection numbers.

All network valve covers will ultimately need to be replaced at a point in time where they are no longer fit for their purpose.

We would propose remodelling the maintenance of valve covers based on the age of the cover as we believe this would provide a more accurate representation of the failure of valve covers and would lend itself to the development of a programme to pro-actively maintain covers that are at greater risk of failure.

We have attached our proposed modelling for GD23 valve cover maintenance in *FE 05_Metering, Maintenance and Emergencies Appendix*.

9.4.2 Governor Reactive Maintenance

As part of the GD23 submission, firmus energy misclassified some governors resulting in an incorrect allocation of governor units between District Governors and Governor Bins.

The impact of this misclassification resulted in inconsistent allowances being derived for installation of new governors, removal of old governors and ongoing governor maintenance.

We have prepared a separate appendix, *FE 05_Metering, Maintenance and Emergencies Appendix*, that presents a more accurate reflection of the existing governor units and the capital and operational costs associated with governor units.

We would request that the Utility Regulator reviews the revised data in the Appendix and redetermines allowances based on this corrected information.

9.4.3 Telemetry maintenance

In relation to forecast connection numbers for large I&C meters, in the absence of any firm commitments to connect, firmus energy did not submit any large I&C connections in the GD23 period.

Whilst capital allowances contain an uncertainty mechanism to “true-up” allowances for actual connections made in the period, there is no equivalent uncertainty mechanism for any telemetry associated with these larger connections.

Historic actuals (2017 to 2021) for large I&C connections, net of any disconnections, shows a net average of 11 large meter connections per annum.

We forecast that 3 sites per year will fall above the threshold for installation of Daily Metering (DM) equipment and would request allowances to maintain the existing DM equipment and these new DM connections.

Part 10. Other Opex

What we're asking for

In relation to the operational cost allowances proposed for GD23, firmus energy believes it is essential that the Utility Regulator reviews its methodology and cost allowances in a number of areas.

Why we're asking for it

The allowances we have requested are necessary to enable firmus energy to deliver as we had intended in our Business Plan submission. The Utility Regulator's assessment appears to have adopted a 'mix and match' approach across manpower and other opex costs, with further inconsistency applied within activity areas, in the absence of supporting narrative for the assessment methodology

10.1 Overview

firmus energy's GD23 Business Plan submission proposed to invest £60.7m in operational expenditure (opex) over the GD23 period.

As can be seen from the table below, the Utility Regulator's Draft Determination proposes to reduce these operational costs by 20% to £48.5m (pre-efficiency).

GD23 Operational Expenditure	FE Submission £'000	Draft Determination £'000	Variance £'000
Asset Management	684	528	(156)
Operations Management	1,906	1,647	(259)
Emergency Call Centre	1,949	1,410	(539)
Customer Management	2,174	1,770	(404)
System Control	1,845	1,455	(390)
Emergency	6,537	5,508	(1,029)
Metering	6,821	6,186	(635)
PRE-Repairs	901	731	(170)
Maintenance	5,133	4,317	(816)
Other Direct Activities	2	3	1
IT & Telecoms	4,374	3,444	(930)
Property Mgt (including rates)	7,216	6,482	(734)
HR & non-ops training	836	690	(146)
Audit, Finance & Regulation	5,382	4,410	(972)
Insurance	1,957	1,464	(493)
Procurement	117	132	15
CEO & group management	1,379	1,314	(65)
Stores & Logistics	117	-	(117)
Advert. & Market Dev. (OO)	8,984	4,840	(4,144)
Advert. & Market Dev. (non-OO)	1,369	1,422	53
Trainees and Apprentices	525	294	(231)
Licence Fees	300	300	-
SOLR	175	175	-
Total	60,683	48,522	(12,161)

TABLE 10.1 DRAFT DETERMINATION OPERATIONAL ALLOWANCES

10.2 Utility Regulator's Approach

In the main, the Utility Regulator's approach for the GD23 Draft opex Determination has followed the approach for GD17.

In relation to determining operating expenditure, the Utility Regulator observes *"To provide structure to our assessment, we collect and analyse opex under 23 cost categories ... Under each of these cost categories we consider a further breakdown by activities such as staff, materials, professional and legal fees, etc. to inform our decisions."*⁷⁴

Rather than look at the total operational costs for an activity, costs were assessed line by line, with comparisons made to 2020 actual costs and to the costs included in firmus energy's GD23 submission.

Whilst in receipt of four years of actual results to assess and determine allowances, the Utility Regulator has only chosen the most recent year of actuals (2020) to use as a base, noting also that the 2020 year was the start of the COVID-19 pandemic, with UK-wide lockdowns affecting many activities and operating costs (increases and decreases).

The table below highlights the inconsistent approach that the Utility Regulator has taken when assessing operating costs, reviewing individual cost lines and generally opting for the lower value when comparing 2020 actual costs and the costs included in firmus energy's GD23 submission.

⁷⁴ GD23 Draft Determination March 2022, Annex D-Opex Detail, Executive Summary

As illustrated in the table, the Utility Regulator’s assessment appears to have adopted a ‘mix and match’ approach across manpower and other costs, with further inconsistency applied within activity areas, without supporting narrative for the assessment methodology.

Activity	Manpower		Other costs	
	FTE's	Costs		
Asset Management	2020 actuals	2020 actuals	fe submission	
Operations Management	fe submission	2020 actuals	fe submission	
Customer Management	fe submission	2020 actuals	Not applicable	
System Control	2020 actuals	2020 actuals	2020 actuals	
Other Direct Activities	2020 actuals	2020 actuals	Not applicable	
IT & Telecoms	2020 actuals	2020 actuals	2020 actuals	
Property Mgt (excluding rates)	fe submission	fe submission - 2023 Year	fe submission - 2023 Year	
HR & non-ops training	fe submission	2020 actuals	2020 actuals	
Audit, Finance & Regulation	2020 actuals	2020 actuals	fe submission (adjusted)	+ 2020 actuals
Insurance	Not applicable	Not applicable	2020 actuals	
Procurement	fe submission	2020 actuals	fe submission	
CEO & group management	2020 actuals	2020 actuals	fe submission	
Stores & Logistics	2020 actuals	2020 actuals	Not applicable	
Advert. & Market Dev. (non-OO)	fe submission + 1 FTE	2020 actuals	2020 actuals	
Trainees and Apprentices	2020 actuals	2020 actuals	2020 actuals	

TABLE 10.2 - APPROACH TAKEN BY UTILITY REGULATOR BY ACTIVITY

By adopting this approach, the Utility Regulator has determined a level of operating costs (excluding emergencies, maintenance, metering and Owner Occupied advertising and marketing⁷⁵) that is substantially below our submitted costs and c.£1m less than if they had only used the 2020 base year figures.

2020 Prices (£'m)	Utility Regulator Draft Determination	Utility Regulator Draft Determination (using consistent 2020 base year)	Variance
Asset Management	0.53	0.63	0.10
Operations Management	1.65	1.79	0.15
Customer Management	1.77	2.00	0.24
System Control	1.46	1.46	-
Other Direct Activities	0.00	0.00	-
IT & Telecoms	3.44	3.44	-
Property Mgt (including rates)	1.02	1.05	0.03
HR & non-ops training	0.69	0.71	0.03
Audit, Finance & Regulation	4.41	4.63	0.22
Insurance	1.46	1.46	-
Procurement	0.13	0.08	(0.06)
CEO & group management	1.32	1.40	0.08
Stores & Logistics	-	-	-
Advert. & Market Dev. (non-OO)	1.42	1.60	0.18
Trainees and Apprentices	0.29	0.29	-
Total	19.59	20.55	0.96

TABLE 10.3 DRAFT DETERMINATION LEVEL OF OPERATING COSTS

⁷⁵ Considered separately within the Utility Regulator

10.3 Our Response

Within each operation cost activity there are manpower costs and other costs.

A separate section has been included in this response outlining our consideration of the manpower Draft Determination allowances (see Part 5).

In addition, separate sections are provided for the following activity areas:

- Emergencies, maintenance, and metering in Part 9
- Advert. & Market Dev. (OO) in Part 2

The following section considers the Utility Regulator's proposed Draft Determination position for other operational costs across various activities.

Customer Management

firmus energy submitted costs for the GD23 period of £253k in relation to the operation of our out-of-hours call centre, a key service for customers seeking to contact us outside of normal business hours or at times when our customer services team are unavailable.

In line with our historic Annual Cost Reporting submissions, these costs were included under the Customer Management (Emergency Call Centre) activity.

When reviewing the costs under this activity, the Utility Regulator determined that only the costs associated with emergency calls taken out-of-hours should reside under the Customer Management (Emergency Call Centre) activity, with the balance residing under Customer Management (Including Non-Emergency Customer Call Centre).

We noted in an Information Request (FE-063) that, re-allocating our submitted costs on this basis would result in a split of £49k to Customer Management (Emergency Call Centre) and £204k to Customer Management (Including Non-Emergency Customer Call Centre).

Allowances of £63k were included in the Draft Determination in relation to the emergency element of out-of-hours calls.

The Utility Regulator has confirmed that no allowances have been included in relation to the non-emergency portion of these calls, i.e. no allowances have been given under the Customer Management (Including Non-Emergency Customer Call Centre) activity.

They have confirmed that they will review this approach for the Final Determination and we would anticipate that allowances relating to the non-emergency element of out-of-hours calls will be considered.

System Control

firmus energy submitted costs of £40k per annum, required to support professional and legal fees for the costs associated with operating and maintaining a Supervisory Control and Data Acquisition (SCADA) system.

The principle driver for firmus energy implementing SCADA is to facilitate and monitor gas injection (biomethane or hydrogen) at specific sites.

This £40k per annum cost was disallowed in the Draft Determination. We understand that the socialisation of costs associated with facilitating biomethane injection connections to the distribution network is being considered within a separate Regulatory (Biomethane) workstream.

IT and Telecoms

The GD23 Draft Determination allows for c.£3m over the period for IT & Telecoms professional and legal fees. This allowance is c.£850k less than our submission.

IT & Telecoms - Professional and Legal Fees	£'000
firmus energy submission	3,810
Draft Determination	2,956
Variance	(854)

TABLE 10.4 PROFESSIONAL AND LEGAL FEES

In setting these allowances for the Draft Determination, the Utility Regulator has used 2020's actual reported costs for IT & Telecoms, professional and legal fees.

The main reason for the large difference between our submission and the Draft Determination/2020's actuals is the inclusion of £100k per annum licencing costs for a new IT system.

The actual costs in 2020 do not contain any main system licencing costs as we don't currently incur licencing costs for our main system (IUS). This is a legacy of inheriting the system from BGE.

The current IUS Distribution system is a legacy platform, inherited from the original owners of firmus energy (BGE). The main driver for the replacement of this system is to retire the 40-year-old IUS system due to the legacy technologies it utilises, making it difficult to support and maintain. The current IUS system is integrated and as such services both the Distribution and Supply businesses. The new IUS Supply replacement system was procured and developed first, with the procurement of the IUS Distribution replacement due to commence in 2022. The capital

allowances to procure, develop and implement this new system were included in the GD17 Final Determination.

The licensing costs we are requesting are for the running of this new asset management and job scheduling solution, i.e. new ongoing operational costs post implementation.

firmus energy is forecasting these costs to be £100k per annum, supported by our recent experience with the procurement and development of our new Supply Billing System.

The Utility Regulator has stated the following on this area in their Draft Determination:

*"We observe that FE received in GD17 a substantial allowance in 2017 (Capex), to replace its IUS/IT Transformation, but note that this development has still not occurred and is pending in 2022, in which a separate request is also made for "New IUS Distribution Replacement licensing", which is based on estimates from its connected supply business. We have rolled forward the majority of 2020 actuals costs for GD23. We plan to review this area further, for the Final Determination."*⁷⁶

firmus energy's forecast licencing costs to support our new IUS Distribution Replacement have been disallowed by the Utility Regulator, pending a further review ahead of the final determination. We would welcome further engagement with the Utility Regulator to discuss licencing costs, as it is imperative that these essential costs are included within the opex allowances.

Audit, Finance & Regulation

Under the opex activity of Audit, Finance and Regulation, the Utility Regulator has allowed our submitted costs, except for the increased costs submitted in relation to price control costs, where firmus energy has been benchmarked against PNGL and only been allowed £210k, compared to our submission of £300k.

We note that PNGL has been allowed an additional £200k per annum more than firmus energy under this operational activity and hence has more resources to draw upon for their Price Control reviews. It is therefore reasonable to conclude that firmus energy will incur additional consultancy costs, when compared to PNGL, to sufficiently and appropriately resource our Price Control activities.

Despite the differences between firmus energy and PNGL with respect to length of network, operations and customers connected, the nature of each company's regulatory activities, obligations and reporting (including Price Control review) is equal.

Insurance

We note that the Utility Regulator has acknowledged the increase in our 2021/2022 insurance premiums (25% overall increase – with certain premiums rising by c.70%) and that they '*...may undertake further analysis of our insurance costs in advance of the GD23 final determination*'⁷⁷.

⁷⁷ Utility Regulator's GD23 Draft Determination, annex d- opex detail Para 4.102

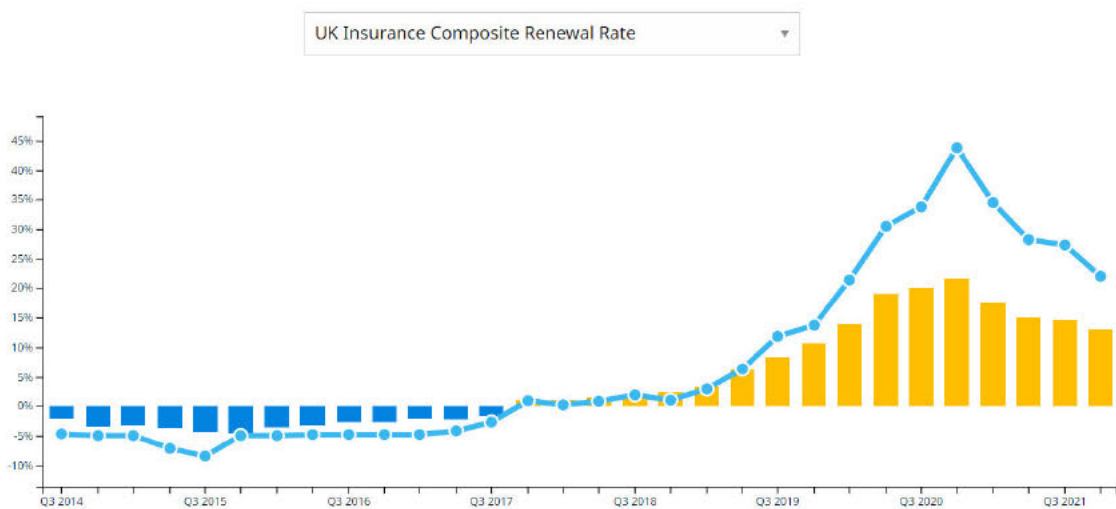
We would welcome this review and support any further analysis that the Utility Regulator would undertake.

Whilst firmus energy’s historical annual insurance costs have shown decreases in past years, these have been a result of reductions in the level of cover, as opposed to a reduction in the premium cost.

The regulatory allowances for insurance for GD14 and GD17 were challenging and meant that we had to reduce the level of cover to remain within allowances. We are now at a level of cover where it would present too great a risk to the public and our staff to reduce this cover any further.

The bar chart below⁷⁸ shows that insurance costs have been consistently rising since the start of 2018 and there are no suggestions that this is likely to change (albeit the level of increases may fall off). The graph below would also not take full account of the effect of the recent invasion of Ukraine and the impact this has had on the global insurance market.

Constant bar chart represents Global Insurance Composite Pricing Change.



Trainees and Apprentices

Similar to HR & non-ops training, the operational cost draft allowances for trainees and apprentices (staff training) have been based on 2020 actuals, a year in which there was restricted activity due to COVID-19 and where a large proportion of our staff were working remotely.

⁷⁸ Marsh Global Insurance Market Index (UK Rate)

In 2020, many training activities were cancelled/postponed due to the pandemic, with costs being 34% down on the previous year (2019).

2020 does not represent the necessary costs to support our GD23 activities for trainees and apprentices. The Utility Regulator's proposed (reduced) allowances in this area will result in staff not receiving appropriate or adequate levels of training.

We believe it is vital to continue to invest in the training of our staff, to maintain our excellent quality of service and to develop and encourage our locally based workforce.

The GD23 Draft Determination provides no commentary regarding the disallowance of these critical costs.

10.4 Proposed elements to review for the GD23 Final Determination

In relation to the operational cost allowances proposed for GD23, firmus energy believes it is essential that the Utility Regulator reviews its methodology and cost allowances in the following areas.

1. General inconsistency of approach to assessing operational cost allowances, specifically the need to review costs at an overall activity level and where more appropriate, assessing actual costs for 2017, 2018, 2019 and 2020 and evidence presented in firmus energy's submission, information requests and this response.
2. Non-emergency out-of-hours call centre costs
3. IT licensing costs
4. HR related costs
5. Audit, Finance & Regulation - Price Control costs
6. Increasing insurance premiums
7. Staff training, including NVQs for Governor Technicians

Part 11. Appendices

The following appendices have been included, as attachments, to support our response the GD23 Draft Determination consultation;

FE 01_Letter to UR Board

FE 03_Rate of Return

FE 04_Security of Supply

FE 04_Security of Supply Risk Assessment

FE 05_Maintenance, Metering and Emergencies

FE 06_GD23 – Construction Cost Inflation

FE 07_Private Streets