PHOENIX NATURAL GAS

Response to the Utility Regulator's GD23 Draft Determination

May 2022

www.phoenixnaturalgas.com

Contents

1 INTRODUCTION

Phoenix Natural Gas Limited (PNGL)[1] is the owner and operator of the largest gas distribution business in Northern Ireland (NI), covering an area that encapsulates c.45% of the population of NI, including Greater Belfast, Larne and more recent extensions into East Down and Whitehead (the 'Licensed Area'):

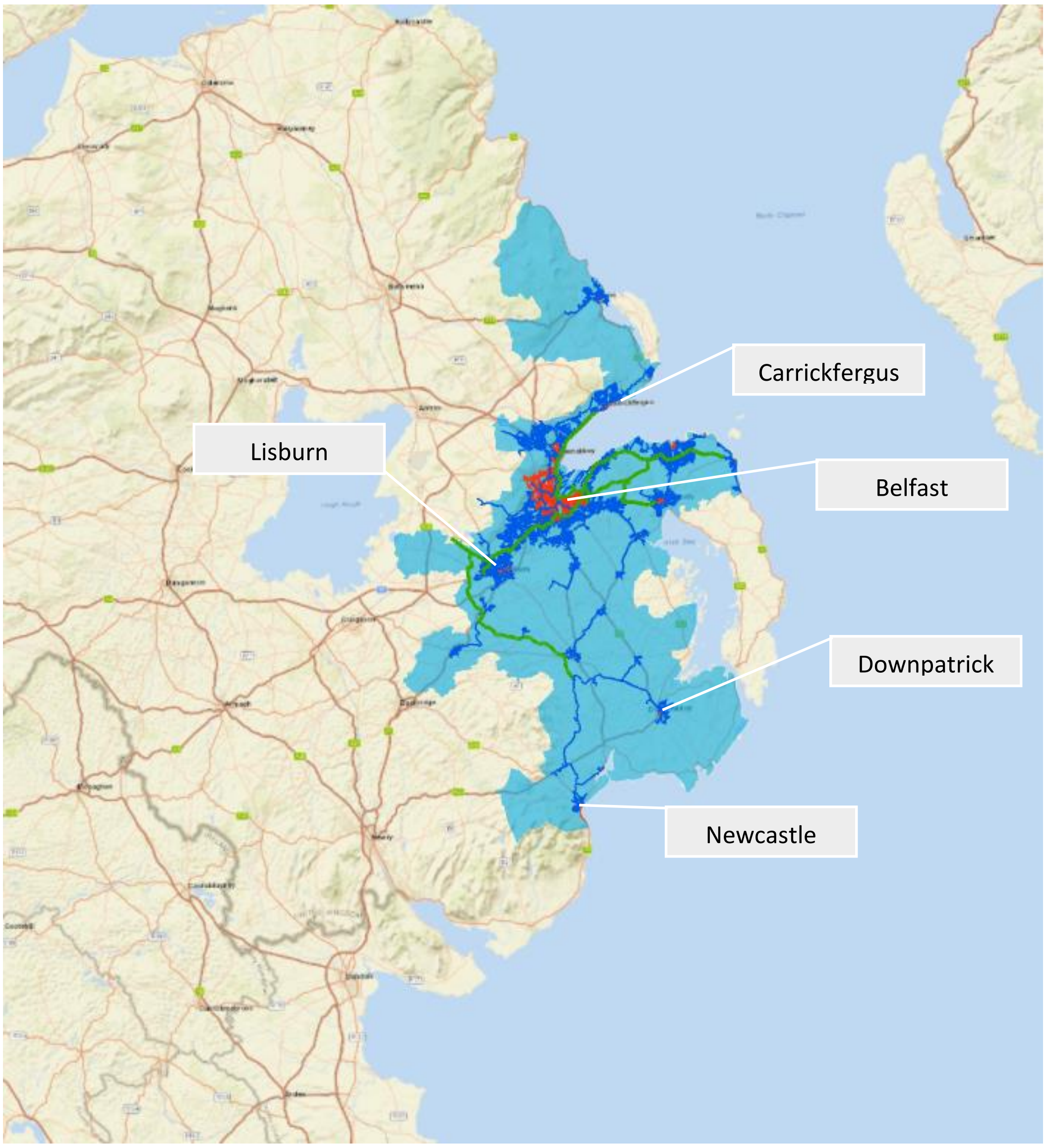

Figure 1 - *the Phoenix Licensed Area is shown in blue*

[1] In this response the words "we", "our" and PNGL are used interchangeably to refer to Phoenix Natural Gas Limited

PNGL holds a perpetual licence, which it was granted in 1996 as the initial greenfield developer of the natural gas distribution market in NI (the 'Licence'). Since that time, PNGL has built a new modern gas network almost exclusively using polyethylene (PE) pipeline technology, a more cost effective and reliable solution in comparison to the steel pipes commonly used in older gas distribution networks elsewhere. This means that, unlike Great Britain (GB), the NI gas distribution network is already well placed to transport low carbon fuel alternatives such as biomethane or hydrogen blends.

The gas network is a secure way of delivering energy to properties. A fundamental part of the PNGL business plan has been to extensively develop all sectors of the market, delivering the benefits of natural gas to homes and businesses throughout its Licensed Area. To that end, PNGL has had a clear focus in meeting (and in fact exceeding) its licence obligations in respect of coverage of the network. At the end of 2021 PNGL's network comprised c.4,000km of intermediate, medium and low-pressure mains, making gas available to 358,456 potential properties of which 244,253 are already connected. This represents a 68% penetration rate of total available properties in PNGL's Licensed Area (vs. 85% in GB)[2].

Snapshot of the PNGL network at the end of 2021

c.4,000km of mains

Gas available to 358,456 properties

244,253 connections

Not only has PNGL achieved its strategic goals and operational success, it has also taken particular pride in being recognised for its outstanding safety and corporate social responsibility performance.

PNGL's Network Performance and Reliability

A key aim for PNGL is to deliver a safe, secure, high-quality and highly efficient network in line with its corporate objectives and its Licence obligations. PNGL's asset management system manages and delivers the operational and capital investment plans required to achieve the optimum performance from its network. Indeed in 2017 PNGL attained ISO 55001 (Asset Management System) accreditation with its asset management system subject to an annual independent audit thereafter to ensure PNGL's ongoing compliance and certification.

[2] Cornwell Energy "Competition in British household energy supply markets" (October 2014)

PNGL's control systems provide a comprehensive and appropriate means for it to manage its network and gas supplies transported through it. PNGL's telemetry installations provide 24/7 remote monitoring of the network and enable it to identify and manage issues when they arise on the network and rectify these as quickly as possible.

PNGL is also required under Licence, and in co-operation with the other gas distribution network operators (GDNs), to maintain a 24-hour emergency service. Phoenix Energy Services Limited (PES) provides PNGL's initial 24/7 emergency response and utilises other local providers to supplement its workforce where required from time to time.

PNGL is party to a mutual aid protocol with three of NI's other strategic infrastructure providers, BT, NIE Networks and NI Water. This protocol is in place to ensure that, during exceptional events, critical infrastructure providers work together to share assets and resources and to aid quick restoration of service for the greater good of the NI population and economy.

Corporate Social Responsibility

Within PNGL, Corporate Social Responsibility (CSR) is entwined with the business strategy, sitting comfortably alongside a long-term, sustainable business which is creating real, economic, social and environmental value:

- PNGL has been recognised as a global leader for its environmental, social and governance performance by GRESB in its Infrastructure Assessment. 2021 was the sixth year of participation by PNGL, who in addition to scoring 97% and being global sector leader for gas distribution companies, maintained their maximum 5-star GRESB rating and were placed in the top ten of the 549 companies who took part across the globe.

- PNGL is listed as one of the top scoring companies in the 2021 Business in the Community's Environmental Benchmarking Survey, achieving Platinum status.

- In achieving Gold CORE accreditation, from Business in the Community NI, PNGL has shown evidence of strong procedures that drive performance forward in all the key CSR areas of People, Planet and Place.

PNGL published its 2020 Responsible Business Report in June 2021, detailing how it undertakes its business activities and creates additional value in the communities it serves. The report included key metrics and examples demonstrating the long-term, sustainable approach PNGL takes across its operations to create positive economic, social and environmental impacts for its customers, colleagues and communities. The Phoenix Natural Gas Responsible Business Report can be found at: www.phoenixnaturalgas.com/about-us/phoenix-group/corporate-responsibility

1.1 PURPOSE OF THIS RESPONSE

Our business is regulated under licence by the NI Authority for Utility Regulation (the Utility Regulator, UR). UR carries out price controls on PNGL and the other network companies in NI to ensure that we remain amongst the most efficient operators in the UK.

The GD23[3] price control process formally commenced[4] with PNGL and the other network companies making their Business Plan submissions in June 2021[5]. PNGL's GD23 Business Plan was developed to deliver upon its Corporate Vision and Objectives detailed in Figure 2:

[3] The GD23 price control runs for six years from 2023 to 2028

[4] Following engagement with UR on its June 2020 discussion document on its overall approach to the GD23 price control

[5] The results of PNGL's financeability assessment were detailed in an addendum to its June 2021 *GD23 Cost of Capital paper* and submitted to UR in July 2021

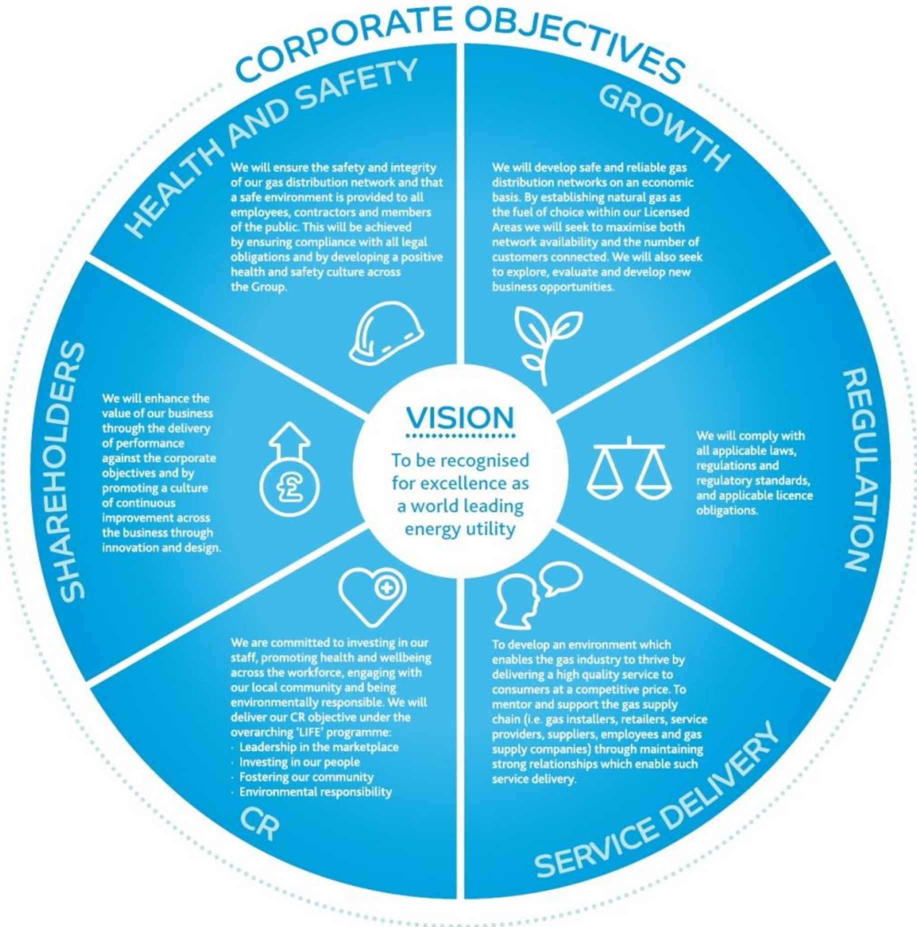

Figure 2 - *Our Vision and Corporate Objectives*

The information provided in June and July 2021 was extensive. PNGL has subsequently responded in a detailed and efficient manner to UR's information requests and has co-operated in all discussions with UR throughout the review.

PNGL welcomes the opportunity to respond to UR's consultation on its price control for NI's Gas Distribution Networks ('the consultation' or 'the draft determination').

PHOENIX
NATURAL GAS

Executive Summary

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2. EXECUTIVE SUMMARY

UR's proposed price control package is flawed and fails to strike the right balance between the need to ensure a high level of protection of the interests of consumers of gas and the need to ensure that PNGL is able to finance its activities, both aspects to which UR must have regard, on an equal footing, when carrying out its functions pursuant to section 14(2) of The Energy (Northern Ireland) Order 2003. PNGL considers that in adopting the GD23 draft determination in its current form UR has failed to comply with its statutory duties.

PNGL has already taken the opportunity to inform UR of a number of concerns which we, our Shareholders and our Board has with the draft determination during the consultation period and which if unaltered would not permit PNGL to effectively run its business in GD23 and beyond, nor deliver the type of positive outcome consistently achieved for the NI consumer over the past 25 years.

PNGL's key areas of concern with UR's draft determination include rate of return, financeability, Advertising and Market Development (OO), capital investment and frontier shift.

In many areas, PNGL is concerned by the lack of meaningful engagement with UR throughout the price control process particularly in areas where there is major divergence between the plan submitted by PNGL and the conclusions reached by UR within the draft determination.

Whilst we have provided UR with extensive evidence to support our GD23 Business Plan both as part of the Business Plan submission and through the information request process thereafter, it would appear that this evidence has not been assessed by UR and has simply been disregarded or misunderstood. In many respects, the draft determination fails to provide a clear account of how UR has considered the evidence provided and why it is appropriate to disregard it or how its evidence is better in supporting an alternative approach. An example of this is the move from a connection incentive to a cost to serve approach in advertising and market development for owner-occupied connections where UR's decision contains assertions without any evidence of an impact assessment having been conducted of how the change is going to affect development of (and rate of new connections to) the gas network. This lack of transparency and due consideration to PNGL's submissions and views puts the certainty and robustness of the regulatory process and the GD23 draft determination into question.

This has meant that the draft determination is misguided in many places, and that UR's evidence and reasoning to dismiss aspects of PNGL's Business Plan is weak and fails to consider the long-term impacts of UR's decisions. UR has made a number of errors in its modelling and benchmarking. While it has recognised some of these in the Financeability Addendum, it has chosen to merely re-affirm its original conclusions therein without providing any additional evidence as to why those errors do not warrant a change in the financeability assessment or the allowed cost of capital.

The issues and errors identified by PNGL in this response are many and not new. We have highlighted these throughout the process from submission of the Business Plan up until the date of submitting this response. In essence, the following need urgent reconsideration in advance of the final determination:

1. **Rate of Return (Cost of Capital):** The GD23 draft determination proposes a cost of capital, which is the lowest rate of return ever determined by a UK Regulator or the CMA for a utility business. Decisions taken by UR in reaching its draft determination have completely ignored evidence presented by PNGL and appear to be based on settling on the lowest available values for each of the key components of the cost of capital, without proper explanation and due consideration to why that would be the most appropriate focus. UR's approach produces a cost of capital figure that is significantly below relevant benchmarks, out of line with the specific risks associated to the business and entirely insufficient to meet PNGL's future business requirements, most notably financeability as described below.

   In its Financeability Addendum, UR claims to have reviewed its GD23 rate of return in light of the error in its financeability calculation and indeed then seeks to justify the decision it has taken in the draft determination without amending its position on cost of capital. It is somewhat difficult to believe that if UR had been aware of the impact of the calculation error before the draft determination was issued, it would not have altered the rate of return presented to PNGL as a reasonable outcome. At the very least PNGL would have expected UR to undertake further work to understand why the proposed rate of return was so hugely different to applicable benchmarks and engage with PNGL on the matter.

   The failure by UR to provide an updated view of cost of capital post identification of the financeability calculation error is a sign of a flawed regulatory process and results in an incomplete draft determination which has hindered PNGL's ability to fully respond to the consultation.

2. **Financeability**: PNGL identified fundamental errors in the financeability calculation within the GD23 draft determination, which have resulted in a proposed determination that would make our business not financeable across the GD23 period and thereafter. Rating Agencies have identified the same error and have concluded that the overall price control package is insufficient to maintain the financial ratios used to determine the necessary investment grade credit rating[6] and necessary capacity in the debt mechanism to deliver a financeable determination.

   "Fitch's preliminary forecast suggests a material deterioration in interest cover metrics, well below the thresholds that are commensurate with the rating."[7]

   This has resulted in PNGL being put on negative watch.

   PNGL has advised UR during the consultation period following the draft determination of the financeability calculation errors which UR has accepted. Although UR has subsequently issued

[6] See PNGL Licence condition 1.22.5

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

a Financeability Addendum[8] to the draft determination to correct the calculation error, the addendum fails to deliver appropriate solutions and certainly fails to demonstrate how UR fulfils its statutory duty to ensure PNGL can finance its activities, instead opting to place all responsibility on PNGL to address the financeability gap arising. The methods proposed by UR in the addendum are either outside our control i.e. in the case of how rating agencies assess credit worthiness or require the use of methods which are well outside the realms of regulatory precedent and reasonableness i.e. a significant injection of equity and a material reduction to gearing levels, well below existing levels, the levels used by UR to determine its own cost of capital determination and substantially below any relevant benchmark. It is therefore somewhat disappointing that UR has taken the opportunity to fix its calculation error but failed to correct the more fundamental errors within its cost of capital calculation (see above) and has instead chosen to claim, without any evidence, that those errors do not affect its views in its draft determination.

Moreover, UR has failed to follow its own guidance with regard sensitivities to ensure the robustness of its financeability assessment, which together with the inadequate approach to financeability in the draft determination and the subsequent addendum has simply compounded the matter.

3. **Operating Expenditure:** Overall UR has proposed operating expenditure (opex) allowances which are c.18%[9] lower than PNGL's submitted cost forecasts for GD23 and are simply too low across various areas of activity in order to run the business in an efficient and effective manner. In some areas costs for ongoing activities currently incurred by PNGL have simply been disallowed and in others cost forecasts have been rejected without any real rationale or explanation for doing so. We consider that cuts of this scale are unjustified, and result in significant downside risk being placed on PNGL and will hinder PNGL's ability to continue to deliver for consumers.

4. **Advertising and Market Development (OO):** UR proposes to move from the current Connection Incentive to what it describes as a Cost to Serve model. In response to this concept in our GD23 Business Plan submission, we outlined that there are fundamental reasons why the introduction of a Cost to Serve model during the GD23 period does not best serve the investment made in the gas industry to date, nor does it recognise the economic, social and environmental benefits of optimising switching householders away from high polluting home heating oil. UR's proposed approach appears inconsistent with its statutory objective to '*promote the development and maintenance of an economic and coordinated natural gas industry*' and is out of step with DfE's NI Energy Strategy, which recognises that *"As natural gas has lower emissions than oil we will continue to encourage people with access to the gas network to connect to it."*

   PNGL believes that it may be possible to move to such a model whilst still retaining the concepts which have enabled it to successfully develop the market to this point and most

[8] https://www.uregni.gov.uk/files/uregni/documents/2022-04/gd23-dd-financeability-addendum.pdf
[9] Table 5.1 of the consultation

importantly facilitate the type of growth needed to support energy transition targets over the next decade. The manner of the proposed move to a Cost to Serve model therefore needs urgent reconsideration and proper consultation, to avoid significant negative impact on the growth of the gas industry by curtailing PNGL's incentive opportunities and ability to promote new connections for OO premises. This in turn would be detrimental to both consumers and the implementation of the NI Energy Strategy[10].

UR's approach is also out of step with that of a "reasonable" regulator who follows best regulatory practice. It has failed to justify or assess the impact of this change on PNGL's incentives (and resulting OO connection requests for GD23). We note, for example, that when other regulators, e.g. Ofwat and Ofgem, look to introduce for the first time a regulatory tool and/or a shift in the way they measure costs, this is usually set out early on in the price control process (at the methodology stage) thus allowing for extensive dialogue and time to conduct the appropriate impact assessments required for such novel approaches.[11]

5. **Capital Investment:** UR has provided insufficient capital expenditure (capex) to allow PNGL to deliver its necessary programme of works during the GD23 period. UR's draft determination sees both unjustified cuts in unit rates relative to those proposed by PNGL together with a disallowance of actual capital spend. This is an area where PNGL presented significant evidence and undertook extensive engagement with UR on its engineering approach and proposed outputs in advance of the draft determination. However, at no point in those discussions were unit rates highlighted as a concern by UR or was an opportunity given to PNGL to respond to any objection to our proposed unit rates for delivering such outputs.

6. **Our People:** UR has not provided sufficient people resource to allow PNGL to deliver its GD23 Business Plan. This has largely resulted from UR's overreliance on 2020 actuals, a year that was heavily impacted by the COVID-19 pandemic, as the basis for determining resource requirements across the GD23 period and an inappropriate methodology applied by UR to calculate the number of FTEs available to support capital and maintenance workstreams. The implication of UR's draft determination across the GD23 period is to disallow:

   - 7 FTEs included within PNGL's opex forecasts; and

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

[11] See Ofwat's PR14 final methodology document at section 1.5.1 regarding retail price controls by reference to cost to serve, available here: https://webarchive.nationalarchives.gov.uk/ukgwa/20150624091829/http:/ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf; see also "Annex 3 Finance" of the RIIO-2 sector specific methodology decision when it comes to the introduction of the outperformance wedge (which we note that, eventually, was overturned by the CMA) at paras 3.62 onwards: https://www.ofgem.gov.uk/sites/default/files/docs/2021/03/riio_ed2_ssmd_annex_3_finance_0.pdf

- a further 7 capitalised FTEs within its capex unit rate proposals.[12]

PNGL also raises concerns with the implications of ongoing allocation of FTEs to AMD mechanisms.

7. **UR's baseline for determining allowances:** As UR is aware, COVID-19 had a significant impact on PNGL's business operations in 2020. Throughout PNGL's 2020 Performance Report in its Commentary to its 2020 Annual Cost Reporting submission, PNGL sought to highlight any effect this had on its business operations and expenditure in 2020. In PNGL's GD17 review[13] it forecast the ongoing effect of the pandemic on its business operations and expenditure in 2021 and 2022. However, this does not seem to have been recognised by UR in its draft determination where 2020 has often been used as the baseline year for its GD23 forecasts. PNGL notes that it is unreasonable to take 2020 as a benchmark year for the remainder of GD23 without proper consideration for the impact of COVID-19 as PNGL has done in its Business Plan. The exceptional nature of COVID-19 for the purposes of setting baselines was recognised by the CMA itself in its PR19 final determination. The CMA considered that COVID-19 adjustments needed to be made but it was comfortable not addressing those impacts in its own determination because it was still too early to know the full extent of those impacts and it was clear that the industry and the regulator were going to tackle these as part of the normal price control regulatory cycles. PNGL has identified a number of concerns with UR's choice of baseline in this response and urges UR to consider the (lack of) appropriateness to use such an unusual year as 2020 as the benchmark to determine what GD23 would look like without adjustment.

8. **Changes in advance of the final determination:** PNGL notes UR's indication that its position on some aspects of its draft determination may change in advance of the final determination[14]. This is unacceptable and leads to uncertainty both for PNGL and consumers. It does not allow PNGL to fully appraise and respond to the impact that the GD23 settlement as currently proposed might have on its business and its ability to carry out its functions in an efficient, sustainable and economical way. Although, PNGL is willing to provide any further evidence requested by UR to enable UR to reassure itself that the allowances proposed in its draft determination are appropriate, this approach adopted by UR removes transparency from the consultation process and PNGL would question the reasonableness of such an approach. It is therefore critical that PNGL has advance sight of any change to UR's draft determination proposals to allow it the appropriate opportunity to respond in advance of UR's final determination.

As it currently stands, the draft determination not only has a number of errors and flaws, but it also presents PNGL with significant challenges around its ability to finance its activities while being able to deliver the investment required for a sustainable and high quality gas network and in support of the

[12] Note, this excludes the 11 management resources of PNGL's construction contractor that UR has disallowed (see Table 11) within the capex unit rates

[13] Section 2 of PNGL's GD23 Business Plan

[14] e.g. paragraph 5.76 of Annex D

NI Energy Strategy. The draft determination lacks the required rigour when it comes to justifying why certain approaches are better than others, especially when there is a departure from the approach taken by UR (and other regulators) in the past to similar questions.

When it comes to financeability, UR seems to expect that PNGL and its shareholders must take a number of steps which could resolve any financing gap, but it fails to recognise that many of these steps are neither short-term strategies to be implemented on time for GD23 nor within PNGL's or its shareholders' control.

Unless there is a shift in some of UR's approaches and decisions for GD23, PNGL will face significant challenges to be able to deliver for consumers in GD23 in a financially sustainable way. We therefore urge UR to be open and transparent, and work with us over the coming weeks to make sure that the flaws in the process and failure to assess the impact of some of UR's conclusions to date, including the errors identified by PNGL, are addressed and amended so that the final determination leads to a package which is robust and fair for consumers yet financeable thus ensures the future viability of the gas distribution networks in NI.

As set out in this response UR has made numerous errors when assessing the evidence presented by us. We also believe the draft determination is flawed because it makes assumptions about our business and financial position which are wrong and unsupported. We are disappointed at the manner in which UR has run the GD23 process to date and the lack of engagement and feedback on important business aspects which will have a significant impact on PNGL's business and its plans for GD23. As it currently stands PNGL will not be able to finance the GD23 Business Plan put forward in June last year. If the final determination does not take into account the issues we have raised in this response and throughout the GD23 process we will not be in a position to accept it and will have to consider all options available to us.

Sections 2.1 to 2.5 provide an outline of PNGL's key areas of concern with the draft determination if it were to be confirmed in the final determination.

2.1 RATE OF RETURN

PNGL engaged NERA Economic Consulting (NERA) to respond to UR's rate of return proposals set out in the draft determination. NERA's *"Cost of Capital and Financeability Assessment for PNGL for GD23"* report is provided at Appendix 1.

Rate of Return (pre-tax CPIH)

In summary the rate of return of 2.59% (pre-tax, CPIH) is significantly lower than recent pronouncements by Ofgem in RIIO-2 of 3.49%, (adjusted to reflect a similar pre-tax CPIH return) and well down on the 4.49% (pre-tax, CPIH) included by PNGL in its submission (revised to 4.13% to reflect the common information date in UR's draft determination).

It therefore should be of little surprise that such a significant reduction creates financeability issues for PNGL (see section 2.2).

We have identified a number of errors in the UR's cost of capital estimate which explains the difference in our two estimates. As UR itself shows, without correcting for these errors, PNGL is not financeable.

Extract of Summary Table from NERA Report

Table 7.1: We estimate a point estimate cost of capital of 4.13 per cent – relative to UR's proposed cost of capital of 2.59 per cent at the bottom of its range

Real CPIH	NERA and PNGL (UR information date)		UR DD	
	Low	**High**	**Low**	**High**
Gearing	60%	60%	55%	55%
RFR	-0.57%	-0.57%	-1.1%	-1.1%
TMR	6.75%	7.50%	6.5%	6.5%
Asset beta	0.39	0.41	0.33	0.37
Debt beta	0.075	0.075	0.075	0.075
Equity beta	0.85	0.90	0.64	0.73
Cost of equity (post-tax)	**5.66%**	**6.69%**	**3.78%**	**4.45%**
Aiming up	0.25%	0.25%	0.00%	0.00%
Cost of equity (post-tax)	**6.41%**		**3.78%**	**4.45%**
Tax rate	24.75%		24.75%	24.75%
Cost of equity (pre-tax)	**8.52%**		**5.02%**	**5.92%**
Cost of debt (pre-tax)	**1.20%**		**0.60%**	**0.60%**
WACC (vanilla)	**3.29%**		**2.03%**	**2.33%**
WACC (pre-tax)	**4.13%**		**2.59%**	**2.99%**

Source: NERA analysis

The summary conclusions from NERA's report are detailed below:

Cost of Equity

As set out in the table above, UR calculates a real post-tax cost of equity of 3.78 to 4.45 per cent, but proposes a point estimate at the bottom-end of its range based on its assumed low beta risk. By contrast, we calculate a cost of equity for PNGL, updated for UR's information date of September 2021 for comparison, of 6.41 per cent.

A summary of the multiple errors in UR's approach to cost of equity are detailed below:

- Beta: UR errs in setting a beta estimate in the low-end of First Economics (FE) estimated range of 0.33 to 0.37, by relying on totex:TRV measures and ignoring PNGL specific risks;
- Beta: UR makes an error in not recognising higher beta risks for PNGL;
- Beta: PNGL's beta risk has increased relative to GD17, not diminished;
- Beta: UR errs in its baseline beta of 0.35, by relying on water sector evidence and/or long-term evidence;
- RFR: UR errs in failing to provide an adjustment for expected forward rate increases in its RFR estimate; and
- TMR: UR errs in making a downward adjustment to CMA TMR of 6.8 per cent.

Cost of Debt

NERA has identified errors in UR's cost of debt allowance that lead to underestimation of PNGL's cost of debt. These are:

- UR's apparent computational error in calculation the nominal cost of embedded debt;
- UR's exclusion of cost of carry from the additional cost of borrowing allowance; and
- UR's exclusion of a PNGL premium for and reliance on an iBoxx benchmark index with a tenor of 7-10 years, below the benchmark tenor of GB energy networks of 10-years or more.

Using the same embedded/new debt approach, but correcting for UR's errors as described above, we estimate PNGL's cost of debt allowance should be 1.20 per cent in real CPIH terms, 60bps above UR's point estimate of 0.6 per cent (real CPIH), as shown in the Figure 3below from the NERA report.

Figure 3: We forecast a cost of debt allowance for PNGL of 1.2 per cent compared to UR 0.6 per cent, based on UR's information date

		NERA	UR PNG
[A]	Average interest costs	1.92%	1.90%
[B]	Additional costs	0.48%	0.33%
[C]=[A]+[B]	Cost of embedded debt (nominal)	2.40%	2.23%
	Cost of embedded debt (real)	0.29%	0.13%

		NERA	UR PNG
[D]	Current market rates	2.35%	2.10%
[E]	Forward adjustment	0.39%	0.40%
[F]	PNG premium	0.40%	-
[G]	Additional costs	0.48%	0.33%
[H]=[D]+[E]+[F]+[G]	Cost of new debt (nom	3.62%	2.83%
	Cost of new debt (real)	1.49%	0.71%

	NERA	UR PNG	
[I]	24.2%	25.0%	Weight of embedded debt
[J]= 1-[I]	75.8%	75.0%	Weight of new debt

		NERA	UR PNG
[K]=[C]*[I]+[H]*[J]	Weighted average cost of debt (nominal)	3.33%	2.68%
[L]	CPI Inflation over GD23	2.1%	2.1%
[M]=((1+[K])/(1+[L]))-1	Weighted average cost of debt (real)	1.20%	0.6%

Note: Our cost of debt methodology is the same as NERA June 2021 cost of capital report, other than we have updated RFR and cost of debt for UR's cut-off date of 30 September 2021 and present values in CPIH real terms.

2.2 FINANCEABILITY

PNGL engaged NERA Economic Consulting (NERA) to respond to UR's financeability assessment set out in the draft determination. NERA's *"Cost of Capital and Financeability Assessment for PNGL for GD23"* report is provided at Appendix 1.

The conclusions of this financeability assessment are detailed below:

Following its necessary correction to the calculation of the PMICR, UR's own analysis shows that the critical PMICR is far below the threshold PMICR for Baa2 of 1.4.

We have identified a number of concerns with UR's financeability test which further reinforce the conclusion that PNGL is not financeable on a notional basis over GD23.

- UR has calculated ratios based on its assumed cost of debt on average over the control period; calculating ratios based on the profiled debt costs demonstrates further weakening of ratios over the price control period;
- UR also needs to ensure that PNGL meets critical ratios over the entire period - PNGL's ratios deteriorate even further towards latter part of the period given expected increases in debt costs;
- We also note that UR's assumed threshold for Baa2 of 1.4 is a lower bound ratio, and indeed Fitch's lower bound threshold is higher at 1.5;
- UR should also consider PNGL's financeability in downside scenarios, and in particular, adverse movements in the market cost of debt, given PNGL will refinance 100 per cent of its debt over GD23; and
- Finally, we consider that the notional gearing should be 60 per cent consistent with market evidence on the efficient notional structure.

UR's proposed solutions to the failed financeability test are not viable. UR suggests that the PMICR should be redefined or ignored, and instead the positive cash-flows from the PA and regulatory depreciation should be recognised in terms of the potential to provide additional interest coverage. However, the rating agencies necessarily adjust PMICR to unwind PA timing differences, as well as any differences between capital expenditure and depreciation, to ensure PMICR provides a long-term measure of financeability. Such adjustments are not unique to PNGL, but the rating agencies make analogous adjustments in other regulatory settings such as GB water and energy. The CMA has also made analogous adjustments at PR19. UR also requires PNGL to maintain an investment grade rating as a Licence condition, and UR must therefore use the rating agencies' methodologies to allow PNGL to attain the required rating.

UR is also wrong to suggest PNGL should address financeability through de-gearing; the financeability test must be undertaken at notional gearing level which, at 55 per cent, is already below market evidence for the efficient level of gearing for energy networks. We also note that CPI index linked debt (ILD) issuance may not be viable given the nascent market; it is also more costly, with Ofgem allowing 30 bps premium at RIIO-2.

As described by the CMA, the financeability test is designed as a crosscheck on the point estimate for the cost of equity. It is clear from UR's own analysis that PNGL does not meet the financeability test, and therefore elements of the cost of equity (and cost of debt) determination should be revisited by UR. UR apparently ignores this inevitable conclusion.

Furthermore, PNGL notes in the addendum the reference to tax and we would advise that the lack of detail in the addendum and indeed consultation on the issue of tax in the GD23 process, does not permit PNGL to meaningfully comment on the addendum claims regarding historical treatment of tax and, as a result, PNGL cannot accept UR's assessment of historic tax as set out in the addendum. Furthermore, PNGL rejects the view that UR has taken that they cannot consider a different approach *"going forward"* given their claims that historically *"tax allowances have exceeded payments"*. For this reason, we reserve our position regarding any future change in approach by UR and urge UR to consult meaningfully at that time.

2.3 ADVERTISING AND MARKET DEVELOPMENT (OO)

Section 3.3 discusses PNGL's concerns with UR's draft determination for Advertising and Market Development (AMD) allowances available under the Owner Occupied (OO) connection incentive. In summary:

It is imperative that the mechanism utilised by UR to set operating cost allowances available for both the support to and development of the OO market (AMD(OO)) actually provides PNGL with sufficient allowance to enable the natural gas market to continue to grow.

No consultation or evidence of any impact assessment has been made available to PNGL. A significant shift in methodology like this one, which could affect the rate of new connections in GD23 and beyond, necessitates a degree of evidence and support that UR has simply not provided or included in its draft determination. PNGL submits that this is not in keeping with the principles of good regulation.

The cost to serve AMD mechanism proposed by UR is not fit for purpose:

- UR has made errors both in failing to factor in the inevitable decline in OO connections due to a reduction in early adopter activity (due to reduction in network development during GD23) and in consideration of the impact of its proposed reduction in AMD(OO) allowances;
- PNGL strongly disagrees with the limited evidence that has been provided by UR which suggests that the cost of securing new connections to the PNGL network during GD23 is '*becoming uneconomic*'[15] thereby is some way appearing to limit the level of allowance UR has granted;
- PNGL is not aware of the rationale for further limiting these allowances across GD23 via a cost to serve AMD mechanism where wider environmental, social and economic factors would point to an even greater need for AMD support to optimise OO connection levels;
- The implication of the reducing allowances across GD23 will severely impact on the actual level of connections deliverable aside from necessary support costs with little or no market development expenditure as early as year two of GD23 and connections significantly lower as a consequence; and
- UR's introduction of a cost to serve AMD mechanism will irreversibly end market growth across the OO sector.

The result of UR's position is that the draft determination is inconsistent with UR's statutory obligation "*to promote the development of an efficient, economic and co-ordinated gas industry*".

PNGL would request that UR considers fully the evidence presented in this response and reflects on the significant impacts that its proposed AMD(OO) allowances would have on the significant market growth opportunities across the PNGL Licensed Area during GD23, that would in turn suppress the future environmental, social and economic benefits that are derived from new connection activity.

[15] Paragraph 2.28 of the draft determination

2.4 CAPITAL INVESTMENT

Section 3.4 begins with PNGL's concerns with UR's approach to determining PNGL's capex allowances for the GD23 price control period. The key areas that PNGL disagrees with are:

- the manner in which UR has assessed the impact in change in mix in capex activities between previous price controls and GD23 and in particular how this change impacts on the absorption of (i) its contractor's management fee and (ii) capitalised opex (management resources employed directly by PNGL); and

- UR's response to recent pressures (principally post 2020) on resources and geographical work shift resulting in above inflationary cost pressures.

Further UR has failed to recognise the specific evidence that PNGL has provided to UR as a result of the open book arrangement in place with its contractor, Kier Construction Services, which clearly demonstrates the impact of these specific issues.

These are discussed in greater detail in sections 3.4.1 to 3.4.3 where PNGL evidences the changes required to UR's draft determination.

In summary, PNGL submits, in line with its Business Plan that:

- the **domestic service allowances** that should be granted by UR for the GD23 period are:

Existing Domestic Service	
2020 outturn cost (Table 4.13 2020 BPT)	*[redacted]*
GD23 unit cost increase	£131
TOTAL	*[redacted]*

New Build Domestic Service	
2020 outturn cost (Table 4.13 2020 BPT)	*[redacted]*
GD23 unit cost increase	£116
TOTAL	*[redacted]*

- the **new build mains unit rate allowance** that UR should grant in its GD23 final determination is *[redacted]*.

The impact of the above issues is material, representing a deficit of £5.2m over the 6-year period of GD23.

In section 3.4.4 we go on to discuss the capex required to undertake the **network reinforcement projects** included by PNGL within its GD23 Business Plan. PNGL submitted six network reinforcement projects (four Intermediate Pressure (IP) network projects and two District Pressure Reduction

Module (DPRM) projects)[16]. The requirements for these projects were based on PNGL's extensive network modelling and historical extreme winter performance analysis. PNGL presented its detailed analysis to UR on 27 September 2021.

Whilst UR agrees the need for the projects, at no point during these discussions or any other stage prior to publication of the draft determination did UR raise any concerns or queries regarding PNGL's forecast unit rates. Had UR discussed with PNGL the commercials of the projects, it would have properly understood the basis of the costs and how to appropriately benchmark these.

UR's flawed approach has ultimately led to a draft determination which does not provide PNGL with the capex required to enable it to complete the four 7 Bar reinforcements and therefore be properly compensated for maintaining security of supply and minimising the risk of gas supply emergencies as a consequence of growing gas demand across its gas network.

PNGL has updated and challenged both its original June 2021 submission and UR's draft determination by going back to actual costs from previous projects and using them as a base to build up a capex forecast based on historic performance. PNGL has also engaged with contractors for project quotations to inform this response. The additional analysis, actually leads to higher costs than those originally submitted as part of the PNGL's GD23 Business Plan. This therefore means that additional allowances would be required, and therefore evidencing that the allowances in the draft determination are simply too low (even more so given current macroeconomic conditions). The methodology and revised costs are explained in detail in section 3.4.4.4 and summarised in *[redacted].*

[16] Table 2 of PNGL's *GD23 Network Reinforcement and Resilience* submission

2.5 <u>FRONTIER SHIFT</u>

PNGL engaged NERA Economic Consulting (NERA) to respond to UR's proposed frontier shift, itself comprising Real Price Effects (RPEs), Ongoing Efficiency (OE) and a forecast of CPIH inflation. NERA's *"Response to GD23 Draft Determination Frontier Shift"* report is provided at Appendix 2.

Whilst the conclusion from NERA's report is provided below, PNGL would also draw on other aspects of its submission to reinforce the comments made by NERA, most notably:

- The very specific inflationary pressures which PNGL has experienced to date are only symptomatic of the wider pressures likely to arise in the years to come. The scale by which UR could get this wrong and the materiality of such is greater in this price control than previously and therefore it is all the more important that baseline allowances are appropriate in the first place.

- PNGL, as consequence of being able to develop with a greenfield environment, has not had any of the constraints of existing legacy arrangements in the way in which it operates. This alongside a focus on innovation and driving of efficiency has enabled it to perform efficiently to date. It is important to be aware as highlighted in our capital expenditure section 5, with workload likely to be more constrained and/or volatile going forward there are significant pressures for costs to rise above inflation in this price control period. Therefore, it is hard to balance this with the inclusion of annual ongoing efficiency factor of 1% in the draft determination.

The conclusion from the NERA report is detailed below:

We find that UR's approach to estimating Frontier Shift materially disadvantages PNGL and does not provide PNGL an opportunity to recover its efficient costs of operating. In particular:

- In setting RPE allowances, UR makes several material errors and omissions within its approach to extrapolating long-term trends.
- UR's overall approach to setting RPEs based on long-term trends is not fit for purpose given respected third-party forecasts of abnormal macroeconomic conditions in the near future. We propose an alternative approach which reflects the likely cost pressures PNGL will face in 2022 and 2023 in line with high inflation forecasts.
- UR's approach to setting an OE target relies exclusively on GB precedent, with no regard for the underlying evidence itself nor the context in which Ofgem made its decision. A robust estimation process, like that we included in NERA2021, points to a much lower OE target, consistent with the reality that PNGL faces as its operations change in nature.

In Table 6.1 and Table 6.2, we derive an alternative Frontier Shift assumption, combining our recommended approaches to RPEs, OE and CPIH.

Table 6.1: Final Frontier Shift Assumption, Opex

	2021	2022	2023	2024	2025	2026	2027	2028
+ Nominal RPEs	6.7%	10.0%	3.1%	2.8%	3.1%	3.3%	3.3%	3.3%
- CPIH	2.5%	7.5%	4.1%	1.6%	1.9%	2.0%	2.0%	2.0%
= RPEs	4.3%	2.5%	-1.0%	1.2%	1.2%	1.3%	1.3%	1.3%
- OE	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%
= Real Frontier Shift	3.9%	2.1%	-1.4%	0.8%	0.8%	0.9%	0.9%	0.9%
(Cumulative)	3.9%	6.1%	4.6%	5.4%	6.3%	7.2%	8.2%	9.2%

Table 6.2: Final Frontier Shift Assumption, Capex

	2021	2022	2023	2024	2025	2026	2027	2028
+ Nominal RPEs	6.7%	10.0%	3.1%	2.8%	3.1%	3.3%	3.3%	3.3%
- CPIH	2.5%	7.5%	4.1%	1.6%	1.9%	2.0%	2.0%	2.0%
= RPEs	4.3%	2.5%	-1.0%	1.2%	1.2%	1.3%	1.3%	1.3%
- OE	0.34%	0.34%	0.34%	0.34%	0.34%	0.34%	0.34%	0.34%
= Real Frontier Shift	3.9%	2.2%	-1.3%	0.8%	0.9%	1.0%	0.9%	0.9%
(Cumulative)	3.9%	6.2%	4.8%	5.7%	6.6%	7.6%	8.6%	9.7%

Source: Analysis above.

Key Issues

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3. KEY ISSUES

UR's proposed price control package is unreasonable and unjustified. PNGL has already taken the opportunity to inform UR of a number of concerns with the draft determination during the consultation period. PNGL's key areas of concern are:

- Rate of Return;
- Financeability;
- Advertising and Market Development (OO);
- Capital Investment; and
- Frontier Shift.

The remainder of this section addresses each of these key areas of concern.

3.1 RATE OF RETURN

PNGL engaged NERA Economic Consulting (NERA) to respond to UR's rate of return proposals set out in the draft determination. NERA's report is provided at Appendix 1.

3.2 <u>FINANCEABILITY</u>

PNGL engaged NERA Economic Consulting (NERA) to respond to UR's financeability assessment set out in the draft determination. NERA's report is provided at Appendix 1.

3.3 ADVERTISING & MARKET DEVELOPMENT (OO)

This section discusses PNGL's concerns with UR's draft determination for Advertising and Market Development (AMD) allowances available under the Owner Occupied (OO) connection incentive.

It is imperative that the mechanism utilised by UR to set operating cost allowances available for both the support to and development of the OO market (AMD(OO)) actually provides PNGL with sufficient allowance to enable the natural gas market to continue to grow.

No consultation or evidence of any impact assessment has been made available to PNGL. A significant shift in methodology like this one, which could affect the rate of new connections in GD23 and beyond, necessitates a degree of evidence and support that UR has simply not provided or included in its draft determination. PNGL submits that this is not in keeping with the principles of good regulation.

The cost to serve AMD mechanism proposed by UR is not fit for purpose:

- UR has made errors both in failing to factor in the inevitable decline in OO connections due to a reduction in early adopter activity (due to reduction in network development during GD23) and in consideration of the impact of its proposed reduction in AMD(OO) allowances;
- PNGL strongly disagrees with the limited evidence that has been provided by UR which suggests that the cost of securing new connections to the PNGL network during GD23 is '*becoming uneconomic*'[17] thereby is some way appearing to limit the level of allowance UR has granted;
- PNGL is not aware of the rationale for further limiting these allowances across GD23 via a cost to serve AMD mechanism where wider environmental, social and economic factors would point to an even greater need for AMD support to optimise OO connection levels;
- The implication of the reducing allowances across GD23 will severely impact on the actual level of connections deliverable aside from necessary support costs with little or no market development expenditure as early as year two of GD23 and connections significantly lower as a consequence; and
- UR's introduction of a cost to serve AMD mechanism will irreversibly end market growth across the OO sector.

The result of UR's position is that the draft determination is inconsistent with UR's statutory obligation "*to promote the development of an efficient, economic and co-ordinated gas industry*".

PNGL would request that UR considers fully the evidence presented in this response and reflects on the significant impacts that its proposed AMD(OO) allowances would have on the significant market growth opportunities across the PNGL Licensed Area during GD23, that would in turn suppress the future environmental, social and economic benefits that are derived from new connection activity.

[17] Paragraph 2.28 of the draft determination

3.3.1 PNGL's GD23 Business Plan submission

PNGL's GD23 Business Plan submission recognised that the Connection Incentive (CI) mechanism, as a means of allowing AMD activity, has effectively supported market growth during consecutive price control periods. The CI mechanism has enabled the necessary investment in market development tactics, engagement with non-connected householders, warm referral of householders to government support schemes and the direct support of new customers through the connection process. PNGL sought a similar level of AMD expenditure during the GD23 period to that actually invested during GD17 and provided a detailed rationale for this continued level within its submission, most notably:

- the c.100,000 unconnected customer base at the start of GD23 being largely consistent with the unconnected customer base at the start of GD17;
- the similar level of underlying OO growth forecast in GD23 to that achieved in previous price controls with the primary difference in forecast connection levels driven by the absence of early adopter connections from network infill activity; and
- the ability of PNGL to undertake effective and efficient investment of the AMD allowance across multi-stranded advertising and marketing outputs that have delivered above target growth across successive price control periods.

PNGL also noted that c.25% of AMD costs related to shared corporate overheads which would be incurred irrespective of the number of OO connections – a point recognised by UR in the draft determination. Reallocating such costs to their underlying cost categorisation reduced PNGL's AMD forecast costs from £1.74m to £1.3m per annum.

Within PNGL's response to the *Connection Incentive Review* information request made in October 2021, PNGL noted that based on the level of growth still required/expected a 'cost to serve' model as defined by UR (see section 3.3.4) would not be appropriate for the GD23 period.

Within this October 2021 response we provided an assessment that the introduction of UR's cost to serve model during GD23 would materially reduce OO connections during the period and prematurely signal the end of optimal market growth in the OO sector.

3.3.2 GD23 draft determination AMD Allowances

We welcome that in the draft determination UR has recognised that Corporate Overheads should not be funded through a CI mechanism (as noted in the figures presented in Table 4) and equally that UR has acknowledged (via the proposal for a fixed £150k annual allowance) that all OO connections require a level of AMD support and in turn a minimum level of AMD expenditure is required to support all OO connection activity.

However, whilst PNGL supports these specific changes to the structure of the CI mechanism, the overall outcome of the proposed draft determination AMD allowances presents an allocation of costs that are materially below those that PNGL submitted as being the minimum amount necessary to continue optimising OO connection growth during the GD23 period.

The cost to serve mechanism proposed in the GD23 draft determination fails to properly consider the extensive detail that PNGL provided in its June 2021 *GD23 Connection Incentive Review* paper that evidenced (i) why the availability of a continued level of spend in AMD is necessary to allow continued OO market growth; and (ii) specifically that a cost to serve model to determine AMD allowances is not consistent with UR's statutory obligation to *"promote the development and maintenance of an economic and coordinated natural gas industry."*

The extent to which PNGL believes the UR approach in this area is fundamentally flawed and does not recognise the critical importance of AMD expenditure in the delivery of OO connections, is highlighted by the fact that whilst UR has presented a draft determination that reduces AMD expenditure by c.40% across the 6-year term, UR only forecast a corresponding decrease of 6% to OO connections, as outlined in the summary tables below[18]:

	2023	2024	2025	2026	2027	2028
PNGL requested allowances	1,323	1,321	1,318	1,278	1,277	1,277
UR Draft Determination	1,218	1,011	822	652	557	517
Variance	(105)	(310)	(496)	(626)	(720)	(760)

Note 1. Figures may not sum due to rounding.

Table 4 - *Summary of PNGL's GD23 Business Plan cost forecasts (excluding Corporate Overheads) vs UR's Draft Determination Allowances*

P1 - Owner Occupied domestic	2023	2024	2025	2026	2027	2028	GD23 Total
Connections proposed by PNGL	4,522	4,159	3,727	3,612	3,502	3,396	22,918
Determined OO connections	4,387	4,073	3,760	3,447	3,133	2,820	21,620

Table 5 - *Summary of PNGL's GD23 Business Plan connection forecasts vs UR's Draft Determination*

3.3.3 UR OO Connection Forecast

PNGL believes that UR has made an error in its forecasting of OO connections that could realistically be achieved across GD23 given the c.40% reduction in AMD costs proposed in the draft determination which leave little to no funds to support advertising and marketing activity once PNGL's core fixed costs are taken into account.

Unfortunately, despite requests from PNGL for sight of the methodology UR applied to reach its OO connection forecast, no analytical evidence has been provided by UR to support its assessment that PNGL could continue to deliver an average of 3,600 OO connections per annum under the restrictive cost to serve model proposed in the draft determination.

[18] Tables 5.20 and 5.21 of Annex D of the draft determination

UR has stated[19] that its glidepath in connections equates to a 60% reduction from 2022 forecast OO connections to those forecast in the final year of GD23, 2028. We believe that UR has used an inappropriate and unsubstantiated benchmark from which to evaluate and in turn forecast the impact of a cost to serve model on OO connection performance. UR has also ignored the body of evidence provided by PNGL as part of its GD23 Business Plan submission and in subsequent information requests.

Furthermore, PNGL forecasts that its effective AMD programme will deliver c.20% of 2022 forecast connections from new network infill projects that have had gas available to them for <2 years (what are known as early adopters). Our historic connections profile (provided to UR as part of our Annual Cost Reporting submissions) demonstrates that in year 1 and year 2 of post infill construction being completed, we are capable of persuading materially higher levels of connection activity, before returning to more typical levels of connection.

PNGL is not scheduled to undertake large levels of network infill during the GD23 period and therefore it is not appropriate to benchmark future forecasts on a 2022 number that is derived from specific market drivers no longer relevant to the GD23 period.

3.3.4 Cost to Serve Definition

The accounting term 'cost to serve' is defined as the actual costs associated with business activities employed in servicing a customer or group of customers.

Therefore, the specific costs associated with a cost to serve model will inevitably be business specific and aligned to relevant features and market growth opportunities within any given marketplace.

Within the GD23 draft determination UR has defined[20] the concept of cost to serve as:

> *"GDNs reasonable costs of responding to contacts and supporting consumers through the connection process, including the cost of energy advisers"*

The UR definition lands on a very narrow view of what costs should be included in a cost to serve model. It does not recognise the continued high level of market growth potential, as recognised by UR in its OO connection forecasts for the GD23 period, and instead the cost to serve model proposed is built upon a variable unit rate, the core purpose of which is to cover the cost of staff who support consumers through the connection process. The AMD mechanism that UR has proposed does not suitably fund expenditure associated with the delivery of optimal connection levels. Indeed, by year 2 of the 6-year price control term, UR's proposed allowance largely funds core staff costs only and does not provide funding for effective marketing or promotional activities. Further detail is provided in section 3.3.5.

[19] Paragraph 4.3 of Annex C

[20] Paragraph 6.133 of Annex D of the draft determination

PNGL believes this to be an error on UR's part that will signal the end of optimal connections growth in its Licensed Area.

3.3.5 Impact of Proposed AMD Allowances on OO Connections

In the draft determination UR has presented a scenario whereby AMD allowances would reduce by c.40% compared to actual AMD expenditure during GD17, and the level requested by PNGL in its submission, however forecast connection levels reduce by only 6% compared to those forecast by PNGL (see Table 4 and Table 5).

Such a scenario is simply not credible and fails to recognise the influence of PNGL's effective utilisation of AMD allowances during recent price control periods and the more challenging marketplace considerations that the GD23 period is likely to present as outlined in PNGL's June 2021 *GD23 Connection Incentive Review* paper, many of which have already materialised, and the supplementary *Connection Incentive Update* information response in October 2021 and *PNGL Connection Incentive Update* paper in January 2022.

It is therefore important to provide additional insight into why a significant reduction in AMD allowances will proportionally impact PNGL's ability to stimulate the marketplace and in turn will lead to material reduction in OO connection growth.

To illustrate the likely impact of this, PNGL has used historic connection data, industry and economic insights and applied a glidepath percentage reduction in OO connections proportionate to the reduced level of AMD spend (as noted in Table 6). The final three years of forecast connection levels are not greater than 33% of the initial PNGL forecast (which assumed continued levels of AMD spend) and is consistent with UR's view in GD17 i.e. its non-additionality assumption that only c.33% of OO connections would happen without the support of AMD allowances. Whilst this is not a view shared by PNGL (we recognise that **all** connecting customers require AMD expenditure) we have used this figure to demonstrate the very stark reality a cost to serve model without advertising and marketing costs would provide.

Indeed, in the final two years of the GD23 period, a percentage of the £150k fixed sum would be required to support staff costs, leading to an AM budget <£150k being available for its intended use during this period.

This glidepath forecasts OO connections decreasing to an average of c.1,890 per annum and c.11,344 total over the price control period – as presented in Table 6:

	2023	2024	2025	2026	2027	2028
UR Forecast Connections (DD)	4,387	4,073	3,760	3,447	3,133	2,820
AM Budget[21]	£735,710	£501,861	£291,389	£161,898	£138,455	£124,611
Impact to Advertising & Marketing tactics	No funds available for Consumer Incentives	No Consumer Incentives & reduced 'Above the line' activity	We now start to see signifcant reduction in above the line activity and targeted marketing	Budget now reduced to core £150k spend on very core collaterals and branding – no funds for targeted market growth activity	Budget now reduced to < £150k spend on very core collaterals and branding – no funds for targeted market growth activity	Budget now reduced to < £150k spend on very core collaterals and branding – no funds for targeted market growth activity
% reduction in OO connections forecast	**20%**	**30%**	**50%**	**67%**	**67%**	**67%**
Updated OO forecast – based on DD *cost to serve model*	3,510	2,851	1,880	1,138	1,034	931

Table 6 - *Impact of reduced AMD budget to forecast OO connections*

3.3.6 The timing of the introduction of a cost to serve model

PNGL does not understand why UR has chosen to introduce a cost to serve model that does not recognise the need for adequate AMD expenditure at this juncture. Whilst we recognise that in a mature marketplace with limited potential to persuade householders to invest disposal income on a discretionary item, a pure cost to serve model may be appropriate. However, this is not a marketplace we recognise nor do we believe is consistent with the significant connection growth opportunities that exist across the GD23 period.

Furthermore, we are disappointed that UR has proposed such a fundamental shift from a mechanism that has previously delivered sustained levels of OO growth, without any form of engagement with PNGL in advance of the draft determination or impact assessment of the consequences of this shift in approach. Despite requests by PNGL for engagement on this critical matter and previous indication from UR that a 12-month review of this critical matter would take place in advance of the GD23 process, such engagement never materialised. This is simply not how good regulation takes place.

[21]AM budget are the AMD costs remaining for Advertising & Marketing purposes once direct and indirect staff costs (see section 3.3.8) are deducted. For note, this includes the fixed sum £150k annual allowance

The detail below outlines why the timing of this proposed c.40% reduction in AMD is an error across a number of industry and consumer related themes:

(i) Does not best serve the investment made in the gas industry to date;

- Whilst PNGL has delivered consistent levels of growth across consecutive price control periods, at the end of 2022 OO penetration levels will be only c.56% which demonstrates a marketplace that continues to have significant growth potential;

- The opportunity to engage with an unconnected customer base of c.100,000 is consistent with the unconnected OO prospect base at the start of GD17. In addition, there has been a considerable shift in market dynamics more recently which will make for a more challenging environment in which to engage this audience and therefore will place an even greater need on an economic level of AMD expenditure. Updated commentary in this regard was provided to UR via PNGL's supplementary *Connection Incentive Update* information response in October 2021 and *PNGL Connection Incentive Update* paper in January 2022;

- PNGL has demonstrated over recent price controls, the optimal level of marketing required to effectively and economically grow the OO market. If PNGL had believed that marketing had limited value, then it would have conserved such expenditure. However, it has consistently maintained marketing expenditure at consistent levels as this has proven beneficial and indeed critical in maintaining conversion rates.

(ii) Does not recognise the economic, social and environmental benefits of optimising the numbers of householders away from high polluting home heating oil; and

- The recently released NI Energy Strategy recognises that *"As natural gas has lower emissions* than oil we will continue to encourage people with access to the gas network to connect to it."22 The decision to introduce such a restrictive cost to serve model, which will materially suppress the opportunity for OO growth, appears at odds with the Department's desire to continue encouraging householders to connect to the gas network;

- The importance of continuing to introduce householders to the range of NI Executive funded social schemes has never been more important. The promotion of these schemes has been largely reliant on PNGL advertising and marketing activity to date;

[22] Page 45, https://www.economy-ni.gov.uk/sites/default/files/publications/economy/Energy-Strategy-for-Northern-Ireland-path-to-net-zero.pdf

(iii) Does not appear consistent with UR's statutory objective to 'promote the development and maintenance of an economic and coordinated natural gas industry'

- PNGL alongside other DNOs, has invested significant capital over the last 6 years in extending the gas network to new areas on the basis that similar penetration levels to those delivered in Greater Belfast could be achieved over a similar period. Without the necessary investment in marketing, these areas will not be capable of proportionally contributing to network distribution costs to the level forecast;

- At a time when other heating industry participants are increasing their marketplace presence (oil boiler manufacturers and heat pump manufacturers), UR is choosing to implement a glidepath from a model that has proven effective in delivering OO connection growth, thereby leaving a vacuum for others to embed their competing messaging and in turn gain traction with the local marketplace.

3.3.7 Justification for proposed change in AMD Mechanism

It is well-established that the evidential threshold for a regulator introducing novel deductions in a price control framework, which depart from regulatory precedent, is high. This was confirmed in the *NPG Determination* on the so-called smart-grid benefits, where the CMA held that a departure from established regulatory practice requires a "*careful consideration*" and "*cogent justification*," especially when this is heavily dependent on the regulator's judgements.[23] UR has changed its approach not only of reducing the AMD as a whole but also moving towards a cost to serve model without providing evidence supporting the need or appropriateness for this change, including the underlying assertions about reduced level of connections.

PNGL was not aware that UR was minded to propose such fundamental, material changes to the AMD mechanism and was only made aware of the UR position in the GD23 draft determination. Indeed, the only rationale provided within the draft determination was the narrative provided on page 1 of *Annex Q (Promoting Connections)* that noted:

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

PNGL does not believe that this explanation provides a reasonable level of insight, evidence nor rationale to support such a radical divergence from a level of funding that allowed PNGL to deliver optimal/above target OO connections across successive price control periods, to a mechanism outcome that signals the premature end of OO market development.

[23] NPG Determination, para. 4.145, 4.139 and 4.140

Furthermore, PNGL strongly disagrees with the evidence that has been provided which allegedly supports that the cost of securing new connections to the PNGL network during GD23 is 'becoming uneconomic'[24].

We have not been provided with any evidence that supports this assessment. Indeed, the associated cost per connection to deliver OO connection growth aligned to the PNGL forecast in its GD23 Business Plan submission (as outlined in Table 7) was below that which UR determined in their own calculation of an economic incentive rate for GD23, outlined in Annex Q of the draft determination.

	23	24	25	26	27	28
PNG Business Plan OO Forecast	4522	4159	3727	3612	3502	3396
Cnx Allowance per customer (£)	**293**	**318**	**354**	**354**	**365**	**376**
Total AMD Budget (£)	1323000	1321000	1318000	1278000	1277000	1277000
Direct Staff Costs	292212	292212	292212	292212	243510	243510
Indirect Staff costs	225446	233476	233532	223242	223295	223359
Costs Available for AM (£)	805342	795312	792256	762546	810195	810131

Table 7 - *Required Connection Allowance per customer based on PNGL GD23 Business Plan submission*[25]

1. To deliver "Total AMD (£)" costs consistent with those that PNGL presented in its GD23 Business Plan, the cost per connection across each OO customer ranges from £293 to £376, across the 6-year term.
2. The cost allowance required per customer increases each year due to a falling level of connections coupled with the fixed costs associated with AMD spend (i.e. the costs associated with an effective AMD strategy are spread across a decreasing level of connecting customers).
3. It is an error however for UR to simply equate decreasing levels of annual OO connections (when compared to GD17) with an uneconomic outcome.
4. It is difficult to comprehend why c.100,000 unconnected households who have not connected to the PNGL network to date, are being afforded materially less investment in encouraging and in turn supporting their connection to the gas network, even though the associated costs of providing this continued market growth remains economic.

3.3.8 Staff Costs

Implicitly the effect of the AMD(OO) mechanism is such that as connections fall, staff costs will form a greater proportion of the overall AMD(OO) allowance thereby resulting in a disproportionate fall in other AMD cost areas across GD23. This issue is accentuated by the fact that as connections fall across

[24] Paragraph 2.28 of the draft determination

[25] See section 3.3.8 for detail on direct and indirect staff costs

the GD23 period, the allowance proposed by UR in the draft determination, rather than rising as would be expected to fund such fixed elements, actually falls.

In Table 7 staff costs have been separated into two different categories:

Direct Staff Costs: These are costs directly associated with new customer connection activity (Energy Advisors visiting householders to support their connection process). The number of Energy Advisors required will vary dependant on annual connection activity *[redacted]*. It is important to note that such reductions are not truly variable i.e. once you reach smaller numbers of connections, a fixed number of Energy Advisors are required to provide the required coverage and response. This again emphasises that the rate per connection should rise rather than fall to offset the effect of reducing connection levels.

Indirect Staff Costs: These are costs attributed to *[redacted]* fixed resources across the business that have a broad set of responsibilities that include areas beyond that of OO Sales & Marketing activities. These have been presented in a separate line in Table 7, as unlike direct staff costs these are not variable and will not decrease in line with OO connection performance and will continue to be key resource requirements within the business, regardless of OO connection performance:

> *[redacted]*
>
> **PNGL requests that consideration is given to the fact when setting the allowance mechanism that these costs are recognised as indirect and therefore do not vary with connections. One option is to remove these costs from the mechanism completely and instead include them as part of core costs. Otherwise it is important to ensure that sufficient capacity exists within the mechanism to meet indirect fixed costs should connections activity not meet forecast levels.**

3.3.9 UR Economic Test

PNGL recognises that in *Annex Q (Promoting Connections)* of the draft determination UR carried out a review of an economic incentive rate.

However, whilst UR decided to replace the existing economic incentive mechanism, it is important to note that PNGL is not supportive of the methodology UR has applied to its calculation and believes if values consistent with established principles were to be applied, the economic incentive rate would be materially above the £410 per connection presented.

For completeness we have provided additional detail on the errors we believe have been made by UR in its presentation of the economic incentive mechanism in Annex Q of the draft determination:

(i) ***The recovery period (i.e. 15 years) is entirely subjective, and with only minor amendment, has significant impact on the calculated OO allowance per connection.*** Indeed, the arbitrary recovery period of 15 years applied to the economic test is in conflict with the current depreciation period for services of 40 years. Furthermore, as recognised by UR in Annex Q paragraph 5.8, if the recovery period was amended from 15 years to 20 years the allowance would increase from £410 to £700, which provides an even greater economic case for continued OO market growth.

(ii) ***PNGL does not recognise the concept of non-additionality.*** UR has implied that it would consider non-additionality alongside utilisation of the economic incentive mechanism. The concept of not allowing any AMD costs for a percentage of connections (33% applied in GD17) is not consistent with UR's approach to a cost to serve model that recognises that all OO connections require some level of AMD expenditure, to support the very basic sales support requirements.

(iii) ***Corporate Overheads*** **-** In Annex Q paragraph 5.9, UR notes that the incentive rates proposed by PNGL are £679 per customer inclusive of corporate overheads. PNGL is confused why UR would misrepresent this incentive rate with corporate overhead costs included given it recognises in the draft determination that corporate overheads should be included in the general opex allowances (recognising that these costs which are fixed and necessary regardless of OO connection performance). The presentation of PNGL AMD allowances in this manner is misleading and presents an unnecessarily inflated view of the per connection rate requested. PNGL costs excluding corporate overhead ranges from £293 per new connection to £376 as highlighted in Table 7.

(iv) ***Additional Opex Costs*** - PNGL does not have detailed information on the economic incentive model and is not familiar with the rationale for every cost that has been applied to the analysis, notably the 'additional opex including maintenance' cost line. However, it would appear unfair to recover marginal costs, including for maintenance, from new customers over the 15-year recovery period.

(v) ***25% Limit*** **-** UR has noted that it continues to believe that limiting the incentive rate to 25% of the determined rate when performance falls below a fixed amount of the total is reasonable. This approach fails to recognise the inherent penal nature of the mechanism in a scenario whereby connections fall below a target level. Given AMD strategies and expenditure are aligned to achieving target levels of connections each year, in the event of a below target performance PNGL would receive a lower AMD allowance. This would detrimentally impact the ability of PNGL to invest in future initiatives designed to reverse the period of lower demand.

(vi) ***Mains Contribution*** **-** The continued inclusion of a contribution to mains costs when investment in mains is sunk investment (i.e. will not increase or decrease as a consequence of an additional connection) is totally illogical in the context of the marginal benefits of adding additional customers. As UR is aware, penetration levels in the OO market remain at only c.56%. Therefore, if the inclusion of a mains contribution results in an economic incentive rate that suppresses further growth opportunities by removing AMD support that could provide a net positive economic contribution to existing distribution and transmission charges, feels counterintuitive and rather short sighted.

3.3.10 PNGL Requests an opportunity to engage with UR on this subject

It is disappointing that UR has chosen not to recognise the importance of sustained levels of AMD expenditure during this period. UR instead appears to have determined that a forecast reduction in future OO connections, brought about by the ending of specific market drivers, should trigger the introduction of a cost to serve mechanism. This approach undermines the opportunity to deliver OO connection potential during the GD23 period and the longer-term opportunity to maximise penetrations levels in the PNGL Licensed Area.

As detailed in this section 3.3, PNGL believes that the introduction of a cost to serve AMD model during the GD23 period is premature and does not recognise the important enabling role that gas infrastructure will play in reaching NI's short and long-term decarbonisation goals. It is also a significant shift from past regulatory practice and UR has not provided sufficient justification or an impact assessment of the consequences and reasons for that shift in approach.

UR has failed to undertake the detailed review of the CI it promised and prior to its draft determination did not take the opportunity to engage meaningfully with PNGL. As indicated during our meeting with UR on 10 May 2022, we would request that further engagement opportunities are provided to allow PNGL to further understand the rationale and drivers for such a fundamental change in approach to this area, and in turn outline the irreversible impacts that a cost to serve model would have to continued growth across the locally natural gas industry during GD23.

3.4 CAPITAL INVESTMENT

PNGL's concerns with UR's approach to determining PNGL's capex allowances for the GD23 price control period are discussed in sections 3.4.1 to 3.4.3 where PNGL evidences the changes required to UR's draft determination.

In summary, PNGL submits, in line with its Business Plan that:

- the **domestic service allowances** that should be granted by UR for the GD23 period are:

Existing Domestic Service	
2020 outturn cost (Table 4.13 2020 BPT)	*[redacted]*
GD23 unit cost increase	£131
TOTAL	*[redacted]*

New Build Domestic Service	
2020 outturn cost (Table 4.13 2020 BPT)	*[redacted]*
GD23 unit cost increase	£116
TOTAL	*[redacted]*

- the **new build mains unit rate allowance** that UR should grant in its GD23 final determination is *[redacted]*.

In the interest of transparency, PNGL is making the underlying data in support of the tables and figures quoted in this section available to UR[26].

In section 3.4.4 we go on to discuss the capex required to undertake the network reinforcement projects included by PNGL within its GD23 Business Plan. Whilst UR agrees the need for the projects, UR's flawed approach has ultimately led to a draft determination which does not provide PNGL with the capex required to enable it to complete the four 7 Bar reinforcements and therefore maintain security of supply and minimise the risk of gas supply emergencies in both new and existing areas of gas demand.

Our response to UR's draft determination of PNGL's overall capex for GD23, including UR's treatment of PNGL's proposed resilience projects and UR's methodological error in the treatment of customer contributions, is provided at section 5.

[26] PNGL supplemental technical evidence provided to UR by email 26 May 2022

3.4.1 DOMESTIC SERVICES

UR's approach to the setting of allowances for domestic connections is fundamentally flawed. If UR implements its proposals at final determination, the allowances granted will not cover the level of costs that will be incurred by PNGL and, contrary to UR's statement in its Executive Summary:

> *The GD23 price control continues to support connections to the gas network by providing for a free connection at the time the connection is made, with the cost of the connection paid for by all consumers over a period of time.*

will work against the public interest (and the interests of consumers of gas) as the proposed allowances will in fact result in domestic customers having to make a contribution to PNGL if they wish to connect their property to the gas network. The key areas that PNGL disagrees with are:

- the manner in which UR has assessed the impact in change in mix in capex activities between previous price controls and GD23 and in particular how this change impacts on the absorption of (i) its contractor's management fee and (ii) capitalised opex (management resources employed directly by PNGL); and

- UR's response to recent pressures (principally post 2020) on resources and geographical work shift resulting in above inflationary cost pressures.

Further UR has failed to recognise the specific evidence that PNGL has provided to UR as a result of the open book arrangement in place with its contractor, Kier Construction Services, which clearly demonstrates the impact of these specific issues.

Each of these will be dealt with in turn.

3.4.1.1 Management Fee and Capitalised Opex

The key error made by UR in its treatment of PNGL's contractor's management fee and the capitalised opex that PNGL attributes to capex activities, is that UR has set allowances on the basis that these two costs are fully and proportionally aligned to the value of works being completed by PNGL. This is not the case, has never been the case and is a clear error on the part of UR. UR has also deviated from its agreed position from previous price controls that these two elements can only change marginally, both upwards and downwards, as workload increases and decreases and cannot fluctuate in direct proportion to the changing workload. Although PNGL has provided a breakdown of the costs incurred in these two cost lines, as well as further supporting information, UR provided no evidence to show what assessment it has undertaken to decide what elements of these cost lines were determined to be inefficient and subsequently disallowed in their proposed GD23 allowances. It is also disappointing that UR chose not to engage with PNGL to discuss such an important element of their thinking and only made PNGL aware of their position in the draft determination.

Table 8 presents the actual capex incurred by PNGL during the GD14 (2014 to 2016) and GD17 (2017-2020) price control periods and its forecasts for the two remaining years of GD17 (2021 and 2022) and GD23.

[redacted]

Table 8 - *Breakdown of PNGL's actual capex (2014 to 2020) and forecasts (2021 onwards)*

As can be seen from Table 8, the combined capitalised opex costs and management fee costs are fairly consistent, averaging *[redacted]*p.a., even though the level and subsequent costs of construction activities is varying each year. In the period:

- 2014-2017 total capex costs averaged c.£13.5m of which capitalised opex and management fee made up *[redacted]*.
- 2018-2020 total capex costs averaged c.£17.9m of which capitalised opex and management fee made up *[redacted]*.

This clearly demonstrates that a large proportion of capitalised opex costs and management fee are fixed irrespective of the level of construction activity. The period 2018-2020 shows that an increase of c.£4m p.a. of capex resulted in an increase of only c.£100k for capitalised opex and management fee. This clearly shows that although PNGL's capex activity increased in 2018-2020 due to the construction of network in East Down (illustrated in Table 9), the level of overall management resources needed to deliver this additional activity only marginally increased. The reverse is therefore also true i.e. with the completion of East Down mainlaying there will only be a marginal reduction in overall management resources employed directly by PNGL (capitalised opex) and indirectly by its construction contractor (management fee).

PNGL has consistently made this position clear to UR at the time of each price control review and UR has consistently agreed with this position. Furthermore, PNGL has clearly demonstrated the fairly static nature of the overall management resource (capitalised opex and management fee) through the provision of its actual cost information as part of the Annual Cost Reporting (ACR) process.

Although PNGL manages its construction activity on an actual cost basis, whereby costs of managing the activity (capitalised opex and management fee) are kept separate to the costs of constructing the activity, UR effectively requires PNGL to provide it with a fully grossed-up construction rate for each activity which encapsulates an apportionment of capitalised opex and management fee. PNGL has therefore presented the information in its ACR submissions as requested by UR but this leads to the position whereby the grossed-up activity rates viewed by UR are only correct for the year in which they were incurred given PNGL's apportionment of capitalised opex and management fee over the actual level of activities incurred each year. When the actual activity numbers change from year to year the level of apportioned capitalised opex and management fee attributable to each activity has to change also in order to fully apportion the constant level of these two cost lines *[redacted].*

As part of its GD23 submission, PNGL provided detail on its forecast level of activities during the GD23 price control period. PNGL also forecast that these activity levels would only result in a marginal reduction of capitalised opex and management fee i.e. to *[redacted]*, a reduction of c.£100k p.a. This was, as can be seen from Table 8, due to the average level of construction costs during GD23 falling back towards the levels incurred during 2014-2017 i.e. the average annual costs in GD23 are forecast at c.£15m p.a. with a total capitalised opex and management fee cost of *[redacted]*. This is in stark contrast to the management fee and capitalised opex allowances determined by UR in the draft determination through its proposed unit rates which equates to an average of only *[redacted]* (shortfall of c.£822k p.a. per section 3.4.1.1.1). UR's assertion that management fee and capitalised opex should reduce proportionately in line with overall capex investment is clearly flawed as (i) historical evidence clearly shows this not to be the case; (ii) UR has departed from its position at previous price control determinations where it accepted the static nature of PNGL's overall management resource. UR's draft determination therefore is flawed and appears to be an opportunistic approach to provide PNGL with insufficient allowances.

It is also worth noting from Table 9 that the average annual number of activities in GD23 are significantly higher than those previously incurred in the period 2014-2017 i.e. c.24,000 p.a. compared to c.17,000 p.a. UR's flawed approach to setting the level of management fee and capitalised opex would imply that the average level during GD23, based on its forecast level of activities, would actually be *[redacted]*. (24,000/17,000 x *[redacted]*). This would also be clearly incorrect.

	2014	2015	2016	2017	2018	2019	2020	2021	2022	GD23 DD Average
Properties Passed	**5,629**	**5,842**	**5,789**	**7,262**	**7,364**	**9,109**	**7,821**	***7,100***	***5,541***	***3,117***
New Build	1,599	1,860	2,151	2,563	2,375	2,143	1,987	*2,000*	*2,200*	*2,000*
Existing	4,030	3,982	3,638	4,699	4,989	6,966	5,834	*5,100*	*3,341*	*1,117*
Connections	**11,094**	**9,668**	**8,641**	**8,594**	**8,776**	**9,398**	**7,979**	***7,880***	***7,582***	***6,066***
Domestic	10,799	9,365	8,385	8,374	8,533	9,160	7,785	*7,700*	*7,400*	*5,928*
I&C	295	303	256	220	243	238	194	*180*	*182*	*138*
Repex	**0**	**0**	**0**	**4,683**	**6,647**	**9,624**	**13,426**	***17,406***	***16,366***	***14,454***
Domestic Life Expired Meter Replacement	0	0	0	776	2,113	5,288	9,098	*11,841*	*10,994*	*9,379*
Domestic Other Meter Replacement	0	0	0	3,752	3,778	3,427	3,538	*4,172*	*4,317*	*4,450*
I&C Life Expired Meter Replacement	0	0	0	91	624	777	699	*1,285*	*944*	*511*
I&C Other Meter Replacement	0	0	0	64	132	132	91	*108*	*111*	*114*
TOTAL ACTIVITIES	**16,723**	**15,510**	**14,430**	**20,539**	**22,787**	**28,131**	**29,226**	***32,386***	***29,489***	***23,637***

Table 9 - *Breakdown of PNGL's actual capex activities (2014 to 2020), forecasts (2021 and 2022) and UR's proposed GD23 activities*

Table 10 shows the level of management FTEs employed by PNGL's construction contractor during GD14 (2015 actual), GD17 (2019 actual) and those forecast for GD23. It can be clearly seen that the level of FTEs has been declining since 2015 with a forecast of 4.7 less FTEs for the GD23 period. UR's proposal in the draft determination would require FTEs to reduce by a further 11 FTEs over and above the 2.7 FTEs already proposed by PNGL in its business plan submission from 2019 levels.

[redacted]

Table 10 – *Management resources of PNGL's construction contractor for GD14 (2015), GD17 (2019) and GD23*

Similarly, Table 11 shows the average capitalised staff resources during GD14, GD17 and GD23 i.e. management resources employed directly by PNGL. UR's proposal in the draft determination would require a reduction of 7 FTEs in GD23.

[redacted]

Table 11 – *Management resources for PNGL (capitalised opex) and its construction contractor (management fee).*

The proposed reduction to the overall management FTEs (management FTEs employed directly by PNGL and by its construction contractor) is unachievable, is unjustifiable and is not based on any form of evidence-based assessment by UR.

As stated above, when the actual activity numbers change from year to year the level of capitalised opex and management fee attributed to each activity has to change also in order to fully apportion the constant level of these two cost lines. Given the reduction in activities in GD23 illustrated in Table 9 for GD23, PNGL took the approach that the activity lines that would receive an increased proportion of the *[redacted]* capitalised opex and management fee would be new build mains and domestic connections. The remainder of this section sets out how PNGL determined the appropriate level of additional allocation to these activities to ensure that it recovered the *[redacted]* cost it will incur over GD23. This was based on the cumulative impact of three main factors:

1. **The reducing level of mainlaying activities**

   The year 2020 was chosen as the base year by PNGL[27]. This was due to 2020 being the most recent year in which actual outturn costs were known prior to the GD23 submission.

   In its 2020 ACR template (ACRT) PNGL allocated *[redacted]* of capitalised opex and management fee to the mainlaying activities completed that year[28]. The number of properties passed in 2020 that received an allowance that included an element for capitalised opex and management fee, was 7,087. The remaining 734 properties that were passed in 2020 formed part of the Greater Belfast Infill Project. As UR are aware, this particular individually funded project **did not** receive an element for capitalised opex and management fee within the allowance granted by UR as PNGL anticipated it could be undertaken alongside its GD17 build programme given that it resulted in a marginal increase to its workload and therefore PNGL believed that it was in a position to facilitate the project based on its existing management resource levels within the GD17 period. This further supports PNGL's position that a large proportion of capitalised opex costs and management fee are fixed irrespective of the level of construction activity.

[27] Note there was limited impact on mainlaying activities during lockdown periods

[28] Note that this figure cannot be evidenced through UR's ACRT given that UR requires PNGL to report on the contractor cost for each activity i.e. the grossed-up activity cost which includes both the cost of undertaking the activity and the cost of managing that activity. That said, PNGL will provide further information to support these numbers which will tie back to the information in its ACRTs and to its accounts

Therefore in 2020 each property passed absorbed *[redacted]* of apportioned capitalised opex and management fee. In the draft determination UR has forecast that PNGL will pass 2,291 properties each year when the Greater Belfast Infill properties are excluded. This means that UR has forecast that PNGL will recover only *[redacted]* of the *[redacted]* recovered in 2020. This is an error on UR's part.

Based on the reduced level of mainlaying activity in GD23, PNGL's construction contractor will operate with 7 less construction teams. With a standard contractual relationship of 1 supervisor to 6 teams, the contractor will therefore only reduce its management resource by 1 supervisor. In addition, the reduced workload will enable the contractor to reduce its resource by 1 Records Assistant. As already provided to UR in support of the GD23 submission, an average contractor resource costs *[redacted]* so this reduction of 2 FTEs will see the management fee costs reduced by *[redacted]*.

The shortfall in UR's GD23 allowance due to the reducing level of mainlaying activity across GD23 is therefore *[redacted]*.

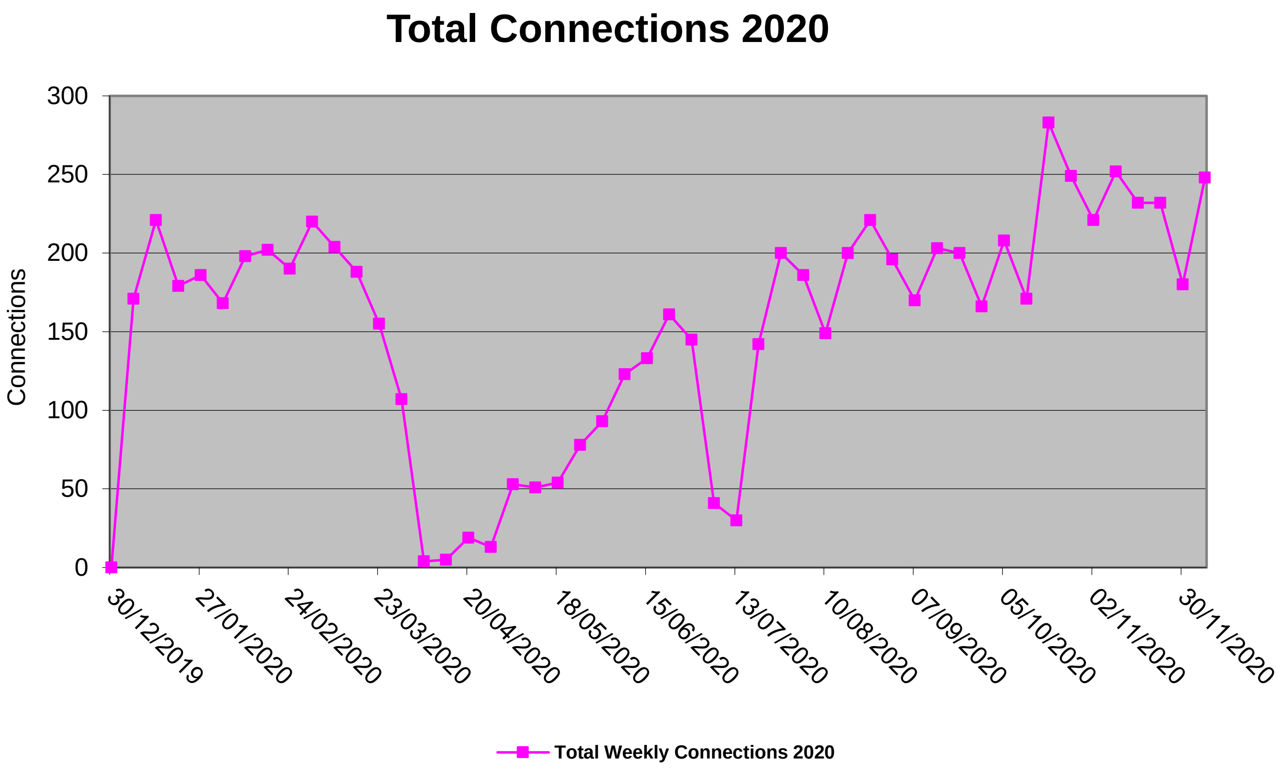
In its GD23 Business Plan, PNGL proposed recovering this *[redacted]* by increasing the apportionment in the following way:

- *[redacted]* to be recovered from new build mains. *[redacted]* this requires 2020 actual outturn costs to be increased by c.£50 per new build property passed (see section 3.4.2).
- *[redacted]* to be recovered from domestic services. *[redacted]* this requires 2020 outturn costs to be increased by c.£12 per domestic service.

Alternatively, if the *[redacted]* isn't recovered from new build mains then the full *[redacted]* would be recovered from domestic services which requires an increase of c.£29 per domestic service.

2. Construction Contractor's Management fee costs in 2020 were uniquely lower due to COVID-19 and impact of Furlough Scheme

At the start of the first 'lock-down' due to the COVID-19 pandemic, PNGL in conjunction with its construction partner had to assess what work activities could take place and what activities could not. On the construction side of the business individual customers, heating installers and developers made the decision for PNGL in that the activity level on connections virtually ceased for a period of time as can be seen below with only distress connections able to be facilitated i.e. where customers existing heating systems had failed.



As mainlaying activities to existing properties takes place outside and in the public highway, PNGL was able to maintain this construction activity.

In order to minimise costs to consumers, PNGL's construction contractor took the decision to utilise the government Furlough Scheme to furlough staff that were directly affected by the reduced workload and those indirectly affected that the contractor felt they could manage without for a short period of time without having a long-term detrimental impact on the construction activity. The overall impact was that the costs they charged to PNGL for management resources (management fee) in 2020 were artificially low (due to the government Furlough Scheme covering some of these), by *[redacted]*, compared to the average costs incurred in the previous three-years as illustrated in Table 12. Therefore, in GD23 a further *[redacted]* needs to be recovered over and above the outturn unit cost for domestic services experienced in 2020.

With *[redacted]* domestic services laid in 2020 the *[redacted]* management fee variance vs. the 2017 to 2019 average equates to a c.£30 per domestic service increase *[redacted]* over and above the 2020 outturn costs. **The shortfall in UR's GD23 allowance due to PNGL's construction contractor's management fee costs in 2020 being uniquely lower due to the impact of the COVID-19 Furlough Scheme equates to c.£30 per domestic service:**

[redacted]

Table 12 – *Management fee for PNGL's construction contractor (management fee)*

3. **Reduction in domestic services in GD23 vs. 2020**

In 2020 PNGL facilitated *[redacted]* domestic connections to its network. As part of its ACR submission for 2020 PNGL allocated *[redacted]* of management fee and capitalised opex to these activities which would imply a rate of *[redacted]* per connection.

As can be seen in Table 13, the average number of domestic services forecast for GD23 in the draft determination is 5,928. This means that at a rate of *[redacted]*per connection only *[redacted]*. on average has been provided as an allowance within UR's GD23 draft determination:

[redacted]

Table 13 – *Domestic services in GD23*

As the GD23 workload is reducing by *[redacted]* services p.a. vs. 2020, there would be a corresponding reduction of *[redacted]* connection teams (one team completes *[redacted]* services per week for a 48-week period i.e. *[redacted]*p.a.). In addition, there would be a reduction of *[redacted]* reinstatement teams. Using a mutually accepted industry standard ratio of 1 supervisor per 6 teams this would mean that the construction contractor would reduce its supervisory manpower by *[redacted]* FTEs i.e. a reduction in management fee of *[redacted]*p.a. Therefore, the **shortfall in allowances provided in the draft determination is** *[redacted]*.

This would require the domestic service costs to increase by c.£70 *[redacted]* in order to recover the management fee allowance necessary to deliver an average of 5,928 existing connections p.a. across GD23. **The shortfall in UR's GD23 allowance due to the reduction in domestic services across GD23 is c.£70 per domestic service.**

3.4.1.1.1 Summary

In summary, the cumulative impact of:

- the reducing level of mainlaying activity across GD23 of *[redacted]* or c.£12 per domestic service and c.£50 per new build property passed;
- the impact of the COVID-19 Furlough Scheme in 2020 of *[redacted]* or c.£30 per domestic service; and
- the reduction in domestic service numbers across GD23 of *[redacted]* or c.£70 per domestic service

is a shortfall in UR's GD23 allowance for management of PNGL's construction activity of c.£822k p.a.

The resulting increase required from UR in its GD23 final determination **over the 2020 outturn unit cost** is therefore c.£112 per domestic service and c.£50 per new build property passed to allow PNGL to manage its construction activity (i.e. capitalised opex and management fee) across GD23.

As referenced earlier in this response, PNGL notes that in its review of PR19, the CMA[29] acknowledged that adjustments for COVID-19 needed to be made by Ofwat in considering its approach once impacts were known. PNGL would suggest UR adopts this regulatory practice and takes due account of COVID-19 impacts both when considering the baseline year to set costs for the remainder of GD23 and when looking at the allowances necessary to cover PNGL's required levels of capital investment to deliver for its customers in the next price control period.

3.4.1.2 Recharge of Opex to Capex

Section 3.4.1.1 explains the rationale for why a combined annual spend of *[redacted]* on management fee and capitalised opex (management resources employed directly by PNGL) is the correct level for GD23. This section provides further information on the exact build-up of capitalised opex and further rationale for PNGL's forecast level of capitalised resources in GD23.

Recharges of opex to capex reflect the proportion of activities carried out by PNGL in support of capital activities. Opex recharges are largely related to specific members of the PNGL team that are either wholly or partially dedicated to the management of capital projects. During the GD17 price control, the recharge of this management resource was directed towards general infill activities and the development of the gas network in East Down, with management resource also required to facilitate PNGL's connections and replacement capex (notably the 20-year meter replacement programme) programmes.

The completion of the bulk pipeline and infill network in East Down has seen capital activity reduce, but as noted in section 3.4.1.1 this will only result in a marginal reduction in management resource. However, any reduction in PNGL's management resource as a result of the reduced mainlaying activity has been replaced by an increasing replacement (repex) programme in GD23. The repex programme is increasingly management resource intensive due to the complexity of planning and completing thousands of individual jobs at customers premises compared to laying km of pipes in the public highway.

In the GD17 period, any fluctuations in capex activity year on year did not result in material changes in the recharge of opex costs, reflecting that the staff recharged were still required to manage capex activity, and this did not vary materially to changes in those activity levels.

Across GD17, capex activities transitioned reflecting the evolution of the PNGL build programme across that price control i.e. where no (nil) repex activities were carried out in 2016, this rose to c.9,000 p.a. in the period 2017-2020, with an average of almost 15,000 p.a. forecast across the GD23 price control. This increase in repex activity is significantly higher than the fall in properties passed (c.8,000 properties passed p.a. in the period 2017-2020 with c.3,000 p.a. in GD23). Connections also fall by c.1,900 p.a. across GD23 vs. 2020. These movements highlight that although the focus of each year

[29] CMA PR19 final report (17 March 2021), para 28

may vary, the underlying programs remain material and require continued management support from PNGL.

The staff that are recharged to capex are based on PNGL's individual assessment of the type of work they undertake. Where a member of staff is carrying out work that is in support of a capital programme, their costs are assessed and the relevant proportion of that person is recharged to capex. Given the nature of the assessment, there is no broad assumption across teams, but an assessment that is specific and detailed. Thus, using Customer Services as an example, staff involved in the planning and scheduling of connections or repex activity are charged to capex. The same principle applies across all recharges (a description of the types of work recharged to capex is provided below).

This assessment of staff capex activity is broadly recognised as a standard accounting process and is completed by PNGL in line with standard methodologies. PNGL's assessment has not changed; thus, the same principal and method has been applied consistently by PNGL since the capitalisation of opex was first undertaken.

The decision by UR to disallow some of the capitalised opex costs (PNGL estimates that *[redacted]* of the c.£822k shortfall identified in section 3.4.1.1.1 relates to the capitalisation of its own costs i.e. capitalised opex) will result in those costs being incurred in opex. Not only would this be inappropriate from an accounting perspective, but UR has not provided adequate opex allowances to allow for such a change of approach.

The remainder of this section provides an overview of the management resources employed by PNGL which it attributes to its capex programme:

Network Development

PNGL has retained the assumption from 2017 that 85% of resources in Network Development (8.5 out of 10 FTEs) are recharged to capex. This team is primarily involved in the management and supervision of new connections, design and planning of work in relation to the network and management of PNGL's construction contract. The additional Network Development FTE employed in 2023 to manage GD23 reinforcement projects is fully recharged to capex.

Operations

The level of resources in Operations recharged to capex has increased from 0.3 FTEs to 1.3 FTEs between 2017 and 2019. This increase is as a direct consequence of the resources required to perform meter replacement activities at I&C premises. The Operations team is also involved in other capital related work, including the management of diversions of the gas network. PNGL has retained the assumption for the entire GD23 period that 10% of resources in Operations (1.4 out of 14 FTEs) are recharged to capex.

Asset Management

The Asset Management team is responsible for the management of the 20-year meter replacement programme and the design of strategic reinforcement. The additional FTE employed by PNGL in 2021 is to carryout condition assessment checks on various asset groups (steel risers, I&C installations and valves) is not recharged to capex.

PNGL has maintained the assumption from 2019 that 1.3 FTEs out of 6.0 FTEs are recharged to capex across the GD23 period.

Grid Control

PNGL has maintained the assumption across the GD23 period that 25% of the resources in Grid Control (1.3 out of 5.0 FTEs) are recharged to capex. The Grid Control team is responsible for new build construction designs and costings and for the administration of several data entry systems relating to mains and services construction.

Engineering Admin

The Engineering Admin team is responsible for maintaining the appropriate records for network construction, commercial services, governor installations and steelworks. The Engineering Admin resources recharged to capex are not anticipated to increase following the recruitment of an additional resource in 2022 to work specifically on the Positional Improvement Project. However, the resources recharged to capex will increase by 1 FTE following the recruitment of an additional resource in 2023 to work solely on the administration of the GD23 reinforcement projects.

Customer Services

As noted above, Customer Services resources are recharged to capex where their role is related to planning and scheduling of connections and repex activity. The net effect being a small decrease in Customer Service resources recharged to capex across the GD23 period (from 5.7 FTEs in 2023 to 5.5 in 2028).

PNGL would request UR provide details of the assessment it undertook to determine the 6 members of staff, identified in the detailed explanation above, that it has disallowed from capitalised opex and details of the rationale for why UR determined these resources were not required in GD23. Also, it is misleading and disingenuous for UR to imply that PNGL's level of capitalised opex is high compared to SGN NG. UR has provided no evidence that SGN NG's capitalisation policy is identical to PNGL's i.e. SGN NG might outsource more of the management of the capex activity to its contractor. In addition, SGN NG undertake no repex compared to PNGL's significant repex programme. With PNGL's and feDL's capitalised opex percentage consistent it would appear opportunistic of UR to use the inconsistent SGN NG one to try and justify disallowing legitimate allowances requested by PNGL.

3.4.1.3 Drivers for underlying (above inflation) rises in unit cost

UR's approach to disallowing any proposed above inflationary rises is fundamentally flawed and demonstrates an error on its part, as it fails to recognise increasing cost drivers which PNGL has been experiencing in recent years.

In response to the information requests raised by UR in advance of its draft determination, PNGL provided a list of cost elements that it forecast would result in cost increases above the allowance increase that would be dealt with normally through RPI indexation (or CPIH inflation as the case may be) in its price control. It would appear that UR's view is that PNGL, and in fact all the GDNs, could not incur any cost increases in connection activity in GD23 that would not be covered by the general movement in inflation. While PNGL recognises that one could argue that some of the elements identified by PNGL may be captured in general inflationary increases, there are unique increases that will not be included in any general inflationary calculation and should be recognised by UR in the setting of the GD23 allowances in its final determination. These are:

1. **Average Service Length increasing**

Year	Total OO Connections Greater Belfast	Total OO Connections East Down	Average Service Length Greater Belfast	Average Service Length East Down	Greater Belfast	East Down	Average Service length
2020	4,692	388	11.88m	13.92m	92%	8%	**12.04m**
GD23 forecast			11.88m	13.92m	75%	25%	**12.39m**

Table 14 *– Service Lengths for existing properties*

As can be seen from Table 14 the percentage split of services constructed in GD23 will increase by c.17% in East Down from 8% in 2020 to 25% across GD23. With c.100,000 properties left to connect, c.25,000 are in East Down and c.75,000 in Greater Belfast. The mix change will result in an increase of the average service length for passing an existing domestic property from 12.04m in 2020 to 12.39m in GD23, or 0.35m per service. As detailed in Schedule 1 of PNGL's Connection Policy, for a U6 service the rate per metre is £43.20. As PNGL operates an actual cost contract this results in a direct increase of £15.30 over the 2020 outturn unit cost paid by PNGL.

The shortfall in UR's GD23 allowance due to the average service lengths increasing is therefore c.£15 per existing domestic service.

2. **Increasing Specialist Gas Training Costs**

With dwindling numbers of newly qualified entrants to the industry, more operatives leaving gas utility works and the closure of previously successful and utilised government schemes such as Bridge to Employment, there has been a requirement for our construction contractor to increase the number of people that it puts through the NVQ2 qualification each year. This equates to c.£25k p.a. (5 people at an average cost of £5k per person). Again, as PNGL operates an actual cost contract this results in an average increase to its domestic service costs of £4.22 (£25k/5,928 services) compared to 2020.

The shortfall in UR's GD23 allowance due to the increasing specialist gas training costs is therefore c.£4 per domestic service.

3.4.1.4 Domestic Services Summary

In summary the cumulative impact of the (i) management fee and capitalised opex; and (ii) above inflationary cost rises results in a shortfall in UR's draft determination of:

- c.£12 per domestic service and c.£50 per new build property passed as a result of the reducing level of mainlaying activity across GD23 (see section 3.4.1.1.1);
- c.£30 per domestic service as a result of the impact of the COVID-19 Furlough Scheme in 2020 (see section 3.4.1.1.1);
- c.£70 per domestic service as a result of the reduction in domestic service numbers across GD23 (see section 3.4.1.1.1);
- c.£15 per existing domestic service as a result of the average service lengths increasing across GD23 (see section 3.4.1.3); and
- c.£4 per domestic service as a result of the increasing specialist gas training costs across GD23 (see section 3.4.1.3).

The resulting domestic services unit cost increase required from UR in its GD23 final determination is therefore:

- **c.£131 per existing domestic service; and**
- **c.£116 per new build domestic service**

over PNGL's 2020 outturn unit cost.

The resulting new build mains unit cost increase required from UR in its GD23 final determination is detailed in section 3.4.2.

The resulting domestic service allowances that should be granted by UR for the GD23 period are as follows:

Existing Domestic Service	
2020 outturn cost (Table 4.13 2020 BPT)	*[redacted]*
GD23 unit cost increase	£131
TOTAL	*[redacted]*

New Build Domestic Service	
2020 outturn cost (Table 4.13 2020 BPT)	*[redacted]*
GD23 unit cost increase	£116
TOTAL	*[redacted]*

Further justification on PNGL's 2020 outturn cost for new build domestic services, *[redacted]*, as the starting point for GD23 allowances is provided at section 3.4.3.

3.4.2 NEW BUILD MAINS

UR has stated in the draft determination that the determination allowance is based on the GD23 basket of works unit rate and the mix of mains sizes included by PNGL in its GD23 Business Plan. In PNGL's case this results in an allowance of £46.66/m[30]. UR requested that PNGL provided in its GD23 Business Plan Template a list of the new build projects that it had as new designs at the time of submission. These designs will more than likely be constructed before the start of GD23. PNGL would argue a more representative mix of workload for UR to determine the unit rate would be by using actual diameter and lengths constructed in 2020. Based on the diameter and length mix provided to UR in the 2020 ACRT this would determine a unit rate of *[redacted]*.

In addition, as discussed in section 3.4.1.1, there is a requirement to recover an additional *[redacted]* from new build mains for management fee and capitalised opex. *[Redacted]* this means that the unit rate needs to be increased by £5.26/m or c.£50 per property passed.

Therefore, the new build mains unit rate allowance that UR should grant in its GD23 final determination is *[redacted]* which is more consistent with the unit rate *[redacted]* requested by PNGL in its GD23 Business Plan.

3.4.3 2020 NEW BUILD SERVICES

This section provides evidence in support of PNGL's new build service outturn cost for 2020 being the appropriate starting point for determining its GD23 allowances.

In the draft determination UR makes the false statement that in the business plan PNGL's new build service rate has increased by c.49%[31]. This is simply not true. The increase proposed is c.29% above the outturn cost for 2020 and can be justified in the following way.

As per PNGL's 2020 ACRT provided to UR the outturn cost for a new build service was *[redacted]* as detailed in Table 15. As PNGL operates an open book actual cost contract PNGL is confident that this unit cost is an appropriate starting point for determining any forecast unit cost for GD23. *[redacted]*

[redacted]

Table 15 – *New build cost breakdown*

[30] Table 4.2 of Annex F

[31] Paragraph 6.56 of Annex F

PNGL is confident that this starting position of *[redacted]* per service is entirely appropriate and justifiable. If UR, as determined in the draft determination believes otherwise, PNGL would ask that UR provide evidence of its assessment to determine which elements in the breakdown of the unit rate provided above is inefficient and as such being disallowed. Without this evidence it would appear to PNGL that UR has unjustifiably provided an allowance that will not cover the cost of this activity without an increase in contributions being paid by consumers.

3.4.4 NETWORK REINFORCEMENT

PNGL submitted six network reinforcement projects (four Intermediate Pressure (IP) network projects and two District Pressure Reduction Module (DPRM) projects) as part of its GD23 Business Plan[32]. The requirements for these projects were based on PNGL's extensive network modelling and historical extreme winter performance analysis. PNGL presented its detailed analysis to UR on 27 September 2021.

Whilst UR agrees the need for the projects, at no point during these discussions or any other stage prior to publication of the draft determination did UR raise any concerns or queries regarding PNGL's forecast unit rates. Had UR discussed with PNGL the commercials of the projects, it would have properly understood the basis of the costs and how to appropriately benchmark these.

UR's flawed approach has ultimately led to a draft determination which does not provide PNGL with the capital expenditure (capex) required to enable it to complete the four 7 Bar reinforcements and therefore be properly compensated for maintaining security of supply and minimising the risk of gas supply emergencies as a consequence of growing gas demand across its gas network.

This section will describe how PNGL has updated and challenged both its original June 2021 submission and UR's draft determination by going back to actual costs from previous projects and using them as a base to build up a capex forecast based on historic performance. PNGL has also engaged with contractors for project quotations to inform this response. The additional analysis actually leads to higher costs than those originally submitted as part of the PNGL's GD23 Business Plan. This therefore means that additional allowances would be required, and therefore evidencing that the allowances in the draft determination are simply too low (even more so given current macroeconomic conditions). The methodology and revised costs are explained in detail later in this section and summarised in Table 17:

[redacted]

3.4.4.1 Current Position

In the draft determination, UR is in agreement with PNGL that the network requires four 7 Bar reinforcements to ensure continued security of supply across large sections of Belfast, Bangor and

[32] Table 2 of PNGL's *GD23 Network Reinforcement and Resilience* submission

Newtownards. In contrast however, the level of capex proposed by UR in its draft determination makes all four projects untenable from a commercial perspective.

UR's current position will not allow PNGL to construct these vital reinforcements, resulting in unacceptably high risks to the customer base due to the large number of supplies that would be interrupted or lost during a future winter event.

UR's failure to provide appropriate allowances to undertake these works puts it at odds with Gas Safety Management Regulations in relation to minimising risk to security of supply[33]. Therefore, given PNGL's network performance modelling and UR's acceptance of that analysis, PNGL must be provided the appropriate level of allowance to deliver these projects.

3.4.4.2 PNGL Original June 2021 Submission Capex

Given the PNGL/Kier open book contract and PNGL's visibility of actual costs, PNGL was confident that the build costs submitted in its GD23 Business Plan provided an accurate forecast of the level of capex required.

PNGL used 2020 contract construction rates to cost each project, but was aware that the additional costs associated with their urban locations, the need for management fee to cover two additional operatives and the current economic environment must be accounted for:

- The urban location uplift was calculated using a previously constructed 250mm 7 Bar project between Fortwilliam and Titanic Quarter in 2010 (project reference BP96). Due to the urban location this project required and increased spend on Special Engineering Difficulties (SPEDs) to navigate various obstacles which occur more frequently in an urban environment. The uplift of *[redacted]*/m applied to PNGL's GD23 network reinforcements was based on actual SPED costs incurred on BP96.
- The GD23 network reinforcements would require at least two additional operatives therefore a management fee uplift of *[redacted]*% was added, which results in a smoothed cost of *[redacted]* per year.
- PNGL's actual construction costs highlighted the pressures of the current economic environment. PNGL engaged with Kier to calculate an uplift to allow for cost increases over and above inflation. The resulted in an above inflation uplift of *[redacted]* being applied to the GD23 network reinforcements.

[redacted]

3.4.4.3 UR Draft Determination Capex Calculation Errors

The approach used by UR to assess PNGL's reinforcement capex is fundamentally flawed. UR's conclusion that PNGL's GD23 Business Plan costs are too high is incorrect as it is based on several

[33] The Gas Safety (Management) Regulations (NI) 1997 place obligations and duties on network operators in relation to the safe and effective management of gas flow through the network. The legislation ensures security of supply to connected consumers, particularly domestic customers, and minimises the risk of gas supply emergencies arising from loss of network pressures

critical errors associated with unit rate calculations, mains location and the current economic environment.

UR calculated previous outperformance on PNGL's East Down PDP and Ballysallagh (project reference BP-126) 7 Bar projects at *[redacted]* and *[redacted]* respectively.

Both of these outperformance figures need to be analysed in more detail before concluding that the rates relating to the GD23 projects were facilitating the outperformance.

Each GD23 reinforcement project is either 100% 315mm or 100% 450mm 7 Bar laid in an arterial urban roadway. For PDP, only 32% of the overall length was 450mm 7 Bar with the remaining project comprising of various smaller diameters and lower pressures. For BP-126, 52% of the costs were associated with 315mm 7 Bar pipe being moved from an initial Cat 3 road to Cat 6 grass after PNGL's contractor agreed more efficient routes with local landowners and continually diverting into the verge where possible. Such efficiencies in construction are obviously not repeatable in a fully urban location. In fact, had it not been possible to lay Cat 6 the project would have performed negatively to the GD17 allowance.

To further assess outperformance on the PDP UR took its PDP 450mm 7 Bar rate of *[redacted]* and concluded it was too high based on a *[redacted]* outperformance against the 450mm PDP Cat 4 unit rate of *[redacted]* agreed with its contractor, Kier. However, UR's *[redacted]* rate was inclusive of management fee, valves and protection whereas Kier's *[redacted]* rate excluded these and was based on a basic 450mm pipe laying rate developed specifically for a rural project after negotiating a reduced PE material cost and assuming increased levels of productivity.

UR then reduced both rates by *[redacted]* based on their outperformance calculations ranging between *[redacted]* for BP-126 and *[redacted]* for the flawed 450mm PDP rate analysis.

Finally, to adjust the calculated rates to represent Cat 2/Cat 1 locations, UR used the ratios between Cat 4 and Cat 2/Cat 1 construction rates to determine an adjustment factor of *[redacted]*. Again, this calculation is flawed as the contract rates are developed based on a mix of locations ranging from city centre urban to out-of-town rural in contrast to the GD23 projects which are all located along urban arterial routes.

UR's approach results in 315mm and 450mm 7 Bar unit rates for urban locations which are fundamentally flawed.

3.4.4.4 PNGL Capex Assessment based on historic costs

Having analysed UR's early actual cost assessment, PNGL believes that this was the correct approach to check the accuracy of PNGL's submission. However, further collaboration with PNGL would have been required to facilitate a more accurate analysis of the actual costs within its Annual Cost Reporting submissions to allow actual 315mm and 450mm base rates to be calculated.

Given the draft determination's 42% reduction, PNGL has used two methods to recalculate the capex required:

- **Method 1.** PNGL analysed the most appropriate previous projects constructed to calculate actual cost unit rates for each diameter. These projects were all located in rural locations and the actual costs were appropriately adjusted to accurately represent urban locations along arterial routes.
- **Method 2.** PNGL replaced the labour, plant and civil materials components from method 1 with specific project quotations obtained from the contractor.

3.4.4.4.1 Method 1

450mm Rural Rate

PNGL analysed the PDP project, specifically considering the 450mm 7 Bar main laying. The majority of the 450mm 7 Bar was laid in 2016 via project PDP-03. Therefore, PDP-03 was considered the most appropriate project to analyse as an accurate average unit rate for the calculation of 450mm 7 Bar.

PDP-03 provided an actual rural cost for 450mm 7 Bar of *[redacted]*/m over a length of 23.5km, which is **£2/m less** than UR's draft determination urban rate *[redacted]*.

315mm Rural Rate

PNGL analysed the BP-126 315mm 7 Bar reinforcement project completed in 2018. It had total length of 5,085m with 2,441m laid in Cat 3 and 2,644m laid in Cat 6.

As the option to divert into more preferable ground conditions will not be available along the GD23 project routes, PNGL removed the Cat 6 mains and calculated the average unit rate for the 2,441m of Cat 3 mains.

This provides an actual rural 315mm 7 Bar rate of *[redacted]*/m which is **£26/m more** that UR's draft determination urban rate of *[redacted]*.

Figure 16 shows the scale of the construction sites on the PDP-03 project, a typical rural based construction site.

Figure 17 shows a typical urban based construction site with multiple obstacles, limited space for large excavators and limited space for the new pipeline resulting in low productivity.

Figure 16 – *A typical rural based construction site*

Figure 17 – *A typical urban based construction site*

Rural to Urban Uplift

The *[redacted]* (450mm) and *[redacted]* (315mm) actual rural rates were broken down into labour, plant, non-engineering materials and engineering materials.

From past experience and having liaised with Kier and other local contractors, PNGL determined that the actual rural rate would have to be adjusted to account for reduced productivity, dedicated specialist traffic management, and material uplifts beyond inflation.

Productivity

The rural locations for PDP-03 and BP-126 allowed PNGL's contractor to significantly increase productivity due the following factors:

- Minimal existing underground utilities facilitating much quicker excavation;
- No restrictions on plant size facilitating much larger plant and excavators;
- Extended working hours;
- Low levels of rural traffic meaning temporary road closures were used on the majority of the works;
- Minimal levels of pedestrian traffic removing the need for Heras fencing around the construction site;
- Large working zones of over 200m could be achieved facilitating space for additional operatives and large butt fusion pipe assembly lines;
- The ability to lay in category 6 grass verges were possible;
- Space to store significant amounts of plant and materials conveniently on-site; and
- Conveniently located satellite yards for material/spoil delivery and removal.

These factors resulted in a significant increase in productivity which reduced PNGL's labour and plant costs.

The urban locations in GD23 will not therefore facilitate similar productivity performance.

The labour and plant constituent parts of each rate will be directly affected by the fall in productivity levels. PNGL has adjusted them based on additional evidence available to more accurately reflect urban locations. The following section describes how the productivity adjustment factors were calculated.

Plant and Labour - 315mm 7 Bar Urban Calculation

The most recent actual costs associated with significant urban 7 Bar construction were incurred whilst completing the **250mm** 7 Bar project in 2010 between Fortwilliam and the Odyssey arena (Construction photos shown in Figure 17). The productivity associated with this project has been used to provide a benchmark for urban build.

Following UR's draft determination, PNGL engaged with its subcontractor for an official quotation which provides the following:

- an accurate productivity rate to adjust the previous actuals; and
- overall comparison to the calculated rate and an insight into other cost increase drivers such as labour and plant costs.

Table 18 shows the data used to forecast the labour and plant adjustment factors for each project.

[redacted]

Table 18 – *Productivity source data*

Table 19 shows the labour and plant correction factors for each project:

[redacted]

Table 19 – *Labour / Plant Adjustment Factors*

Traffic Management

Traffic management costs will drive an uplift on previous actuals as the GD23 projects will require continuous specialist traffic management due to their location on busy urban arterial routes. PDP-03 and BP-126 incurred negligible traffic management costs due to their rural locations and numerous road closures. As this required a specialist contractor, PNGL has obtained a quotation from local specialist traffic management contractor, *[redacted]*, on each project to inform this response. *[redacted]* quotation is accurate as they have extensive experience working with numerous utilities along the same arterial routes. Table 20 shows the cost per metre for traffic management on each of the four reinforcement projects based on the *[redacted]* detailed quotation.

[redacted]

Table 20 – *Traffic Management Uplifts*

Materials

Whilst a significant amount of additional costs associated with market forces are resolved by inflationary uplifts, some areas are currently experiencing a step change beyond inflationary allowances that must be considered by UR within the final determination.

The following analysis looks at cost increases forecast for Polyethylene (PE) pipe and concrete protection as well as the additional costs associated with PE couplers due to the additional fusion joints required in urban construction.

PE Pipe Costs

PE pipe costs are directly related to the wholesale price of oil. The 450mm and 315mm 7 Bar PE material costs in BP-126 and PDP-03 cannot be repeated given the continually increasing costs well above the annual inflationary increase since mid-2020. Figure 21 and Table 22 provide PE pipe cost data for the last 7 years.

[redacted]

Figure 21 – *PE Price Trend*

	Increase in the last 18months	Increase since 2017	Pre pandemic October 2019
250mm 4Bar	59%	37%	30%
250mm 7Bar	59%	37%	30%
315mm 4Bar	59%	37%	30%
315mm 7Bar	59%	37%	30%
355mm 4Bar	59%	37%	30%
450mm 4Bar	59%	37%	30%
450mm 7Bar	59%	37%	30%

Table 22 – *Period price shift summary*

To account for this additional cost the cost of PE within the base actual rates has been increased as per the following:

BP-126 315mm 7 Bar PE for BP-126 was purchased for *[redacted]*/m in 2017 compared to a current price of *[redacted]*. Correcting both to £2020 generates an uplift of c.£10/m.

PDP-03 450mm 7 Bar PE for PDP-03 was purchased for *[redacted]*/m in 2016 compared to a current price of *[redacted]*/m. Correcting both to £2020 generates an uplift of c.£48/m.

PE Coupler Costs

Large diameter urban construction will result in a significant increase in the number of mains couplers required compared to rural build where the vast majority of mains joints are completed via butt fusion. The numerous underground obstacles and restricted construction site length means it will not be possible to butt fuse and "ditch" long strings of pipe. Therefore, in restrictive urban locations each 15m length will be connected to the next via a fusion coupler installed in the trench.

Table 23 details the coupler rate adjustments required for each project.

Project	No. of Couplers/km
Bangor Road	17
Ormeau Road	76
N'ards Road	76
Shore Road	44

Table 23 – *Fusion Coupler Requirements*

Concrete Protection

Concrete has increased rapidly over the last 12 months, with slabs more than doubling in cost well above inflationary uplifts. Table 24 details the concrete protection adjustments required for each project.

Project	Adjustment £/m
Bangor Road	£5
Ormeau Road	£17
N'ards Road	£17
Shore Road	£17

Table 24 – *Concrete protection adjustments*

3.4.4.4.2 Method 2

Sub-Contractor Quotations

Given the 42% difference between PNGL's GD23 Business Plan submission and UR's draft determination, PNGL has engaged with its current large diameter mains sub-contractor, *[redacted]*, for project quotations with the aim of providing additional clarification on the capex required. PNGL is providing supplemental technical evidence[34] summarising *[redacted]* productivity, unit rates and the resulting overall project costs. (Note: *[redacted]* will have to compete in a tender process with other sub-contractors so their pricing is considered competitive by PNGL.)

3.4.4.5 Capex Summary

Having considered each method's outcome, PNGL believes that method 2 provides the more accurate forecast as its accounts for the above inflationary rises across the various supply chains in engineering materials, civils materials, plant, equipment and resourcing over the last 12 months which result in method 1 being undervalued.

Table 25 shows the summary original June 2021 cost forecasts, UR's draft determination allowances and PNGL's current capex forecast via methods 1 and 2:

[redacted]

Table 25 – *Capex Cost summary*

3.4.4.6 Conclusion

PNGL has used historical actual costs as reported via the Annual Cost Reporting process to calculate accurate rural unit rates and then used other productivity, materials and traffic management data to adjust these rates for an urban environment.

PNGL has engaged with its contractors obtaining competitive quotations for mainlaying and traffic management for each project.

[redacted]

PNGL has proven that UR's capex assumptions for network reinforcements in its draft determination are flawed and should be reviewed in advance of its final determination.

Table 26 outlines PNGL's revised reinforcement capex based on this analysis:

[redacted]

Table 26 – *Revised Network Reinforcements Capex*

[34] PNGL supplemental technical evidence provided to UR by email 26 May 2022

3.5 FRONTIER SHIFT

PNGL engaged NERA Economic Consulting (NERA) to respond to UR's proposed frontier shift, itself comprising Real Price Effects (RPEs), Ongoing Efficiency (OE) and a forecast of CPIH inflation. NERA's report is provided at Appendix 2.

Operating Expenditure (Opex)

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4. OPERATING EXPENDITURE

Overall UR has proposed operating expenditure (opex) allowances which are c.18%[35] lower than PNGL's submitted cost forecasts for GD23 and are simply too low across various areas of activity in order to run the business in an efficient and effective manner. In some areas costs for ongoing activities currently incurred by PNGL have simply been disallowed and in others cost forecasts have been rejected without any real rationale for doing so despite significant evidence having been provided. We consider that cuts of this scale are unjustified, and result in significant downside risk being placed on PNGL.

As UR is aware, COVID-19 had a significant impact on PNGL's business operations in 2020. Throughout PNGL's 2020 Performance Report in its Commentary to its 2020 Annual Cost Reporting submission, PNGL sought to highlight any effect this had on its business operations and expenditure in 2020. In PNGL's GD17 review[36] it forecast the ongoing effect of the pandemic on its business operations and expenditure in 2021 and 2022. However, this does not seem to have been fully recognised by UR in its draft determination where 2020 has often been used as the baseline of its GD23 forecasts. PNGL notes that in its PR19 final determination the CMA acknowledged that adjustments for COVID-19 needed to be made by Ofwat in considering its approach once impacts of the pandemic were fully known.[37] It is therefore clear that other regulators, including the CMA, have recognised the exceptional circumstances in 2020 and that adjustments to account for such unforeseen events (and impacts on costs, particularly opex) would be expected and reasonable. PNGL considers that UR should similarly take into account these exceptional circumstances and not use 2020 as a baseline for GD23 without proper consideration to whether this is appropriate as this could inevitably lead to erroneous assumptions and forecasts for the next six year period. PNGL has identified a number of concerns with UR's choice of baseline elsewhere in this response.

PNGL also notes UR's indication that its position on some aspects of its draft determination may change in advance of the final determination[38]. Although, PNGL is willing to provide any further evidence requested by UR to enable UR to reassure itself that the allowances proposed in its draft determination are appropriate, this approach adopted by UR removes transparency from the consultation process and PNGL would question the reasonableness of such an approach. It is therefore critical that PNGL has advance sight of <u>any</u> change to UR's draft determination proposals to allow it the appropriate opportunity to respond in advance of UR's final determination.

Two cost items require detailed analysis due to their impact on overall opex i.e. costs associated with our people and costs associated with growing the market i.e. Advertising and Market Development (OO). We begin with these cost items, move on to UR's policy of disallowing profit margins of related

[35] Table 5.1 of the consultation

[36] Section 2 of PNGL's Business Plan

[37] CMA PR19 final report (17 March 2021), para 28

[38] e.g. paragraph 5.76 of Annex D

parties and then discuss PNGL's concerns with UR's draft determination for the remaining opex cost items (excluding the cost element therein associated with our people) detailed in Table 5.3 of the consultation. Where no comments have been made e.g. under "*IT & Telecoms*", PNGL acknowledges, in the round, the GD23 draft determination provides an appropriate allowance to operate and maintain the PNGL network in GD23.

4.1 <u>OUR PEOPLE</u>

The implication of UR's draft determination across the GD23 period is to disallow:

- 7 FTEs included within PNGL's opex forecasts; and
- a further 7 capitalised FTEs within its capex unit rate proposals.[39]

PNGL also raises concerns with the implications of ongoing allocation of FTEs to AMD mechanisms.

4.1.1 SUMMARY

PNGL provided a detailed paper as part of its GD23 Business Plan submission describing its current resource levels, expectations for changes to these resources over the price control period, together with rationale to substantiate any changes.

PNGL examined resources on a gross level, in the knowledge that the associated costs were translated by PNGL into its GD23 Business Plan Template submission in accordance with the Regulatory Instructions and Guidance. Notably some of these costs were then reallocated to activities such as capex and Advertising and Market Development (OO) (AMD(OO)) where they are typically allowed by UR indirectly via drivers such as unit rates multiplied by an output.

PNGL is providing a focussed response to UR's proposed allowances in respect to people resources gross of corporate overheads, with comments being made only to the extent that the draft determination differs from PNGL's GD23 Business Plan.

PNGL's concerns with UR's proposed allowances in respect to its GD23 people resources are summarised below:

1. PNGL concurs with the approach taken by UR in the draft determination to remove Corporate Overhead costs (including people costs) from being recovered under the AMD(OO) mechanism. However, as noted in section 3.3.8, *[redacted]* incorrectly remain as part of the AMD(OO) mechanism and should be removed. Similarly, *[redacted]* have been allocated to the AMD(OO) cost line, but are required to support this sector irrespective of whether PNGL

[39] Note, this excludes the 11 management resources of PNGL's construction contractor that UR has disallowed (see Table 11) within the capex unit rates

generates 1,000 OO connections or 4,000 OO connections per annum. Consideration of the allocation of these positions within AMD(OO) allowances should also be reconsidered.

2. UR's overreliance on 2020 actuals as the basis for determining resource requirements across the GD23 period is inappropriate and has resulted in the following necessary FTEs being disallowed by UR in the draft determination:
    - **1 FTE**, in place since 2021, to enable PNGL to continue to support the remedial works identified through its Asset Condition Assessment Programme;
    - **1 FTE**, in place since 2021, to specifically work on the critical GIS Positional Improvement Project to update PNGL's gas asset records following an update by Land and Property Services to their maps;
    - The recruitment and in-house training of **2 Apprentice Technicians**;
    - **2 FTEs** required to specifically support the network reinforcement projects that have been identified by UR for the GD23 period (note these FTEs are fully capitalised and should be allowed for in the relevant capex unit rates);
    - **1 FTE** that was requested by PNGL to support upcoming regulatory workstreams;
    - **1 FTE** in the Project Sales Officer role to support the management of LPG multi-occupancy conversions and the introduction of gas mains and connections into privately owned 'non adopted' areas during the GD23 period; and
    - **0.6 FTEs** to ensure that the overall FTEs within the Finance Department are in line with the numbers currently employed and the number of FTEs required to support PNGL's business activities.

3. The methodology applied by UR to calculate the number of FTEs available to support maintenance workstreams is inappropriate and does not take into account the significant increase in maintenance activities that will be performed by PNGL during the GD23 period. The net impact of UR's draft determination is the disallowing of **0.5 FTEs** on average across the GD23 period to support maintenance workstreams.

4. There appears to be no formal linkage between the capitalised FTEs allowed by UR, as per the opex workbooks provided to support the draft determination, and the capex unit rates proposed in the draft determination. The impact of UR's draft determination is the disallowing of **7 capitalised FTEs**[40] on average across the GD23 period.

5. UR's proposal to base PNGL's GD23 allowances for **CEO & Group Management** on benchmark data derived in 2011 is fundamentally flawed. This benchmark continues to be inconsistent with actual costs of employing the management team both historically and going forward.

6. UR's proposal to base PNGL's GD23 people allowances on 2020 actuals is inappropriate as it does not take account of the **Health & Social Care Levy** that was announced in September 2021.

[40] Including the 2 FTEs required specifically to support the reinforcement projects

PNGL would request UR to reconsider its proposals in respect to PNGL's people resources.

4.1.2 PEOPLE RESOURCES

This section discusses PNGL's concerns with UR's draft determination in respect to its people resources.

4.1.2.1 Advertising & Market Development (Owner Occupied)

PNGL concurs with the approach taken by UR in the draft determination to remove Corporate Overhead costs (including people costs) from being recovered under the AMD(OO) mechanism.

However, as noted in section 3.3.8, *[redacted]* incorrectly remain as part of the AMD(OO) mechanism and should be removed. Similarly, *[redacted]* have been allocated to the AMD(OO) cost line but are required to support this sector irrespective of whether PNGL generates 1,000 OO connections or 4,000 OO connections per annum. Consideration of the allocation of these positions within AMD(OO) allowances should also be reconsidered or at the very least the allowance mechanism adjusted to ensure recoverability.

Further information on PNGL's response to the AMD(OO) mechanism proposed for GD23 is provided at section 3.3.

4.1.2.2 Capitalised People

Detailed information on the number of resources forecast to be capitalised for the GD23 period was provided in our *GD23 People Recharges* paper provided as part of our GD23 Business Plan submission.

Table 27 provides information on the actual FTEs capitalised by PNGL for 2020 and the forecast FTEs to be capitalised from 2021 to the end of the GD23 period, compared with the FTEs proposed to be capitalised by UR in GD23 (i) as per the workbooks provided by UR to support the opex section of the draft determination[41]; and (ii) within the capex unit rates proposed by UR.

[41] UR's proposals for the volumes of FTEs to be capitalised were obtained from opex workbooks provided by UR to PNGL to support the allowances provided in the DD

	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Actual	Forecast							
PNGL Requested FTEs	18.4	18.5	18.7	20.8	20.7	20.7	20.6	20.6	20.6
UR Proposed FTEs (as per UR's opex workbooks)				18.5	18.4	18.7	18.6	18.5	18.5
Difference within UR's opex workbooks				**-2.3**	**-2.3**	**-2.0**	**-2.0**	**-2.1**	**-2.1**
UR Proposed FTEs (as per UR's Capex unit rates)				**GD23 Average = 13.7 FTEs**					
Difference within the capex unit rates proposed by UR				**Average Difference -7.0 FTEs**					

Table 27 - *FTEs requested by PNGL to be capitalised and proposed by UR*

The primary variance between the FTEs requested by PNGL and those proposed by UR within the opex workbooks relates to 2 FTEs required to specifically support the network reinforcement projects that have been allowed by UR for the GD23 period (see section 4.1.2.3).

However, even discounting UR's incorrect disallowing of these FTEs, there appears to be no formal linkage between the capitalised FTEs allowed by UR as per the opex workbooks and the capex unit rates proposed in the draft determination. Further information on this fundamental issue is provided at section 3.4. In short, with the changing forecast level of capex proposed during GD23, PNGL will not be granted sufficient overhead recovery to cover the cost of its capitalised FTEs. The implication of UR's capex draft determination is to disallow 7 capitalised FTEs on average per annum across the GD23 period[42].

4.1.2.3 People Levels

PNGL submitted a paper[43] as part of its GD23 Business Plan submission on the people resources required to run its business over the six-year GD23 price control period. It is not proposed that all of the views provided therein are repeated in this consultation response. However, the more pertinent issues and areas that have progressed from the June 2021 submission are explored in more detail in this section.

UR considers it appropriate to base the majority[44] of the levels of FTEs allowed for the GD23 period on 2020 actuals with a small increase to Operations as *"this is consistent with the medium term historical actual averages"*[45].

[42] Note, this excludes the 11 management resources of PNGL's construction contractor that UR has disallowed (see Table 11) within the capex unit rates

[43] PNGL's *GD23 Our People* paper

[44] UR proposes to base the level of FTEs allowed for customer management based on 2019 actual FTEs and emergency, pre-repairs and maintenance based on flat reductions to submitted FTEs based on associated disallowed cost lines (e.g. material costs disallowed for the maintenance category)

[45] Paragraph 5.17 of the GD23 Draft Determination (Annex D), March 2022

Table 28 provides information on the FTEs requested by PNGL and the FTEs proposed by UR for the GD23 period.

	2023	2024	2025	2026	2027	2028
PNGL Requested FTEs	126.9	126.3	123.9	122.9	122.9	122.9
UR Proposed FTEs	118.6	118.4	118.0	117.1	117.1	117.1
Difference	**-8.3**	**-7.9**	**-5.9**	**-5.8**	**-5.8**	**-5.8**
%	(-6.5%)	(-6.3%)	(-4.7%)	(-4.7%)	(-4.7%)	(-4.7%)

Table 28 - *FTEs requested by PNGL and proposed by UR*

On a more general theme, PNGL questions UR's overreliance on 2020 as the basis for determining resource requirements across GD23, especially when allowances have been granted in the draft determination for an increasing number of activities across the GD23 period.

The consequence of UR's overreliance on 2020 data is that the following resources (detailed in sections 4.1.2.3.1 to 4.1.2.3.7), **which are required to deliver PNGL's GD23 Business Plan**, have been disallowed by UR within the draft determination:

4.1.2.3.1 UR's proposal to disallow the FTE recruited by PNGL to work on the Asset Condition Assessment Programme

As outlined in PNGL's *GD23 Our People* paper, PNGL recruited an additional 1 FTE part way through 2021 in its Asset Management department to design, raise and manage the delivery of the critical remedial workstream derived from asset condition assessment checks performed[46]. As the PNGL asset ages, these condition assessments have been generating an increasing volume of remedial works. This increase aligns fully to the step increase in work during GD17 and was slightly delayed (from 2020 to 2021) due to operating constraints during COVID. This increase in activity is forecast to continue to grow in the GD23 period and the additional people resource in place from 2021 is necessary to support its ongoing delivery.

As the volume of FTEs allowed by UR in the draft determination has been calculated based on historic average FTEs employed by PNGL, UR has disallowed the necessary FTE employed by PNGL in 2021 to manage this critical workstream.

UR's determination should include the additional FTE, in place since 2021, to specifically support the remedial works identified via PNGL's asset condition assessments.

4.1.2.3.2 UR's proposal to disallow the FTE recruited by PNGL to work on the Positional Improvement Project

As outlined in PNGL's *GD23 Our People* paper, PNGL recruited an additional 1 FTE part way through 2021 in its Engineering Administration department to facilitate the delivery of a positional improvement GIS project[47]. The positional improvement project involves repositioning all PNGL's gas

[46] In PNGL's GD23 submission, the relevant FTE was allocated between Operations Management, System Control and Asset Management (0.45FTEs, 0.35FTEs and 0.15FTEs respectively)

[47] In PNGL's GD23 submission, the relevant FTE was included in Customer Management

asset records as Land and Property Services have updated their maps leading to a shift of many background features. This is an onerous manual process that is of critical importance as PNGL cannot afford to lose positional accuracy due to the associated safety implications. Whilst PNGL made inroads to this project during the early part of GD17, in order to be able to complete the project, we needed to appoint additional resource to the project for a sustained period (2021 to 2024). Again, like the asset condition maintenance work above, this escalation plan was suspended due to COVID, and recommenced during 2021.

As the volume of FTEs allowed by UR in the draft determination has been calculated on historic average FTEs employed by PNGL, UR has disallowed the necessary FTE employed by PNGL in 2021 to manage this critical workstream.

UR's determination should include the additional FTE, in place since 2021, to specifically work on the critical GIS Positional Improvement Project to update PNGL's gas asset records following an update by Land and Property Services to their maps.

4.1.2.3.3 UR's proposal to disallow the recruitment and training of Apprentice Technicians

As outlined in PNGL's *GD23 Our People* paper, PNGL requested allowances to recruit and train two in-house apprentice technicians[48]. The recruitment and in-house training of apprentice technicians during the GD23 period is an essential element of PNGL's succession management and is necessary to maintain the continued safe operation of the PNGL network. The role performed by PNGL's Governor Technicians is highly specialised, with only a limited pool of experienced technicians in NI. Two of PNGL's existing pool of Governor Technicians are scheduled to retire during the GD23 period. These retirements will leave PNGL critically short of essential resources. The most cost-effective method for PNGL to recruit new Governor Technicians is through the training and development of apprentices.

Whilst PNGL requested funding of a scheme to address such known staff turnover during the GD23 period, there is strong logic for PNGL to deliver an ongoing apprenticeship scheme, especially having established a course for the first cohort. PNGL would therefore request UR to grant allowances for 2 apprentices on a rolling three yearly basis throughout the entire GD23 period.

As the volume of FTEs allowed by UR in the draft determination has been calculated on historic average FTEs employed by PNGL, UR has disallowed the necessary apprentice technician FTEs.

UR's determination should include allowances for PNGL to recruit and train two apprentice technicians on a rolling 3-yearly basis throughout the GD23 period.

[48] In PNGL's GD23 submission, the relevant 2 FTEs were allocated between Maintenance, Operations Management, Emergency (1.0FTE, 0.5FTEs and 0.5FTEs respectively)

4.1.2.3.4 UR's proposal to disallow FTEs specifically required to support the GD23 Network Reinforcement Projects

In the draft determination UR has identified the need for PNGL to undertake six major network mains reinforcement projects[49] during the GD23 period. As outlined in PNGL's *"GD23 Our People"* paper, PNGL requested two additional FTEs to specifically support these projects:

- 1 FTE in the Network Development Department: 7 bar reinforcement mains construction requires much more intensive supervision from the PNGL team compared with MP and LP mains construction (included in Operations Management in PNGL's submission); and
- 1 FTE in the Engineering Administration: 7 bar reinforcement mains construction requires much more onerous collection and recording of data including detailed locations of relevant assets (included in Customer Management in PNGL's submission).

As the volume of FTEs allowed by UR in the draft determination has been calculated on historic average FTEs employed by PNGL during periods when mains reinforcement projects were not undertaken, UR has effectively disallowed these necessary FTEs.

UR's determination should include the additional requested FTEs that are required to specifically support the network reinforcement projects it has identified for the GD23 period.

As the FTEs requested to specifically support these network reinforcement projects are fully capitalised, the allowances should be allowed for in the relevant capex unit rates (see section 3.4).

4.1.2.3.5 UR's proposal to disallow the regulatory FTE specifically required to support upcoming regulatory workstreams

As outlined in PNGL's *GD23 Our People* paper, PNGL requested allowances for one additional Senior Business Analyst to allow it to facilitate upcoming regulatory workstreams and ensure that it may deliver upon additional regulatory requirements which result.

Examples of such projects include:

- PNGL is ready and equipped to be front and centre of NI's energy transition. PNGL will have a key role in the specifying, implementation and co-ordinating the development of key operational and regulatory processes associated with energy policy outputs including, biomethane injection into the grid and other energy transition opportunities. These additional activities will be required to be undertaken by the operational and strategic regulatory team;
- Projects currently identified by UR for development going into the GD23 period include future metering solutions and meter reading responsibility. PNGL's regulatory team will be essential to provide operational and strategic support for such projects. Alongside the necessary regulatory frameworks, the operational procedures and processes which support them, not only within PNGL, but as part of the wider gas networks and supplier interfaces, will need to be facilitated by the operational and strategic regulatory team; and

[49] GD23 Draft Determination Annex F paragraph 6.12

- UR's GD23 requirements on consumer engagement, consumer protection and vulnerability will see additional regulatory support needed for delivering the appropriate regulatory framework, increased collation and reporting of data, as well as potential new practical help and assistance measures being implemented within the business. These additional activities will need to be delivered in part by the operational and strategic regulatory team.

As the number of FTEs allowed by UR in the draft determination has been calculated on historic average FTEs employed by PNGL, UR has disallowed the necessary FTE required to support these upcoming regulatory workstreams.

UR's determination should include the additional requested FTE to support upcoming regulatory workstreams.

4.1.2.3.6 UR's proposal to disallow the Project Sales Officer FTE to support the management of LPG multi-occupancy conversions and the introduction of gas mains and connections into privately owned 'non adopted' areas

As outlined in PNGL's *GD23 Our People* paper, PNGL requested allowances for a Project Sales Officer responsible for the delivery of multi-occupancy sales projects that require a greater level of consumer engagement, planning and trade engagement than an individual OO connection[50]. This includes the management of LPG multi-occupancy conversions and the introduction of gas mains and connections into privately owned 'non adopted' areas. Experience gained in GD17 has highlighted, both in Greater Belfast and East Down, that network development is inhibited in private roads and LPG developments without such a resource being in place.

As the number of FTEs allowed by UR in the draft determination has been calculated on historic average FTEs employed by PNGL, UR has disallowed the necessary FTE required to support these more complex connections.

UR's determination should include the additional requested FTE to undertake the Project Sales Officer role.

4.1.2.3.7 UR's proposal to disallow 0.6 FTEs in the Finance Department

As outlined in PNGL's *GD23 Our People* paper, the PNGL Finance department requires 7.8 FTEs to fully support the activities of the business. During 2019 and 2020 the department experienced high levels of staff turnover and problems recruiting and replacing leavers. This resulted in the FTEs employed running at levels below that required. The recruitment of the resource to bring the finance department up to the required 7.8 FTEs was delayed due to COVID-19 in 2020 and thereby subdued actual numbers in 2020.

Table 29 provides information on the FTEs employed (including agency employees) in the Finance department from 2017 to 2020.

[50] In PNGL's GD23 submission, the relevant FTE was included in Operations Management

	2017	2018	2019	2020
Finance Department - FTEs	7.6	7.7	7.3	7.2

Table 29 – *Finance department FTEs 2017 to 2020*

As the number of FTEs allowed by UR in the draft determination has been calculated on the 2020 FTEs employed by PNGL, UR has disallowed the 0.6 FTEs currently employed by PNGL to support business activities.

UR's determination should include the additional 0.6 FTEs to ensure that the overall FTEs within the Finance department are in line with the numbers currently employed and the number of FTEs required to support PNGL's business activities.

4.1.2.3.8 The inappropriateness of UR's proposal to reduce the volume and associated allowances for FTEs to support maintenance workstreams based on a flat reduction tied to disallowed material costs

PNGL provided information on the various maintenance workstreams to be performed during the GD23 price control period as part of its GD23 Business Plan[51]. With the exception of strategic mains inspections (inspection of protective steel plates) and the installation of new telemetry at governor installations, the maintenance workstreams requested have been allowed for in the draft determination.

PNGL forecasts that the volume of maintenance activity that will be required to be performed during the GD23 period will increase significantly from that actually performed during the GD17 period. Table 30 provides information on the volume of metering related maintenance actually performed from 2019 to 2020 and that forecast during the GD23 period.

	Actual[52]		Forecast[53]							
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Metering Maintenance Activity	9,720	10,362	13,872	17,306	17,277	30,676	31,965	35,573	33,826	35,542

Table 30 – *Metering Maintenance Activity Levels 2019 to 2028*

Figure 31 provides an overview of the maintenance activity levels forecast to be performed in the GD23 period.

[51] PNGL's *GD23 Maintenance Programme* paper

[52] PNGL ACR 2019 & 2020 Table 3.14b

[53] PNGL GD23 Business Plan Template Table 3.16

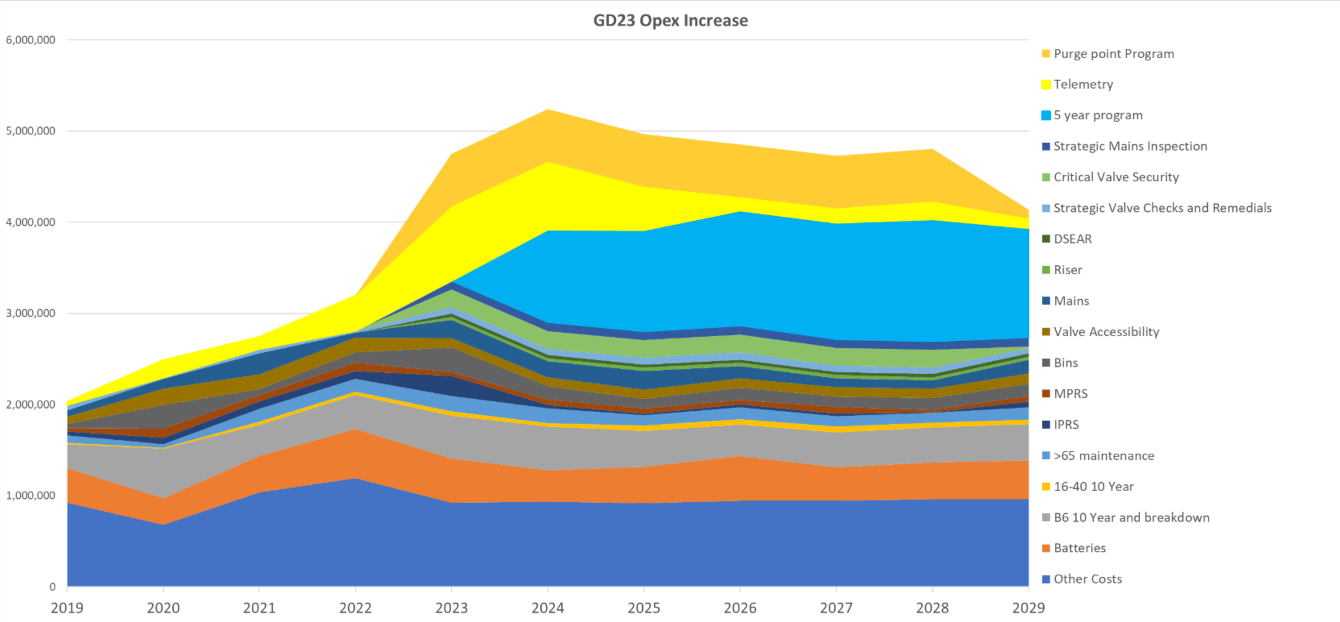

Figure 31 – *Maintenance activity required during the GD23 period*

PNGL has requested only a small increase in FTEs in the GD23 period to support this significant increase in maintenance activity. Table 32 provides information on the actual FTEs employed to support maintenance activities in 2019 and 2020, those required to support the significantly higher levels of maintenance activities to be performed during the GD23 price control period and the FTEs proposed by UR for the GD23 period.

Maintenance	Actual		Forecast							
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
PNGL FTEs	6.6	6.6	6.9	8.1	8.1	8.1	7.1	7.1	7.1	7.1
UR Proposed FTEs					6.8	6.6	6.6	6.6	6.6	6.6

Table 32 – *Maintenance People FTEs requested by PNGL versus proposed by UR*

UR's proposed methodology for the calculating the level of FTEs available to undertake maintenance activities in the GD23 period is based on a flat reduction in FTEs based on the reduction of material costs in the maintenance category that have been disallowed in the draft determination.

The methodology applied by UR is inappropriate and includes no consideration for the significant increase in maintenance activities that have been allowed in the draft determination. UR's final determination should include sufficient increase in FTEs to account for the significant increase in maintenance activities to be performed during the GD23 period.

The implication of UR's draft determination is the disallowing of 0.8 FTEs on average across the GD23 period to support maintenance workstreams. However, the 0.8 FTEs disallowed includes 0.3 FTEs associated to apprentice technicians (see section 4.1.2.3.3). Therefore, the net impact of UR's draft determination is the disallowing of **0.5 FTEs** on average across the GD23 period to support maintenance workstreams.

4.1.3 PEOPLE COSTS

PNGL has two key issues with UR's proposed people allowances across the GD23 period:

i. UR's proposal to base PNGL's GD23 allowances for **CEO & Group Management** on benchmark data derived in 2011 (12 years before the start of the GD23 period) is fundamentally flawed. This benchmark continues to be inconsistent with actual costs of employing the management team both historically and going forward; and

ii. UR's proposal to base PNGL's GD23 people allowances on 2020 actuals is inappropriate as it does not take account of the **Health & Social Care Levy** that was announced in September 2021.

4.1.3.1 UR's proposal to base CEO & Group Management allowances on outdated benchmarked data that is entirely inconsistent with actual costs incurred as dictated by market conditions

[redacted]

4.1.3.2 UR's proposal for allowed people costs does not include appropriate uplifts for the Health & Social Care Levy

In a statement to the House of Commons on the 7th September 2021, the Prime Minister announced plans to substantially increase funding for health and social care through a new tax, 'the Health and Social Care Levy'. The Levy was introduced in April 2022 and will be collected by means of an increase in the current rates of NICs by 1.25 percentage points in 2022/2023. In 2023/24 a formal legal surcharge of 1.25 per cent will replace the increase in NICs rates, while the underlying NICs rates will return to their previous level.

As PNGL's forecast people costs were submitted in June 2021 (prior to the announcement of the new Health & Social Care Levy) they do not include allowances for the new Levy. As the allowances for people granted by UR in the draft determination are based on historical average annual salary costs (e.g. 2020 actual costs) they also do not include allowances for the Health & Social Care Levy.

PNGL would therefore ask UR to uplift allowed people costs to correctly account for the impact of the Health & Social Care Levy.

4.2 ADVERTISING & MARKET DEVELOPMENT (OO)

Section 3.3 discusses PNGL's concerns with UR's draft determination for Advertising and Market Development (AMD) allowances available under the Owner Occupied (OO) connection incentive.

4.3 PROFIT MARGINS OF RELATED PARTIES

PNGL notes that UR is proposing to retain its policy established in previous price controls of disallowing profit margins of related parties.

This has resulted in a difference between charges levied by PES to PNGL and that allowed in the price control even though margins are low, aligned to best practice and normal transfer pricing between group companies.

We note that SGN NG has been granted a higher allowance under its *Emergency* cost category in 2026 "*due to additional involvement of the SGN NG services contractor in that year. Although this is a related company, SGN have assured us that there is no profit margin associated with this work and so no further adjustment is required*."[54]

Therefore, whilst UR appears to be adopting a consistent policy, PNGL would expect this to be supported by targeted benchmarking of the three GDNs' costs across each such area to ensure that the GDNs, and indeed consumers, are not unjustly disadvantaged as a result of each GDN's choice of how they meet their emergency, maintenance and metering obligations during GD23. For example, it would seem unjust that UR would not allow PES to earn any profit on works undertaken on PNGL's behalf if PNGL pays PES at market rates. Were PNGL to employ an independent third party to carry out this work then the third-party provider would charge enough to earn a profit on works undertaken. It is therefore unreasonable for UR to maintain a position whereby PES does not achieve a market level of return on its work.

4.4 ADVERTISING & MARKET DEVELOPMENT (non-OO)

4.4.1 ENTERTAINMENT

We note that UR has mistakenly used 2020 actual costs for UR's proposed allowance for Entertainment during GD23.

The activities associated with Entertainment were curtailed by the COVID-19 pandemic and therefore PNGL believes 2020 is not an appropriate baseline. 2017 to 2019 costs averaged c.£4.2k p.a. vs. 2020 costs of c.£0.7k (PNGL's GD23 submission averaged c.£4.9k p.a.)[55]. For the reasons set out above, it is not appropriate to use 2020 as the benchmark for any cost projections/forecasts due to exceptional circumstances of that year.

PNGL would request UR to reconsider its proposal on this basis.

[54] Paragraph 6.54 of Annex D

[55] Figures derived from UR's DD Opex Matrix shared with PNGL on 16th March 2022

4.5 EMERGENCY COSTS

UR has mistakenly used 2020 in deriving emergency call rates when 2020 was materially impacted by COVID-19 factors.

UR's proposed methodology for estimating the volume of emergency calls during the GD23 period uses historic average actual calls received during the first four-years of GD17 (2017 to 2020), expressed as a percentage of the cumulative connections. Table 33 provides summary information on the emergency call information used by UR to calculate the historic average:

	2017	2018	2019	2020	Total
Cumulative connections	209,259	218,035	227,433	235,412	890,139
No. calls	24,028	27,573	23,828	20,567	95,996
% calls to connections	11.5%	12.6%	10.5%	8.7%	10.78%

Table 33 – *Historic emergency calls data used by UR to estimate forecast emergency calls during GD23*

2020 was an abnormal year. Similar to other UK GDNs, PNGL experienced a 35% drop in emergency calls in Q2 2020 that was directly attributable to the pandemic and the reluctance of customers having utility personnel visit their homes. Table 34 provides an overview of the emergency call numbers PNGL experienced in 2020 compared with the first half of the GD17 period:

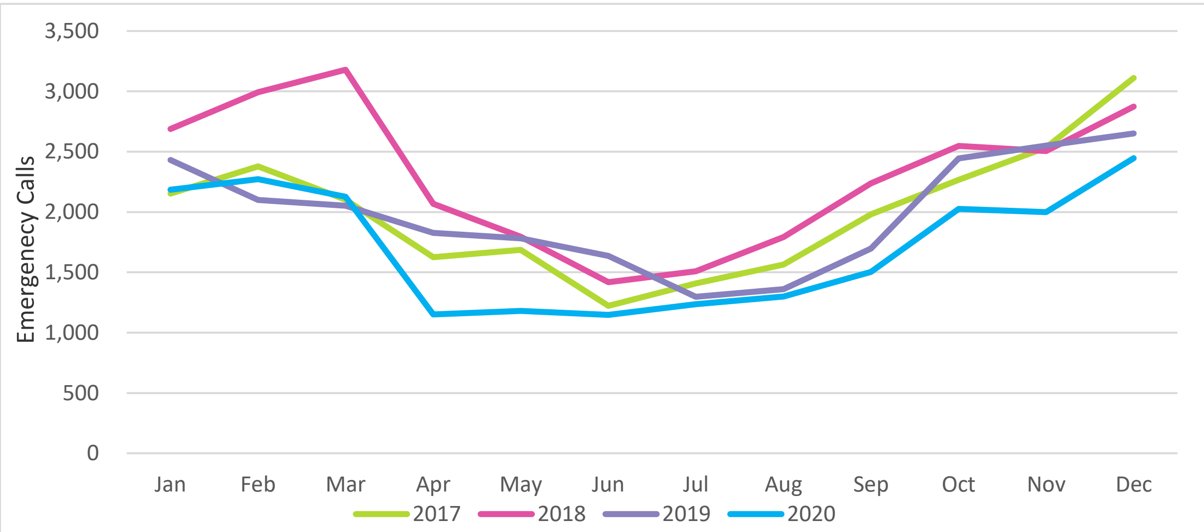

Table 34 – *Comparison of emergency call volumes received by PNGL on a monthly basis in 2020 versus 2017-2019*

When developing its estimate for the volume of emergency calls during the GD23 period, PNGL also utilised historic call volumes from the GD17 period but elected to exclude 2020 from its analysis, given the impact of abnormal customer behaviour experienced during the pandemic that would not be reflective of the GD23 period.

In the draft determination UR estimated a total number of emergency calls during the GD23 period which was around 3,000 less than forecast by PNGL[56]. However, if 2020 is removed from the methodology employed by UR, the volume of emergency calls forecast for GD23 is more aligned with those submitted by PNGL.

The methodology utilised by UR to estimate the volume of emergency calls during the GD23 period is fundamentally flawed. It includes actual data relating to 2020 which was an abnormal year that was heavily impacted by the once in a lifetime[57] COVID-19 pandemic. It is statistically inappropriate for UR to consider actual emergency job numbers experienced in 2020 as part of the normal standard operating environment. PNGL requests that UR refines its methodology to exclude 2020 data.

As UR's methodology employed to estimate emergency call volumes is linked to forecasts for PRE Repairs, PNGL requests that UR's PRE Repairs analysis is similarly refined to exclude 2020 data.

The methodology employed by UR, once corrected to exclude the 2020 as an abnormal year, should determine suitable emergency allowances under non-extreme conditions across the PNGL network. However, utilities must have resources available to manage extreme events as was experienced in winter 2020/11. In GB it is reasonable to assume that, given the size and operation of the networks, extreme events could be alleviated by diverting resources from other regions or areas of the business. As UR is aware however, PNGL is a relatively small company and the climate of NI is relatively similar e.g. if Belfast in the PNGL Licensed Area is experiencing an extreme weather event it is likely the firmus Licensed Area and the SGNNG Licensed Area is experiencing a similar extreme event; PNGL does not therefore have the option of drafting resources from other regions or areas of the business. While PNGL was able to meet the short-term spike in demand in Winter 2010/11, PNGL is concerned that the allowances proposed by UR would make managing a similar extreme event in GD23 unfeasible.

PNGL would highlight that activity levels have been set in the context of a number of relatively benign winters and is therefore concerned that in the context of a more extreme winter, emergency response costs are more likely to be abnormally affected.

PNGL would request that UR consider how additional expenditure required for extreme events or those outside the control of PNGL are accounted for under its proposal for GD23.

Note, section 4.3 details PNGL's comments on UR's proposal to retain its policy established in previous price controls of disallowing profit margins of related parties.

[56] Paragraph 5.35 of Annex D

[57] The United Nations Covid-19 response (https://www.un.org/en/un-coronavirus-communications-team/all-hands-deck-fight-once-lifetime-pandemic)

4.6 MAINTENANCE

PNGL's response focusses on UR's proposal to disallow PNGL's proposed Strategic Mains Inspection Programme (section 4.6.1) and pressure monitoring at governor bin level (section 4.6.2).

Note:

- The methodology applied by UR to calculate the number of FTEs available to support maintenance workstreams is inappropriate and does not consider the significant increase in maintenance activities that will be performed by PNGL during the GD23 period. Further detail is provided at section 4.1.2.3; and

- Section 4.3 details PNGL's comments on UR's proposal to retain its policy established in previous price controls of disallowing profit margins of related parties.

4.6.1 STRATEGIC MAINS INSPECTION PROGRAMME

PNGL is disappointed not to have received the funding to carry out exploratory trial holes to determine the condition of its protective steel plate asset ranging between 25 and 19 years old[58]. Use of steel plates is a recognised industry method (IGEM TD3 section 6.4.5) for reducing risk of damage for mains with a reduced depth of cover which are critical to minimising the risk of damage to PNGL's strategic mains infrastructure from heavy machinery and therefore lowering the risk of large-scale customer outages.

PNGL accepts that within its GD23 Business Plan it did not propose a prioritisation of works based on a risk ranking level assessment. However, PNGL has now undertaken this assessment[59] and would therefore ask UR to take this ranking into account when deciding what level of risk it deems appropriate for GD23 and therefore the allowances made available to PNGL in its final determination.

4.6.2 NETWORK PRESSURE MONITORING – GOVERNOR BINS

PNGL is disappointed at UR's proposal[60] to disallow all costs associated with proposed pressure monitoring at governor bin level.

PNGL provided significant detail in its GD23 Business Plan submission[61] and presented further explanation to UR as to the rationale and justification for this telemetry investment through the subsequent Information Request process.

[redacted]

These proposals present a simplified technical and reduced cost solution for extending existing pressure monitoring practices adopted for all below ground District Pressure Reduction Stations

[58] Paragraph 5.79 of Annex D of the draft determination

[59] PNGL supplemental technical evidence provided to UR by email 26 May 2022

[60] Paragraph 5.81 of Annex D of the draft determination

[61] June 2021 *GD23 Telemetry Update* paper

supplying larger networks to that of specific network governor bin supply set-ups (multiple feed systems and single source supply to greater than 10 properties) serving groups of currently unmonitored consumers.

UR's draft determination does not provide PNGL with the funds to undertake these pressure monitoring works and thus enable adoption of a uniform approach to the implementation of pressure recording across network pressure control assets.

PNGL would request UR to reconsider its determination of this proposal in its final determination and has provided supplemental technical evidence *[redacted]* to facilitate this.

4.6.3 PURGE POINT INSPECTION MAINTENANCE PROGRAMME

In its draft determination, UR allowed PNGL's proposed purge point inspection programme in full but indicated that it would explore specific avenues of this programme further for the final determination. PNGL has provided supplemental technical evidence[62] to respond to the avenues noted by UR in its draft determination and therefore assure UR that PNGL's proposals for ensuring it mitigates against the issues identified to date are reasonable.

PNGL would request UR to continue to allow PNGL's proposed purge point inspection programme in full in its final determination.

4.7 METERING

PNGL acknowledges the GD23 draft determination allowance for metering (excluding 5-year regulator inspection as detailed in section 4.7.1) as an appropriate allowance to deliver PNGL's regular metering maintenance programme in GD23.

Note, section 4.3 details PNGL's comments on UR's proposal to retain its policy established in previous price controls of disallowing profit margins of related parties.

4.7.1 B6 AND U16-U40 REGULATOR INSPECTIONS – 5-year jobs

PNGL provided additional evidence to support its 5-year regulator inspection requirements on 23rd February 2022 and acknowledges UR's confirmation[63] that:

- options for refining the *B6 Regulator Inspections – 5-year jobs* adjustment will be considered for the final determination. PNGL recognised in its February 2022 submission that either its operational or UR's strategic approach will ensure that an allowance is given to inspect each B6 regulator only once in any 5-year period; and
- it will review the *U16-U40 Regulator Inspections – 5-year jobs* for the final determination with a view to clarifying and reconciling any differences. PNGL confirmed in its February 2022

[62] PNGL supplemental technical evidence provided to UR by email 26 May 2022

[63] See PNGL's query raised under reference PNGL-005 of the post-DD Query Log

submission that its 5-year inspection and functional test of the slam-shut devices has resulted in the 5-year inspection of all U16 to U40 regulators commencing in 2021 (as opposed to 2024 when BS6400 requirements commence).

PNGL would request UR to reconsider its proposal on the basis of the information it made available to UR on 23rd February 2022.

4.8 PROPERTY MANAGEMENT

4.8.1 NETWORK RATES

Given network rates are costs incurred by PNGL over which it has limited control, we welcome UR's proposal in paragraph 5.96 of Annex D:

> *For the draft determination we are of the view for the GD23 period that uncertainty mechanism should be updated to reflect actual costs for network rates, subject to PNGL demonstrating that it has taken appropriate actions to minimise valuations. We will expect PNGL (as well as the other GDNs) to provide a copy of its actual network rates bill and appropriate payment verification to the Utility Regulator alongside its annual Uncertainty Mechanism submission which is usually submitted with the Annual Cost Reporting Template.*

i.e. that the previous treatment of network rates will continue to apply during GD23. For transparency, PNGL would ask that Table 9.7 of the consultation is updated to reflect the wording provided in paragraph 5.96 of Annex D. Further detail is provided in section 8.1.

Whilst we appreciate that network rates will continue to be treated as pass-through in GD23, PNGL believes that the calculation used by UR in its draft determination is incorrect in its treatment of the rate in the pound. We raise this in response to the consultation for transparency and to ensure that UR's network rates forecasts are the best available forecasts based on its final determination proposals. Further detail is provided below.

PNGL understands that the total revenue collected from business rates across NI is broadly flat year-on-year. The total revenue is 'normalised' at each revaluation through the rate in the pound i.e. the rate in the pound is periodically reset to ensure that the total revenue collected across NI remains static in real terms. As detailed in the announcement by the Finance Minister in June 2021 to revalue all non-domestic properties to calculate business rate bills from April 2023[64], there is an expectation that the review will rebalance rates charges away from businesses that have suffered due to the pandemic and also other underlying pressures on retail premises. With PNGL operating under a revenue cap system, this is expected to deliver a continuing increase in relative rates charges across GD23, however there is a likelihood that the rate in the £ applying to this rateable value will increase at the time of the valuation and then roll forward on this basis. PNGL's GD23 submission included an increasing rate in the pound to reflect this expected increase but a lack of clarity of when it might be

[64] https://www.finance-ni.gov.uk/news/murphy-announces-business-rates-revaluation

applied. UR's calculation includes a flat rate in the pound which does not seem an appropriate assumption upon which to base PNGL's network rates forecasts across GD23 and therefore PNGL would request that UR consider some form of adjustment to reflect the point it raised above.

We would therefore suggest that UR calculates PNGL's network rates charge based on either an uplift on baseline from the beginning of GD23 or through an increasing rate in the pound, as used by PNGL in determining its forecasts, to ensure that UR's forecasts are the best available forecasts based on its final determination proposals.

4.8.2 OFFICE RENT AND RATES

4.8.2.1 Office Rent

In its draft determination UR has reduced the annual rental of PNGL's office at Airport Road West by 1/6th to take into account its view that PNGL has an opportunity to sublet part of its premises.[65]

PNGL has been located within the office at Airport Road West from late 1999. During that period, PNGL has always sought to sublet any unutilised space to 3rd party organisations when feasible to do so. This subletting has proven to be increasingly challenging with the two unutilised areas within the building substantially unlet for much of the GD17 price control period (the most recent sublet arrangements of the two unutilised areas came to an end in 2014 and 2018). Whilst we have continued to market the available space since 2014, neither area has proved attractive to potential tenants. Therefore, one area has not been sublet for c.8 years, the other for c.4 years.

Given the unutilised space, and as noted in its GD23 Business Plan, PNGL undertook a review of its office facilities during 2019 to consider alternatives and identified that the overall cost of moving to a proportionally smaller office with similar requirements to that in Airport Road West (such as accessibility and parking) would be similar to the cost of its existing facilities, even if it is assumed that PNGL receives no income from subletting. Also, there would be considerable initial outlay required to build out and configure any new office, and PNGL has the opportunity to continue to 'sweat' the capital costs of operating within the existing premises for a longer period. On the other hand any new tenant for the property at Airport Road West is likely to have to incur significant upfront cost to make the space work for them – therefore the value in its utilisation is greatest for the incumbent.

Furthermore, the benefit of the current facilities was magnified during COVID-19 with PNGL being able to use its unutilised office space to keep the business fully operational during the pandemic.

Thus, UR's draft determination should be amended to include the full rental cost of the property at Airport Road West as subletting is highly unlikely and overall cost is in line with applicable benchmarks. In addition, if PNGL was to move elsewhere, UR would then have to incorporate the significant cost of moving within capital expenditure requirements and duplication of rental costs for a period in light of the need for continuity.

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[65] Paragraph 5.97 of Annex D

4.8.2.2 Office Rates

UR has mistakenly used 2020 actual costs for its proposed office rates allowance during GD23 when these where abnormally affected by COVID-19.[66].

PNGL received a 4-month office rates holiday in 2020 due to the COVID-19 pandemic. This means that UR's draft determination allowance is understated by 4/12th.

PNGL would request UR to increase PNGL's office rates allowance in its final determination to ensure that this is reflective of a 12-month period.

4.9 AUDIT, FINANCE & REGULATION

4.9.1 STATIONARY, COMMUNICATIONS AND BILLING

PNGL has forecast an increase of c.£60k p.a. within its *Stationary, Communications and Billing* cost line:

- 2017 to 2020 costs averaged c.£44k p.a.
- PNGL's GD23 submission forecasts average c.£104k p.a.

For reference, these figures have been derived from UR's DD Opex Matrix shared with PNGL on 16th March 2022.

The historical average of c.£44k p.a. is attributed to the costs incurred by PNGL to undertake meter reads for the following activities: re-visits following meter removals or return of a meter point where the property is vacant, meter queries or disputes, potential fraud situations, regular transportation service reads to facilitate allocation algorithms, implication of notional reads and other Network Code requirements.

The c.£60k p.a. increase relates to the requirement to re-visit properties to gain access to undertake necessary meter maintenance works. These costs are required during GD23 given PNGL's increasing maintenance programme and therefore increasing numbers of no access.

4.10 INSURANCE

As noted by UR in its draft determination, PNGL's insurance costs are dominated by three key areas, namely Business Interruption (BI), Public Liability and Directors and Officers (D&O) cover. PNGL highlighted in its GD23 Business Plan[67] that significant increases in costs had been encountered between 2020 and 2021 and were particularly marked for two of these areas, BI and D&O insurance. Whilst UR acknowledges the substantial documentation we provided as part of the review on our

[66] Based on PNGL's analysis of UR's DD Opex Matrix shared with PNGL on 16th March 2022

[67] Section 4.3.6.3.3 of PNGL's GD23 Business Plan

insurance premiums, including our 2021 actual costs[68], UR comments that fluctuations have been encountered in the past and proposes to roll forward PNGL's actual 2020 insurance costs:

> *For the GD23 draft determination we have rolled forward PNGL actual 2020 insurance costs except for car insurance. While we note the increased insurance costs overall in 2021 we are mindful that PNGL overall opex costs have actually decreased over the medium i.e. from 2010, and in that period PNGL insurance costs have experienced both annual increases and decreases and there has not been any period of sustained increases. However, we may undertake further analysis of PNGL insurance costs in advance of the GD23 final determination.*[69]

To facilitate UR's further analysis in advance of the GD23 final determination, PNGL advises that the insurance costs for 2022 have now been finalised and the increased 2021 premiums remain. Thus:

- where the cost for Public Liability plus D&O for 2021 was *[redacted]*, the charge for 2022 is *[redacted]*. These compare with the cost for 2020 which was *[redacted]*.
- where the cost for BI insurance for 2021 was *[redacted]*, the charge for 2022 is *[redacted]*. These compare with the cost for 2020 which was *[redacted]*.

Premiums therefore remain at the 2021 level. PNGL is providing UR with third party evidence[70] that the increase experienced by PNGL (specifically in D&O) in 2021 were relatively standard across almost all sectors.

The allowances provided by UR should be based on the actual premiums paid by PNGL. PNGL would request UR to reconsider its proposal based on the additional evidence now available, following finalisation of the insurance costs for 2022, which supports the increased premiums forecast by PNGL in its GD23 Business Plan submission.

4.11 CEO & GROUP MANAGEMENT

The main difference between PNGL's submission and the draft determination is that UR disallows a significant proportion of the remuneration packages forecast by PNGL for its management team. PNGL's detailed response is provided in section 4.1.3.1.

4.11.1 CORPORATE AFFAIRS

UR has mistakenly used 2020 actual costs for UR's proposed allowance for Corporate Affairs (captured under *Stationary, Communications and Billing*) during GD23 when these where abnormally affected by COVID-19.

[68] Paragraph 5.110 of Annex D

[69] Paragraph 5.113 of Annex D

[70] PNGL supplemental technical evidence provided to UR by email 26 May 2022

The activities associated with Corporate Affairs were curtailed by the COVID-19 pandemic and therefore PNGL believes 2020 is not an appropriate baseline. 2017 to 2019 costs averaged c.£180k p.a. vs. 2020 costs of c.£150k (PNGL's GD23 submission averaged c.£200k p.a.)[71].

PNGL notes that in its PR19 consideration the CMA acknowledged that adjustments for COVID-19 needed to be made by Ofwat in considering its approach once impacts were known. PNGL would suggest UR adopts this regulatory practice.

PNGL would request UR to reconsider its proposal on this basis.

4.12 NON-CONTROLLABLE OPEX

Licence Fees

PNGL welcomes UR's proposal to continue to treat licence fees as pass-through and therefore retrospectively adjust them to reflect the actual fees levied on PNGL by UR.

[71] Figures derived from UR's DD Opex Matrix shared with PNGL on 16th March 2022

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Capital Expenditure (Capex)

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5. CAPITAL EXPENDITURE

UR has provided insufficient capital expenditure (capex) to allow PNGL to deliver its necessary programme of works during the GD23 period. UR's draft determination sees both unjustified cuts in unit rates relative to those proposed by PNGL together with a disallowance of actual capital spend. This is an area where PNGL presented significant evidence and undertook extensive engagement with UR on its engineering approach in advance of the draft determination. However, at no point in those discussions were unit rates (or their level) highlighted as a concern by UR or was an opportunity given to PNGL to respond to any objection to our proposed unit rates.

Therefore, as detailed in section 3, UR's approach to determining PNGL's capex allowances for the GD23 price control period is one of our key areas of concern with the draft determination. We begin with this, move on to UR's draft determination for PNGL's reinforcement and resilience projects and then discuss PNGL's comments on other aspects of UR's draft determination. Where no comments have been made e.g. under "*Other Capex*", PNGL acknowledges, in the round, the GD23 draft determination provides an appropriate allowance to operate and maintain the PNGL network in GD23. However, should UR be minded to depart from or change some of these other allowances that PNGL has not specifically contested in this response, for the purposes of the final determination, PNGL would require advance sight of <u>those</u> changes to allow it the appropriate opportunity to respond in advance of UR's final determination.

If UR implements the capex proposals which PNGL addresses in this response at final determination:

- UR will fail to fulfil its statutory objective *to promote the development and maintenance of an economic and coordinated natural gas industry*; and
- the allowances granted will not cover the level of costs that will be incurred by PNGL and, contrary to UR's statement in its Executive Summary:

  > *The GD23 price control continues to support connections to the gas network by providing for a free connection at the time the connection is made, with the cost of the connection paid for by all consumers over a period of time.*

  will work against the public interest (and the interests of consumers of gas) as the proposed allowances will in fact result in domestic customers having to make a contribution to PNGL if they wish to connect their property to the gas network.

5.1 <u>CAPITAL INVESTMENT</u>

Sections 3.4.1 to 3.4.3 discuss PNGL's concerns with UR's approach to determining PNGL's capex unit rates for the GD23 price control period.

Section 3.4.4 discusses the capex required to undertake the network reinforcement projects included by PNGL within its GD23 Business Plan.

5.2 RESILIENCE

PNGL is disappointed at the lack of detail in the draft determination as to why its proposed resilience projects have not been appropriately provided for by UR in the GD23 price control period.

PNGL provided significant detail in its June 2021 submission and through the subsequent Information Request process justifying the set of resilience projects it proposed as part of its GD23 submission.

[redacted]

In summary, UR has failed to provide any transparency its decision-making regarding disallowance of the resilience projects proposed by PNGL, nor has it provided us with the appropriate means to undertake such resilience works in GD23 or in future price control periods.

[redacted]

5.3 ACTIVITY LEVELS – Properties Passed, Connections and Replacement Meters

PNGL notes that UR has not always accepted its properties passed, connection or replacement meters activity forecasts across GD23. PNGL does not dispute UR's proposal however on the basis that its capex allowance will be retrospectively adjusted via the capex uncertainty mechanism[72] based on actual number of properties passed, connections or replacement meters at the next price control review.

Section 6.3.2 details PNGL's comments on UR's proposed GD23 properties passed incentive.

Section 3.3 details PNGL's comments on the implications of UR's proposed Advertising, Marketing and Incentives (OO) allowance on its GD23 OO connections.

5.4 CUSTOMER CONTRIBUTIONS

PNGL notes that UR has based its Basket of Works analysis on PNGL's gross costs. This change in approach from previous price controls (where UR determined capex allowances net of customer contributions) has led to a methodological error in the treatment of customer contributions where UR proposes a c.2.8% reduction across all PNGL's capex cost lines in GD23.

[72] Table 9.6 of the consultation

PNGL urges UR to rectify this methodological error in its final determination by:

- Firstly, excluding diversions from its analysis of gross and customer contributions.

  Diversion works are unforeseeable, largely rechargeable, and indeed in its 2017-2020 Annual Cost Reporting submissions, PNGL has assumed that these costs are recovered in full. On this basis, PNGL has not included any proposed diversions in its GD23 Business Plan submission. Therefore, it is flawed to assume a contribution will be received from an activity that has not been forecast in PNGL's GD23 Business Plan. Removal of diversions from UR's analysis would reduce the 2017-2020 four-year average calculated by UR to c.2.15% and represents a c.£0.5m reduction in contributions across GD23 based on the total capex proposed by UR in its draft determination; and

- Secondly, attributing customer contributions to the GD23 basket of activities where contributions are received to create an accurate net allowance.

  It seems unreasonable for UR to adopt a methodology which assumes that PNGL will receive a customer contribution towards <u>all</u> capex activities in GD23 e.g. its 20-year meter replacement programme, implementation of TMA. The approach proposed addresses this by ensuring that the level of contribution is reflective of the GD23 basket of activities i.e. each individual activity has its own average contribution (e.g. the 2017-2020 four-year average contribution for New Build Mains was 3% therefore the GD23 customer contribution for New Build Mains would be 3% of the GD23 gross cost for New Build Mains). The following illustrates the flaw in UR's draft determination:

  - A large proportion of the contributions received are from I&C customers. As UR is aware, a customer pays a contribution based on a cost exceeding a published allowance in PNGL's Connection Policy (the published allowance being the price control allowance). Using the allowances granted in GD17, in 2020 I&C customers contributed *[redacted]* or *[redacted]* of I&C connection costs. In 2020, domestic customers contributed *[redacted]* or *[redacted]* of domestic connection costs. If UR's proposed approach to dealing with contributions is adopted, i.e. a 2.8% contribution from <u>all</u> activities, based on 2020 costs I&C customers would only contribute *[redacted]* towards their connection and domestic customers would now have to contribute *[redacted]*. This means that:
    - the *allowance* being set for I&C is artificially high and as such I&C customers in the future would contribute proportionately less towards their connection; and
    - the *allowance* being set for domestic is artificially low and as such domestic customers in the future would contribute proportionately more towards their connection.

    An example of the contribution being made by an I&C customer in GD17 is to pay for the expensive reinstatement of a public realm street. A domestic customer does not have this type of reinstatement so why should they now in practice, given the impact of UR's proposed reallocation of customer contributions detailed above, subsidise the cost of an I&C reinstatement? UR's approach in its draft determination is unfair, unjustifiable and flawed and will work against the public interest as domestic customers will be subsidising the cost of I&C reinstatements.

Based on the 2017-2020 four-year average contribution for each activity would reduce UR's proposed GD23 customer contribution by c.£0.6m based on the total capex proposed by UR in its draft determination.

In effect UR is continuing to grant GDNs a net allowance in GD23 and therefore consumers will continue to receive a net allowance for any chargeable works. However, UR's proposal to determine activity allowances that are not representative of the customer contributions received for each of the activities is not accurate or transparent for consumers given that GDNs transpose UR's net allowances into Connection Policy. This change in approach will mean that there will be no direct read across to the gross allowances quoted by UR in its final determination. PNGL would therefore ask UR how we create transparency within our Connection Policy for consumers when publishing allowances associated with each of the Basket of Works activities?

PNGL notes that UR has not proposed that customer contributions are subject to uncertainty adjustment i.e. the reduction will be fixed as part of the GD23 final determination.

PNGL urges UR to reconsider its proposal on this basis and advise PNGL how the adjustment for customer contributions is to be implemented via the GD23 Uncertainty Mechanism.

5.5 TRAFFIC MANAGEMENT ACT (TMA)

PNGL welcomes UR's proposal that TMA costs will continue to be subject to retrospective adjustment at the time of the next price control review given the uncertainty in terms of the timing of implementation of TMA in NI and the impact on costs. PNGL notes UR's analysis retains TMA forecasts as a separate capex cost line to better facilitate the retrospective adjustment.

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6. ENERGY STRATEGY, INNOVATION AND INCENTIVES

6.1 ENERGY STRATEGY

PNGL acknowledges that the GD23 price control process commenced in advance of the publication of the *Northern Ireland Energy Strategy - the Path to Net Zero Energy*[73] (the NI Energy Strategy) and changes in UR's vires to facilitate net zero ambitions form part of the necessary considerations therein. However, PNGL believes there is sufficient time for UR to consider the NI Energy Strategy's ambition for use of the gas network under the current regulatory framework and reflect this in its final determination, specifically aspects that can be effectively progressed within the current UR vires.

We welcome UR's acknowledgement that costs related to the implementation of the NI Energy Strategy[74] will be captured within a ring-fenced Uncertainty Mechanism and will **not** be subject to the materiality threshold. However, as previously highlighted by PNGL in its *GD23 Innovation Business Plan* we believe UR needs to consider further a GD23 Gas Networks Innovation Fund that could be utilised for individual projects and trials during the GD23 price control period. Projects undertaken will help all parties to understand the strategic and operational viability of innovation on the NI gas network to align with the NI Energy Strategy's position on its future. Again, PNGL's *GD23 Innovation Business Plan* detailed how innovation funding could be established and utilised and we consider it is worth detailing again PNGL's proposal:

1. It would first require UR to determine the value of a GD23 Gas Networks Innovation Fund and how this should be funded.

    - PNGL welcomes discussion with UR on the principle adopted for establishing the Social Enhancement Fund within the transmission regulatory framework. PNGL believes investment of c.£2m a year would be required to inform NI's energy transition for heat and proposes £12m is included within a GD23 Gas Networks Innovation Fund.

2. It would also require UR to establish how the fund is operated. PNGL believes the key principles should be:

    - The fund is governed by UR.

    - Funding is used solely to further the development of the gas network in NI.

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

[74] Paragraph 7.8 of the consultation

- Applications for funding are made by the GDNs, singularly or jointly, or other interested parties.

- Applications for funding are open between 1 January 2023 and 31 December 2028.

- The goals of the fund are detailed within the GD23 final determination. Like the CRU, UR should recognise that:

  > *…due to the uncertainty inherent in innovation, it is likely that not all innovation projects will be successful - indeed the positive learnings from a project could be that a particular practice or technology is not viable.*[75]

- Funding is authorised by UR after receiving guidance from an advisory panel.

It is PNGL's understanding that the approach we propose is similar to that facilitated by UR in the NIE's RP6 price control.

6.2 INNOVATION

PNGL notes UR's approach to innovation will follow the innovation principles outlined in GD17 and that it welcomes *"…innovation initiatives from the GDNs, where reasonable and economically viable"*[76].

Supplementary to this, Section 6.1 details PNGL's proposal for the establishment of a specific GD23 Gas Networks Innovation Fund to trial and develop projects in support of the NI Energy Strategy's ambition for the future of the gas network.

6.3 INCENTIVES

Incentive based regulation is the cornerstone of economic regulation and unlike our GB counterparts, the opportunities presented for PNGL to outperform are more limited. Therefore, it is disappointing to note that even the current limited incentives are subject to reduction and inappropriate amendment without proper engagement on impact on PNGL.

6.3.1 CAPEX SHARING MECHANISM

Section 10.1 details PNGL's comments on UR's proposed capex sharing mechanism.

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[75] Gas Networks Ireland, "*PC4 Gas Innovation Fund Annual Report: 2017/18 and 2018/19*" https://www.gasnetworks.ie/business/renewable-gas/innovation-fund/PC4_GIF_Annual-Report_Oct-2017-to-Sep-2019-v2.pdf

[76] Paragraph 2.7 of Annex H

6.3.2 PROPERTIES PASSED INCENTIVE

UR confirmed[77] its proposal to apply the GD23 properties passed incentive to Individually Funded Projects and to the infill mains to make gas available to existing properties i.e. new build infill mains are excluded from the incentive. As detailed in PNGL's *GD23 Infill Allowances* paper submitted to UR in June 2021:

1. The c.4,000 properties[78] remaining to be passed across PNGL's Individually Funded Projects in GD23 are LPG properties and properties with wayleaves or unadopted roads which have more complex requirements. Specifically:
    - 2,118 properties within the Greater Belfast Infill Project;
    - 78 properties in Whitehead; and
    - 1,668 properties in East Down.
2. Although PNGL does not envisage any other significant network development, it believes there may be c.900 properties which do not fall within the Greater Belfast Infill Project, Whitehead or East Down infill schemes which it will be asked to make gas available to during GD23.

Making gas available to these properties is largely reliant on external factors and is not therefore a controllable activity which should have an incentive attached to it:

Firstly, LPG sites are not natural gas prepared and therefore PNGL will be required to install new mains and services to connect each site to its network i.e. it will not be able to repurpose the existing infrastructure. To ensure the safety and integrity of its network, PNGL requires that works may only commence when all properties within each LPG site have made the decision to convert to natural gas i.e. PNGL will either have to pass and connect all properties at once or pass and connect none as mixed gas sites are not permitted for health and safety reasons. For the avoidance of doubt all LPG sites referred to in the PNGL GD23 Business Plan are **not** natural gas prepared sites.

Secondly, wayleave requirements and unadopted roads prevent PNGL from making gas available to a street. However, obtaining the necessary wayleaves and indeed the adoption of roads are outside of PNGL's control.

For the avoidance of doubt, all properties remaining to the passed in Whitehead, East Down and within the Greater Belfast Infill Project (from 2024 onwards) are LPG sites and/or have wayleave requirements / unadopted roads. Making gas available to these properties is not therefore a controllable activity which should have an incentive attached to it. UR's application of a properties passed incentive is therefore both flawed and unfair.

Thirdly, the c.900 properties forecast to be passed outside of the Greater Belfast Infill Project, Whitehead or East Down infill schemes will only be passed where a consumer makes a specific request for connection. These properties have not been identified by PNGL and do not form part of its infill

[77] See UR's response to PNGL's query raised under reference PNGL-013 of the post-DD Query Log

[78] excluding the 2,838 properties within the Greater Belfast Infill Project that will be passed under PNGL's infill development programme in 2023

programme for GD23. UR appears to appreciate this and has not included any infill targets re. existing properties passed in its draft determination for PNGL. On that basis, PNGL will not be subject to any penalty under the GD23 properties passed incentive.

Finally, PNGL's GD23 submission simply spread the remaining properties to be passed across GD23 pro rata on the basis that its allowance will be adjusted based on actual properties passed each year via the GD23 Uncertainty Mechanism. However, in reality the phasing of the works will be dictated by the three factors detailed above.

In summary, as the timing of when PNGL may make gas available to these properties is largely reliant on external factors, PNGL does not believe it is appropriate to include a properties passed incentive for PNGL in GD23.

PNGL would request UR to remove its proposed GD23 properties passed incentive for PNGL on this basis.

For the avoidance of doubt, UR would be in error if it implemented its proposal and kept the mechanism separate across the GD17 and GD23 price control periods i.e. GD17 will end and GD23 will start afresh[79] for Individually Funded Projects. This proposal would mean that PNGL may be penalised for making gas available to a property earlier than planned e.g. if PNGL was able to bring gas to a site within the Greater Belfast Infill Project in 2022 which it had originally included in its infill development programme in 2023. This steps on the toes of the overarching purpose of the properties passed incentive which was to reward GDNs where cumulative performance is ahead of target. Indeed, in approving the Greater Belfast Infill Project UR accepted that it would span two price control periods. To introduce a properties passed incentive in the final year of the project is fundamentally wrong and brings only downside risk for PNGL.

6.3.3 COST OF DEBT MECHANISM

Section 2.1 discusses PNGL's concerns with the cost of debt mechanism.

[79] See PNGL's query raised under reference PNGL-013 of the post-DD Query Log

7. STAKEHOLDER AND CUSTOMER / CONSUMER ENGAGEMENT

In its approach document[80] UR placed significant emphasis on stakeholder and consumer engagement and advised[81] that consumers remain at the centre of its consideration. PNGL agreed that consumers need to be at the heart of its GD23 Business Plan and undertook extensive stakeholder and consumer engagement evidenced in the *GD23 Stakeholder and Consumer Engagement* paper. This paper provided UR with a comprehensive insight into the commitment PNGL has to invest in effective and meaningful engagement on a regular basis and specifically how stakeholder and consumer engagement and insights informed its GD23 Business Plan submission as a result.

We note and welcome UR's recognition that "*PNGL is committed to a high level of consumer engagement which should result in enhanced customer service*"[82], however it was disappointing to see little evidence within the draft determination of UR's consideration of PNGL's detailed engagement process.

7.1 CONSUMER AND STAKEHOLDER ENGAGEMENT IN GD23

PNGL welcomes UR's indication that it will reconvene the Consumer Engagement Working Group to:

- review GDNs' delivery against local consumer needs and expectations; and
- agree on the timetable for the introduction of additional consumer focused metrics, KPIs and targets, where the review indicates that these provide further actionable data for the GDNs.

In the meantime, PNGL remains committed to the delivery of high levels of service across all gas consumers within its Licensed Area. Throughout the GD17 review period PNGL has continuously assessed its customer service offering to include the development of a Vulnerability Strategy which is being incorporated into existing workstreams and integrated into the wider workplace as best practice. PNGL does however recognise that its approach to consumer engagement will evolve in line with the needs of the UR Consumer Protection Programme (CPP) and in particular its best practice framework project in the coming years and may require PNGL to embrace additional responsibilities. As UR's CPP does not align wholly with the price control review the additional responsibilities with this workstream are not fully known. These may require operational changes to deliver the necessary consumer protection measures to continue meeting the needs of gas consumers.

PNGL would therefore welcome discussions with UR on an appropriate mechanism within its GD23 Final Determination which would (i) allow it to increase its resources and develop systems to facilitate any new operational requirements in this area; and (ii) be cognisant of the resources, time

[80] https://www.uregni.gov.uk/files/uregni/media-files/GD23%20Approach%2001.00%20-%20Consultation%20published%202020-06-01.pdf

[81] Paragraph 6.1 of UR's approach document

[82] Paragraph 8.16 of the consultation

and cost that will need to be dedicated to achieving, and thereafter maintaining, BSI 18477 or alternative accreditation.

8. UNCERTAINTY MECHANISM

8.1 UNCERTAINTY MECHANISM

PNGL notes that an uncertainty mechanism has been proposed for GD23 in line[83] with that currently being applied for GD17.

PNGL comments on the treatment of network rates within the mechanism in section 4.8.1. For transparency, **PNGL would ask that Table 9.7 of the consultation is updated to reflect the wording provided in paragraph 5.96 of Annex D**, which reflects the previous treatment of network rates i.e.

Opex Item	Uncertainty Mechanism applicable in GD23
Property Management	Updated to reflect actual costs for network rates, subject to PNGL demonstrating that it has taken appropriate actions to minimise valuations.

PNGL would also ask that Table 9.6 of the consultation is updated to include:

Capex Item	Uncertainty Mechanism applicable in GD23
Domestic and I&C meters - other replacement	Output based on the actual number of meters replaced.

in line with the mechanism currently being applied. The treatment of other replacement meters during GD17 was clarified by UR via email on 18th July 2019.

8.2 MATERIALITY THRESHOLD

PNGL made its Business Plan submission on the basis that the current £100k materiality threshold for significant costs not reasonably foreseeable at the price control determination but incurred by GDNs thereafter, remained.

We note that GB regulators have proposed materiality thresholds linked to proportion of revenue for specific projects. However, given the level of, and long-term profiling of, revenues in NI, the adoption of a GB approach appears inappropriate. PNGL notes that SONI has a materiality threshold of £40k and given the differing scale of operations, PNGL would question why UR is proposing a much higher threshold of £120k would apply to GDNs.

The use of a materiality threshold for project assessment must be considered against the overall level of incentives available within the price control. It would be unacceptable to PNGL that the incentive to deliver efficiencies or outperform would be undermined by penal thresholds which would see it

[83] Updated for GD23 unit rates and activities

having to deliver new projects with no associated allowances. This approach could harm consumer interests as it may discourage PNGL from investing in certain projects which do not have the sufficient scale or where payback is a deterrent to delivery of certain efficiency projects.

PNGL welcomes UR's acknowledgement that costs from the NI Energy Strategy[84] will be captured within a ring-fenced Uncertainty Mechanism and will **not** be subject to the materiality threshold. This approach should be extended to all projects captured within the Economic Project Mechanism:

> "*Economic Project Mechanism – allowances for major new projects not included in our determination, delivery of the Energy Strategy objectives or Innovative projects including new metering solutions and meter reading.*"[85]

PNGL also expects that costs associated with implementing UR's Consumer Protection Programme and Best Practice Framework's Project (see section 7.1) are allowed for in full and not subject to a materiality threshold.

PNGL would ask UR to clarify in the GD23 Uncertainty Mechanism that:

- **all projects captured within the Economic Project Mechanism; and**
- **costs associated with implementing UR's Consumer Protection Programme and Best Practice Framework's Project**

are not subject to a materiality threshold.

It is also important that PNGL has advance sight of any change to UR's draft determination proposals to allow it the appropriate opportunity to respond in advance of UR's final determination.

[84] Paragraph 7.8 of the consultation
[85] Paragraph 9.4 of the consultation

9. FINANCIAL ASPECTS

We begin with UR's proposal to change the general measure of inflation applied in the GD23 price control to the Consumer Prices Index including owner occupiers' housing costs (CPIH) and then discuss PNGL's concerns with UR's rate or return proposals for GD23, the financeability analysis UR has undertaken and its approach to determination of the frontier shift.

9.1 ADJUSTING FOR INFLATION

PNGL provided UR with a detailed assessment of how the RPI CPIH switch could be implemented. In particular, we provided UR with a revised Pi model to demonstrate that our approach provided revenue neutrality, i.e. we provided a model that could work in CPIH and RPI terms and we demonstrated that cash-flows were equivalent in PV terms under both indices. We note that UR has not adopted the same approach as that set out by PNGL, and importantly UR has not built within the GD23 Pi model a revenue neutrality check using its approach. In the interest of transparency, we ask that UR incorporate a revenue neutrality check within its revised Pi model and provide this to PNGL.

9.2 RATE OF RETURN

Section 2.1 discusses PNGL's concerns with UR's proposed rate of return.

9.3 FINANCEABILITY

Section 2.2 discusses PNGL's concerns with UR's financeability assessment.

9.4 FRONTIER SHIFT

Section 2.5 discusses PNGL's concerns with UR's proposed frontier shift, itself comprising Real Price Effects, Ongoing Efficiency and a forecast of CPIH inflation.

10. OUTPUTS, OUTCOMES AND ALLOWANCES

10.1 RISK SHARING MECHANISM

PNGL notes that the GD23 draft determination indicates a change in the capex rolling incentive mechanism without a robust rationale or analysis provided for such a move. As detailed earlier in this response, it is well-established that the evidential threshold for a regulator introducing novel deductions in a price control framework, which depart from regulatory precedent, is high and therefore PNGL would have expected some discussion on this matter, not least on the incentive properties of its proposal vs. the 5-year capex rolling incentive and indeed given the significant reduction in capex unit rates proposed by UR in its draft determination. As it stands, PNGL believes that its current proven principles of risk sharing i.e. a 5-year capex rolling incentive mechanism for PNGL, remain reasonable for GD23.

PNGL notes UR's current thinking[86] that a simplified 35:65 risk sharing mechanism could be a reasonable alternative. PNGL understands the simplification and clarity that such a risk sharing mechanism may bring for UR. However, UR has not presented as part of its draft determination or in response to subsequent queries raised by PNGL, rationale for amendment to the current principle of risk sharing supported by detailed analysis on the impact to GDNs / consumers e.g. does this distort the incentive properties of a rolling mechanism. If UR's proposal for GD23 is indeed "*in the interest of simplicity and consistency*"[87], we would have expected UR to propose the alternative approach i.e. <u>retaining</u> the capex rolling incentive mechanisms for FE and PNGL and applying a similar approach to SGN given that SGN's Licence already contains a capex rolling incentive mechanism, albeit the condition is switched off.

PNGL is content that its current 5-year capex rolling incentive mechanism is appropriate and should be maintained for GD23. PNGL would however be happy to engage with UR to investigate a simplified risk sharing mechanism as part of the GD29 price control process.

10.2 DESIGNATED PARAMETERS AND DETERMINATION VALUES

PNGL notes that UR will modify PNGL's Licence to reflect the GD23 Designated Parameters and GD23 Determination Values in order to bring into effect its GD23 determination.

As advised during the consultation process[88], PNGL identified some transposition errors within UR's Pi model for PNGL published at Annex K of the consultation:

- *Pis Calc* tab - *Allowed Capex Overspend* in row 26 should be linked to row 37 of the *DAV Pi* tab.

[86] Paragraphs 11.2 to 11.5 of the consultation
[87] Paragraph 11.2 of the consultation
[88] See PNGL's queries raised under reference PNGL-027 and PNGL-031 of the post-DD Query Log

- *Inputs* tab – column H rows 111 to 116 should reflect *UM Adjusted Capex* (not actual capex as per Annex K).

- *Inputs* tab – actual capex detailed in rows 127 to 132 should be restated to ensure that the correct depreciation profile is provided until 2017.

PNGL would ask that UR make these adjustments in its final determination Pi model.

10.3 LICENCE MODIFICATIONS

PNGL notes that UR would need to modify PNGL's Licence to implement its proposal to adopt CPIH as the general measure of inflation in GD23 (see section 9.1). PNGL would therefore welcome early sight of UR's proposed licence modifications so that any discrepancies are addressed at the earliest opportunity.

11. BUSINESS PLAN ASSESSMENTS

PNGL's self-assessment of its GD23 Business Plan submission against the criteria set out by UR was presented to UR as part of its June 2021 submission. This included a reference to the key documentation in the GD23 Business Plan submission which supported PNGL's delivery of an Exceptional business plan.

Categories	Features
A: Exceptional	Exceptional and stretching business plan. Excellent responses across most test areas. Limited regulatory intervention to translate to price control package. Relatively high degree of trust in company.
B: Good	Good plan but falling short of being an exceptional and stretching plan. Excellent responses in some test areas. Some regulatory intervention and therefore less trust than Category A.
C: Meeting Basic Expectations	Plan does not evidence how best to serve customers and stakeholders. Significant concerns and lack of excellent responses across all test areas. Extensive regulatory intervention and therefore less trust than Category B.
D: Poor	Self-serving business plan with poor responses in multiple test areas. Extensive regulatory intervention to translate to price control package. Severe concerns about company's ability to deliver outcomes for stakeholders and consumers. Requirement for detailed monitoring of company during the price control period.

Table 12.2: Business plan categorisation expectations

PNGL welcomes UR's conclusion that overall, the PNGL business plan was rated as **Good** with one area identified as **Exceptional**[89]. However, this has not been reflected by UR in its draft determination where it is proposing extensive regulatory intervention across many aspects of PNGL's Business Plan. UR's proposed price control package is unreasonable and unbalanced as detailed throughout this paper and notably in sections 2 and 3. This leads to a package which in the round is not in the best interest of consumers and which does not ensure that PNGL is able to finance its activities.

PNGL has already[90] recommended further discussion with UR on the approach to business plan assessments and in relation to UR's assessment of PNGL's GD23 business plan, flagged two references within the document which, in the interest of transparency, we wished to clarify:

[89] Paragraph 12.29 of the consultation

[90] Emails between PNGL and UR of 3 March 2022

- *"When utilising PNGL's GD23 P1 tariff versus the 2020 P1 tariff, there is an increase of 0.4%. This is in contrast to the 3.6% reduction in average distribution tariff from PNGL's business plan."*[91]

  Reference to the 2020 P1 tariff is misleading as conveyance charges are subject to over/under-recoveries each year. The GD17 P1 price would appear a more appropriate comparison.

- *"PNGL's plan could have included measures toward fixing financeability issues, should they arise during the GD23 period."*[92]

  This reference is misleading given PNGL's financeability submission was backed by detailed revenue neutrality and RPI / CPIH modelling and supported by PNGL's engagement with UR.

[91] Table 1.3 of Annex N

[92] Table 1.6 of Annex N

12. NEXT STEPS

In many of the key areas identified in section 3, PNGL is concerned by the lack of meaningful engagement with UR throughout the price control process to date. Whilst we have provided UR with extensive evidence to support our GD23 Business Plan at the time of submission and through the information request process thereafter, it is not clear to us whether this evidence has been disregarded or misunderstood. In other areas, PNGL believe that inappropriate forecasts and errors may also have arisen due to lack of engagement and understanding. This lack of transparency and due consideration to PNGL's submissions and views puts the certainty and robustness of the regulatory process and the GD23 draft determination into question.

PNGL has already taken the opportunity to inform UR of a number of concerns, errors and flawed methodology within the draft determination during the consultation period. Given that UR intends to publish its GD23 final determination in September 2022, we would welcome and encourage further engagement and discussion between UR and PNGL on the price control so as to reach a satisfactory final determination which protects the interests of consumers of natural gas, secures that PNGL is able to finance its activities which it is authorised or required under Licence to undertake and permits UR to fulfil its statutory duties in both of these areas.

12.1 FURTHER ISSUES

PNGL would suggest that the Gas Distribution Forum is reconvened following UR's GD23 determination to agree a suitable timetable for addressing areas that are to be considered during the GD23 price control period but after the GD23 final determination, notably the future metering solutions project[93] and implementing UR's Consumer Protection Programme (CPP)[94], so that GDNs may prioritise UR's most relevant aspects. This will ensure that there is a transparent and workable timetable for both UR and GDNs to manage workloads into the future.

[93] Paragraphs 2.35 to 2.39 of the consultation

[94] Section 7.1 of this response