Paul Harland
Finance and Network Assets
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED

25th November 2022

Dear Paul,

Re: Licence Modifications Pursuant to the GD23 Final Determination and other Regulatory Decisions, Consultation Paper, 28 October 2022

firmus energy (Distribution) Limited ("firmus energy") welcomes the opportunity to respond to the consultation on the Utility Regulator's Licence Modifications pursuant to the GD23 Final Determination (the "Licence Modifications").

Please note, however, that this response is without prejudice to firmus energy's right to make further representations and comments (which may potentially include comments on issues not set out below) prior to the publication by the Utility Regulator of its decision to proceed with the Licence Modifications.

Outcome of the Final Determination

Cognisant of the Utility Regulator's, consumers' and our own objectives, firmus energy developed a GD23 Business Plan that set out ambitious but deliverable targets to continue making connections to our network whilst supporting the efficient operation and maintenance of our assets and recognising the significant contribution to be played by firmus energy in Northern Ireland's journey to net zero carbon.

Our Business Plan for the GD23 period was developed with customers front and centre of our objectives for the six-year review period and with the new Energy Strategy's objectives very much in mind.

In seeking to further develop the gas network, to achieve greater economies of scale and lower network usage charges, we are also committed to developing biomethane and hydrogen as sustainable alternatives to natural gas, thus further reducing carbon emissions and providing greater energy security, and further reducing overall energy costs by better utilising food/agricultural waste and curtailed wind in Northern Ireland.

firmus energy's Business Plan aligned fully with the Utility Regulator's primary objective for gas, i.e. "*to promote the development and maintenance of an efficient, economic and coordinated gas industry in Northern Ireland"*[1], as well as the goals of Northern Ireland's recently published Energy Strategy, which states, "*we will continue to encourage people with access to the gas network to connect to it."*[2]

In our consultation response we raised serious concerns around the practical implications of the Utility Regulator's GD23 Draft Determination. We did not believe that it would deliver the best outcomes for consumers in the short, medium or longer term, with opportunities to optimise investment already made in our network and contribution to Northern Ireland's energy transition being materially and irreparably impacted.

In particular, we focussed upon the Owner Occupied Connection Incentive, our contractor unit rates, Rate of Return, and allowances to support the delivery of the new Northern Ireland Energy Strategy.

We welcome the Utility Regulator's acknowledgement and decision to address some of the above concerns in its Final Determination, with more appropriate allowances for Owner Occupied Connection Incentives, contractor unit rates for capital expenditure and ringfenced Energy Strategy funding.

One area that remains a key concern however, is the Rate of Return and specifically the ability for firmus energy to finance the GD23 activities.

Article 14 of the Energy (Northern Ireland) Order 2003 places a statutory duty upon the Utility Regulator to ensure that licence holders are able to finance their activities.

Paragraph 10.63 of the Final Determination states *"The evidence that we have seen in rating agency reports, as well as analysis conducted by other UK regulators, indicates that a GDN will normally need to maintain post-maintenance interest cover ratio (PMICR) of at least 1.4 times and gearing of no more than 70% in order to obtain a BBB credit rating."*

Despite this assessment, the financeability metrics published in the GD23 Final Determination, even at notional gearing levels of 45%, show firmus energy falling well below this 1.4 threshold in 2023.[3]

No mitigation has been provided by the Utility Regulator to demonstrate how they have fulfilled their statutory duty around financeability for the first year of the GD23 Price Control.

Whilst firmus energy has no formal requirement to obtain/maintain a BBB credit rating, we will however shortly commence the refinancing of our debt and lenders are not going to be encouraged by such poor financeability metrics, inevitably leading to higher costs of debt.

Therefore, firmus energy requests the opportunity for further dialogue with the Utility Regulator prior to a decision to proceed on the Licence Modifications.

[1] The Utility Regulator's principal objective is set out in Article 14 of the Energy (Northern Ireland) Order 2003
[2] DfE's Energy Strategy "The Path To Net Zero Energy", December 2021
[3] Table 10.14 of the GD23 Final Determination shows a PMICR of 0.85 in 2023 at 45% gearing

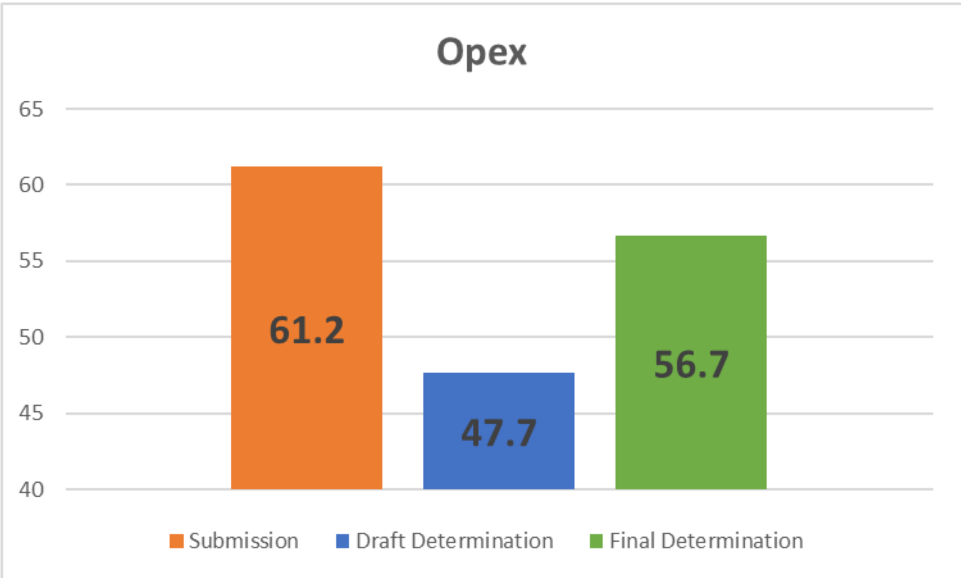
Learnings from the Gas Distribution Price Control 2017 to 2022 ("GD17")

For GD23, firmus energy and the Utility Regulator built on the processes, templates and learnings from GD17. A key learning from GD17 was the importance of consistency. The inputs and data templates were consistent with GD17 and the Annual Cost Reporting (ACR) process. The data capture and reporting mechanisms remained in line with the GD17. This consistency proved invaluable in populating the templates and providing a shared platform to compare historical results to the GD23 forecast figures.

Operating Cost and Capital Expenditure Allowances

Whilst the final determined GD23 allowances for operating costs and capital expenditure are less than our submitted figures, we welcome movements from the Draft Determination, with the Utility Regulator addressing a proportion of the inappropriate and insufficient allowances we identified in our response to the Draft Determination.

Operating cost allowances



The operating cost allowances provided in the Final Determination reflect a much more balanced view of forecast costs for the GD23 period, when compared to the Draft Determination.

In particular, the increased allowances for owner occupied advertising and marketing, funding work undertaken to promote and secure owner occupied connections, should benefit all consumers by helping maximise new connections to the network, increasing volumes and thereby reducing conveyance charges for all customers.

We were, however, disappointed to note the Utility Regulator's comments on Audit, Finance and Regulation costs[4] where comparisons were drawn between proposed GD23 allowances and GD17

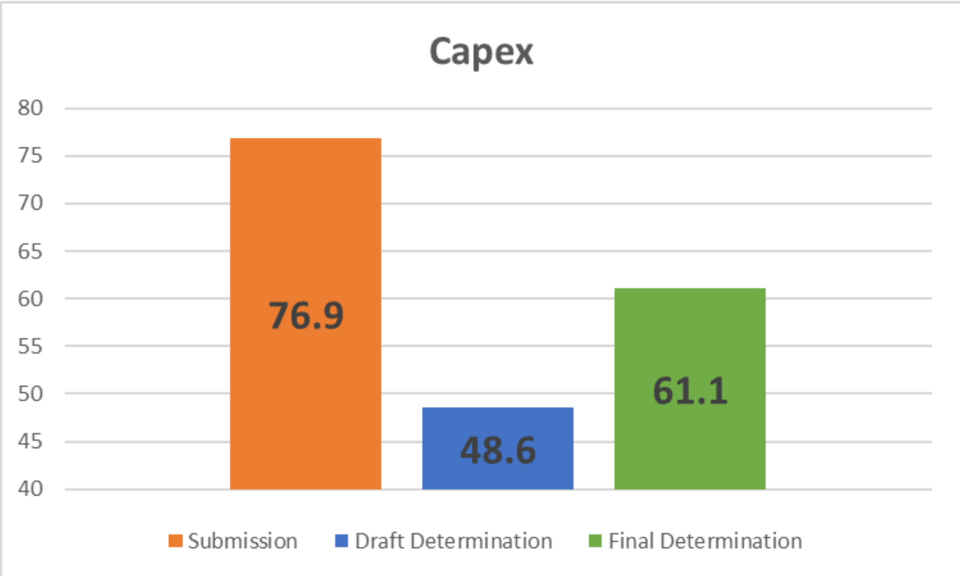
[4] Paragraph 4.133 – GD23 Final Determination Annex D Opex Detail

allowances with no recognition of actual historic costs or the increased allowances provided to Phoenix Natural Gas for the same activities.

At present engineering contractor costs (maintenance and emergency) accounts for c.12-15% of operating costs over the six-year period. The Final Determination includes a material uplift to the frontier shift for capital expenditure because of capital cost pressures experienced by the contractor. Whilst we welcome the uplift to capital cost allowances because of the frontier shift, we would note that these same cost pressures will also translate in to increased operational costs for maintenance and emergencies. Over half of the reduction to our submitted opex is in relation to forecast contractor costs.

The capital cost sharing mechanism provides protection to consumers and firmus energy on capital cost underperformance however there is no similar mechanism for operational costs and any underperformance on contractor operational costs will be borne by firmus energy.

<u>Capital cost allowances</u>



When we consider reduced connection forecasts and excluded work, the Final Determination capital costs are comparable to the costs we broadly consider to be appropriate to support activities within the GD23 six-year period.

We specifically welcome the movements in domestic service allowances and the frontier shift, both of which reflect the cost pressures in the industry, specially passed on to us by our contractor.

Rate of Return

Whilst the Final Determination has seen some upward movements in the rate of return compared to the figure used in the Draft Determination, most of these movements have been market driven.

We do welcome the uplift to the draft determined asset beta noting however, that the final determined figure still lies at the lower end of the range included in our Draft Determination response and that our comments on the relationship between asset beta and notional gearing do not appear to have been considered.

Other considerations on the rate of return are outlined below.

Underestimation of parameters in Draft Determination that were retained in the Final Determination

As we set out in our response to the Draft Determination, there were several parameters in the Utility Regulator's Draft Determination that were underestimated, resulting in an overall underestimation of the cost of equity. These include:

- A notional gearing level of 55% that is too low, as evidence from benchmarks, rating agencies' methodology guidance, regulatory precedent, and firmus' actual gearing all suggest a gearing level no lower than 60%.

- A TMR of 6.5% CPI real, where evidence from long term historic average using the latest data would point to a range between 6.7%-7.3%.

- No aiming up on the cost of equity.

We have previously provided detailed reasoning to support our views on these parameters in our response to the Draft Determination, and we do not repeat them here.

Changes in Final Determination

For the Final Determination, the Utility Regulator has proposed several changes compared to the Draft Determination. Most of these changes take the form of a true up mechanism. In particular, the Utility Regulator is proposing to true up:

1. The inflation assumption used in the cost of debt calculation to outturn inflation in each year of the price control period.

2. The cost of new debt used in the cost of debt calculation to outturn BBB-rated iBoxx 10+ year index, but without the 20:80 sharing.

3. The risk-free rate assumption used in the cost of equity calculation to reflect the movement in the ILG yield in each year of the price control period; and

4. The tax rate used in the pre-tax cost of equity calculation to the outturn corporate tax rate in each year of the price control period.

A change of regime from real cost of debt allowance to nominal

We consider adjustments 2, 3 and 4 above reasonable, as they are mainly aimed at addressing underlying economic or policy uncertainties (noting that the removal of the sharing mechanism under adjustment 2 to some extent increases uncertainty). However, adjustment 1, on inflation, is in our view much more problematic. The Utility Regulator's proposal represents a fundamental shift of regulatory regime on the inflation protection on the TRV, which has been explained in our previous letter (dated 10 October 2022) to the Utility Regulator prior to the Final Determination.

As we have explained to the Utility Regulator in our letter and in our bilateral meetings, this inflation true up would result in a cost of debt allowance effectively resembling a nominal allowance, instead of the real cost of debt allowance that has been part of the UK regulatory regime since privatisation. We have demonstrated our point using a worked example in our letter to the Utility Regulator.

The effect of this true up is that the company is allowed the nominal cost of debt regardless of the outturn inflation. The only technical difference is that in a nominal allowed cost of debt regime the company would be allowed the entire nominal cost within the price control. So, the cashflow in the proposed true up scenario is slower than a nominal cost of debt allowance.

In contrast, a regime that operates on a real cost of debt allowance remunerates investors the real cost of debt regardless of the outturn inflation. We understand that Utility Regulator may consider it appropriate to remunerate firmus with a cost of debt allowance that does not move with inflation because firmus currently does not hold inflation-linked debt. However, we note that the Utility Regulator has always stressed that the actual financing decision of the company is entirely to the company, so in that sense whether firmus has historically chosen to take out inflation-linked debt should not change the fact that the Northern Ireland regulatory regime has always been understood to be real cost of capital allowance with an inflation indexation on the TRV.

In fact, the Utility Regulator has acknowledged that the regime has removed the focus on the real cost of debt allowance. Paragraph 10.45 of the Final Determination states:

*"In addition due to uncertainties over the trajectory of interest rates and inflation in the economy, we propose to put in place an additional adjustment mechanisms that will adjust the allowed return on equity for risk free rate and **the real cost of debt** for inflation if they turn out to be higher or lower than our base case forecast [emphasis added]."*

The real cost of debt is now no longer determined and allowed for but depends on the outturn inflation. This is a fundamental change of the regulatory regime that was not signalled in advance and not formally consulted on.[5]

To see the point more clearly, Table 10.5 in the Final Determination (reproduced below) shows the allowed real cost of debt fluctuates significantly throughout the GD23 period. The most striking year is 2023, where the allowed real cost of debt is shown to be -2.22%, on an embedded debt with a nominal cost of 2.8%. This embedded debt was taken out at a time of relatively normal levels of inflation, and the real cost of this could not have been -2.22%.

[5] See notes below on procedural shortcomings

	2023	2024	2025	2026	2027	2028
Cost of embedded debt	2.80%	2.80%	2.80%	-	-	-
Placeholder cost of new debt	-	-	6.60%	6.60%	6.60%	6.60%
Weights	100:0	100:0	50:50	0:100	0:100	0:100
Fees etc.	0.41%	0.41%	0.41%	0.41%	0.41%	0.41%
Inflation	(5.55%)	(2.28%)	(1.09%)	(2.09%)	(2.09%)	(2.09%)
Real cost of debt	(2.22%)	0.91%	3.98%	4.82%	4.82%	4.82%

Table 10.5 - Firmus Cost of Debt

For the avoidance of doubt, we are not stating that a nominal cost of debt regime would be wrong in principle. What is problematic is the asymmetric timing of the proposed inflation true up mechanism which switches the regulatory regime from real to nominal.

In simple terms, when the inflation turns out to be lower than forecast, companies are better positioned in a nominal cost of debt regime, and conversely if the inflation turns out to be higher than forecast, companies are better positioned in a real cost of debt regime. When the inflation turns out to be the same as forecast, companies are indifferent between the two regimes.

The regime in Northern Ireland has always been understood to be a real cost of debt regime, and in the past 10 years when inflation turned out to be lower than forecast (i.e., when companies would have been better positioned with a nominal cost of debt regime), the Utility Regulator did not propose a true up mechanism.

Indeed, during the GD17 consultation process, firmus energy and Phoenix Natural Gas (PNGL) had requested an inflation true-up mechanism analogous to the one proposed by the Utility Regulator for GD23. However, the Utility Regulator had rejected the companies' proposal.

'*PNGL and firmus energy both advocated a different approach in which the Utility Regulator would provide for annual inflation to be subject to the same kind of adjustment mechanism that is to be applied to the forecasts of prevailing nominal market interest rates. The Utility Regulator has not been persuaded by the companies' representations on this matter […]*

The Utility Regulator accepts that it might mis-forecast RPI inflation and/or make too big or too small an allowance for inflation in the nominal-real transformation of the cost of debt, but many other regulated companies find themselves in a not dissimilar position and it is not clear why the Utility Regulator should step in to shield PNGL and firmus energy from this type of risk in this review, contrary to normal regulatory practice. The Utility Regulator also does not agree with an argument that PNGL has advanced which says that a nominal interest rate adjustment mechanism has to go hand-in-hand with an inflation adjustment mechanism because interest rates and out-turn RPI inflation are highly correlated, and that to adjust for the former but not for the latter could give rise to a claw-back of revenues when no actual gains have accrued to the companies. Having compared the iBoxx indices and out-turn rates of inflation over the last ten years, we see no clear evidence of such a correlation.'[6]

[6] Paragraphs 1.17 to 1.19 – GD17 Final Determination Annex 14 Rate of Return Adjustment Mechanism

Switching from a real to a nominal regime when inflation is running high, and hence companies would be better positioned with a real cost of debt regime, could be perceived as regulatory opportunism. It effectively takes away the inflation protection on the (notionally) debt funded part of the TRV, as the inflation log up is fully offset by this proposed true up mechanism and the (notionally) debt funded TRV does not end up being logged up by inflation. This will significantly undermine the credibility of the regime and ultimately lead to investor nervousness and consumer detriment.

Potentially less destructive alternative disregarded

We recognise the uncertainty in forecasting inflation and, upon receipt of the Utility Regulator's draft changes to the rate of return adjustment mechanism, proposed an alternative form of true up that would not involve turning the regime into a de facto nominal one. This involves updating the inflation forecast figure in the year in which the company raises debt. As well as updating the iBoxx, the inflation forecast value would be updated to reflect the latest long-term forecasts available that year. This would reflect the inflation expectation that is priced into the benchmark market rates when the company raises debt.

A mechanism such as this would preserve the real cost of debt regime, continue to protect the TRV from inflation risk, and mitigate the Utility Regulator's concern that in a fast-moving capital market it is hard for the regulator to get all assumptions right at the start of the price control period.

However, the Utility Regulator has chosen to disregard our proposal and offered no justifications in the Final Determination as to why the more fundamental and problematic form of the true up was chosen.

Misrepresentation of allowance

Furthermore, Table 10.5 contains misleading information on the likely real cost of debt allowance in the later years of GD23. For example, in the column for the year 2025 when new debt is assumed to be issued, the placeholder number that the Utility Regulator chose to put in the table is drawn from today's iBoxx rate, at 6.6%, whereas the inflation placeholder number is Utility Regulator's current forecast for 2025 inflation, at 1.09%. This leads to a real cost of new debt of 5.01%. This is problematic because the placeholder iBoxx number is a 10+year bond traded today, and the inflation assumption is for 2025. If inflation were really taken back under control at 1.09% in 2025, one would expect the iBoxx rate to reflect that and be much lower than 6.6%, all else being equal. As a result of this misleading presentation, the real cost of debt and hence real WACC shown in Table 10.5 is likely to be significantly overestimated relative to what the companies would receive in reality if today's forecast turns out to be true on inflation.

If the Utility Regulator is to switch to a nominal cost of debt regime, it should transparently present cost of debt (and hence WACC) in real terms in its Final Determination as they are subject to significant true up risks brought by outturn inflation. In a nominal cost of debt regime, the price control determination ought to present a nominal cost of debt allowance.

The rate of return will lead to higher revenues in the GD23 period and enhance the financeability metrics (PMICR), however this is an artificial position, and the additional revenue will all be returned in the true-up at the end of the period.

<u>High-level sense check of the allowance</u>

A significant outworking from the Utility Regulator's determined cost of capital is a marked drop in the differential between the post-tax cost of equity and the pre-tax cost of debt from the date of refinancing.

Whereas in GD17 the differential was 282 basis points (bps), 5.28% post-tax cost of equity compared to 2.46% pre-tax cost of debt, in the GD23 Final Determination, from 2026, the differential is only 20bps, 5.02% post-tax cost of equity compared to 4.82% pre-tax cost of debt.

Typically, the cost of equity exceeds the cost of debt by a much higher margin, to reflect the increased risk to shareholders compared to those faced by debt lenders.

This would indicate that the cost of equity set by the Utility Regulator is too low and lacks an element of aiming-up to reflect the increased risks faced by shareholders. We would also highlight our previously noted underestimations within the cost of equity parameters, namely a TMR that is too low and an asset beta set at the lower end of the range.

<u>Utility Regulator's Procedural Shortcomings</u>

The paragraphs above highlight our concerns with the conclusions drawn by the Utility Regulator in its Final Determination in estimating some of the key parameters within the rate of return and, in relation to the change of regime from a real cost of debt allowance to nominal, their rejection of our less destructive alternative.

The decisions reached in this Final Determination are the conclusion of a process and throughout this process there have been serious deficiencies, in particular the consultation with stakeholders on material changes being ultimately adopted by the Utility Regulator.

In firmus energy's appeal to the Competition and Markets Authority (CMA) on the Utility Regulator's GD17 Final Determination, the CMA noted, '*The appeal has highlighted a number of process issues where, in our view, the Utility Regulator fell short of the high standards expected from a regulator*.'[7]

We believe the Utility Regulator to have fallen short in their consultation with stakeholders and due consideration of material matters included within the GD23 Final Determination.

[7] Paragraph 5.111 Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation - Final determination

Move of inflation measure from RPI to CPIH

In November 2020 the Utility Regulator published its final approach document for GD23 in which they stated their intention to use RPI as the measure of inflation for the GD23 Price Control. firmus energy's GD23 submission followed this approach.

We have been led to understand that following concerns raised by another GDN regarding the lower returns on capital proposed in the Draft Determination and the consequential financeability challenges, the Utility Regulator chose to change the measure of inflation for the Draft Determination from RPI to CPIH.

Whilst firmus energy supports the need to switch from RPI to CPIH, we note that long and detailed consultations took place in the Great Britain sectors prior to these policy changes, to ensure that stakeholders' concerns had been adequately considered and addressed.

We acknowledge that the possibility of a move from RPI was intimated in the GD23 Approach document, however the move to CPIH by the Utility Regulator then took place with very minimal consultation and in an extremely condensed timescale. The proposed move in GD23 from RPI to CPIH was included in a letter dated 2 December 2021 and the Draft Determination (on a CPIH stripped basis) was published only 3 months later, on 9 March 2022.

This truncated timeline for moving to CPIH resulted in an inappropriately compressed period to consider the full implications of the move and led to increased consultancy costs due to the expedited timelines. We would also note that these consultancy costs were not foreseen or allowed as part of the GD17 Final Determination (or allowed within the GD23 Final Determination).

Revision of the rate of return adjustment mechanism

As part of the GD17 Price Control Final Determination, the Utility Regulator introduced a rate of return adjustment mechanism to retrospectively adjust the cost of debt for movements in interest rates (iBoxx benchmark).

The GD23 Draft Determination made no change to this mechanism noting only that it would be retained.

Similar to the move from RPI to CPIH, with minimal consultation with the Distribution Network Operators, this mechanism was amended for the Final Determination to add inflation and risk free rate to the retrospectively adjusted metrics.

Whilst we acknowledge the objective to better reflect market and economic movements, similar adjustments proposed in Great Britain have warranted extended and significantly detailed consultations with all stakeholders.

The Utility Regulator signalled their intentions to materially revise this mechanism on 30 September 2022, i.e. less than a month before publication of the Final Determination.

We do not believe such timescales are appropriate precedent for such significant regulatory decisions and, as with the move to CPIH, these timescales resulted in increased consultancy costs. Again, these additional consultancy costs were not foreseen or allowed as part of the GD17 Final Determination (or allowed within the GD23 Final Determination).

Designated Parameters and Determination Values

As noted above, shortly before the publication of the GD23 Final Determination (in September/October 2022), the Utility Regulator foreshadowed that they would be amending the rate of return adjustment mechanism, as proposed in the Draft Determination, adding inflation and risk free rate to that mechanism.

Paragraph 7.12 of the consultation on the GD23 Licence Modifications[8] states *'We are aware that some of the figures from government and other independent sources used within our Final Determination will change prior to the final decision on the proposed licence modifications. These figures and sources could include any new OBR forecast, future Corporation Tax Rate, the Risk Free Rate of Return and the Cost of Debt. It is our intention to consider any new relevant information of this nature along with the consultation responses.'*

Given the introduction of the new uncertainty mechanisms to capture movements in these metrics, it seems unnecessary to introduce this further level of uncertainty to the GD23 Price Control Final Determination.

We do not believe it to be appropriate for the Utility Regulator to consider redetermining the published GD23 Final Determination allowed rate of return and revenue figures, updating forecast metrics that are already subject to retrospective adjustment. This further accentuates the procedural shortcomings outlined above and adds significantly to the regulatory burden on the company.

The Utility Regulator's own values quote a best practice regulator as being transparent, consistent, proportionate, accountable and targeted. The adjustment of published Final Determined values, in this instance, would run contrary to several of these values.

* * *

We trust that you will give the contents of this letter due consideration before deciding to implement the GD23 Final Determination.

As ever, we would welcome the opportunity to continue our engagement with you regarding the issues outlined in this consultation response, and in any case, prior to any decision to proceed by the Utility Regulator.

Yours sincerely,

Niall Martindale
Chief Executive Officer

cc. John French – Chief Executive, Utility Regulator

[8] Licence Modifications Pursuant to the GD23 Final Determination and other Regulatory Decisions – Consultation Paper 28 October 2022