Licence Modifications pursuant to the GD23 Final Determination and other regulatory decisions

25 November 2022

Introduction

Phoenix Natural Gas Ltd. (**PNGL**) 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**).

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 Great Britain (**GB**))[1].

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 GB, the NI gas distribution network is already well placed to transport low carbon fuel alternatives such as biomethane or hydrogen blends.

Overview

The NI gas distribution network is at a transformational juncture. PNGL is currently assessing the impact of the Utility Regulator's (**UR**) GD23 Final Determination on its business and has serious concerns around its ability to finance its activities and deliver the investment required for a sustainable and high-quality gas network and in support of the NI Energy Strategy. Although we do not agree fully with UR's position on many aspects of the price control, we are concentrating our assessment on the more material issues within the Final Determination. In line with regulatory best practice, PNGL should be able to undertake this assessment based on UR's **final** decision at this stage of the price control review. Instead, our review has become extremely difficult given UR's indication that its position on some crucial aspects of its Final Determination may still change prior to the final decision on the proposed licence modifications. This creates uncertainty for PNGL, makes it difficult to fully assess the impact of the Final Determination and the proposed licence modifications and significantly compresses the timeline available to us to review UR's final position. As a matter of regulatory principle, it would be wholly inappropriate to introduce material changes into the final text of the

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

licence without sufficient warning, transparency, and/or a proper consultation process, which would ensure that PNGL's views and rights have been properly considered by UR.

PNGL has provided UR with extensive evidence to support its GD23 Business Plan as part of its Business Plan submission in June 2021, its comprehensive response to UR's Draft Determination in May 2022 and through the GD23 information request processes and specific meetings set up to discuss its concerns. Whilst UR may believe that it has attempted to address our concerns post its Draft Determination, many of our issues remain outstanding in the Final Determination. We have serious concerns that many of our issues around WACC and financeability, together with developing themes around the implications of rising cost of debt, have not been dealt with in the Final Determination. PNGL has engaged constructively and proactively with UR on relevant issues, particularly those of a material nature, throughout the review and remains committed to continuing engagement with UR on critical matters to provide appropriate solutions. However, a lack of transparency on UR's part has been a constant theme throughout the GD23 review process. There have been multiple delays and changes in approach by UR, without PNGL having been given a chance to comment or engage in a discussion about the evidence it has provided. This does not reflect regulatory best practice and UR again fails in its Final Determination to provide a proper assessment of the arguments presented by PNGL in many key areas.

We provide in the remainder of this document our response to the licence modifications presented by UR for consultation following its GD23 Final Determination and other regulatory decisions (**the Consultation**). This is detailed under sections:

- Uncertainty within the Final Determination; and
- PNGL's comments on UR's proposed Licence modification drafting.

Uncertainty within the Final Determination

At Draft Determination, we indicated that the failure by UR to provide an updated view of cost of capital post identification of its financeability calculation error was a sign of a flawed regulatory process and resulted in an incomplete Draft Determination, which hindered PNGL's ability to fully respond to the consultation. Regrettably, PNGL now finds itself in a similar, if not more critical, position at Final Determination due to UR's indication that its position on some aspects of its Final Determination may change prior to the final decision on the proposed licence modifications[2]. More specifically, UR indicates that 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."* This proposal is far from clear and does not convey any specific information as to the nature of the potential changes, their materiality, whether they would be limited to updating input data or involve amending approaches. As set out above, this uncertainty is not in line with regulatory best practice, particularly at this stage of any price review process. In particular, the regulatory framework does not permit UR to simply introduce material changes into the final text of the licence without sufficient warning, transparency, and/or a proper consultation process.

The approach adopted by UR is flawed, unacceptable and leads to an incomplete Final Determination and, therefore, regulatory uncertainty both for PNGL and consumers, who will ultimately face any negative consequences of higher-than-normal risk associated to financeability and debt cost being higher than they need to be. It severely compromises PNGL's evaluation of a truly final GD23 settlement and the impact it might have on its business and its ability to carry out its functions in an efficient, sustainable and economical way. While PNGL appreciates the uncertainty surrounding current macro-economic conditions, it would question the reasonableness of such an approach, which ultimately goes well beyond what is both best practice and necessary to address the broader economic climate. Furthermore, the vagueness of UR's proposals puts into question its undertaking of a proper impact assessment in relation to the approaches UR proposes to take. This removes transparency from the process and does not represent sound regulatory practice.

Given UR's decision to leave some crucial elements of the Final Determination open, the company's ability to respond to any subsequent change has also been restricted. PNGL would therefore ask UR to consider the following relevant information relating to the figures and sources listed as potentially subject to change by UR prior to the final decision on the proposed licence modifications:

- *Corporation Tax Rate*

  PNGL was surprised that UR did not issue the pre-tax WACC based on the correct corporation tax rate, given that the 25% tax rate was clearly known at the time of the Final Determination.

  As tax is a fundamental cost item that PNGL will bear during the price control and it will be at the higher rate of 25%, it is clearly wrong for UR not to reflect it in the WACC and update its financeability calculations accordingly.

[2] paragraph 7.12 of the Consultation

- *Risk-free Rate*

  Setting aside PNGL's reservations on the manner in which UR plans to update the risk-free rate as part of the end of period Rate of Return Adjustment Mechanism, PNGL was somewhat surprised that UR potentially plans to update this metric subsequent to the Final Determination.

  UR is aware that risk-free rate is a key factor influencing PNGL's financeability metrics and, bearing in mind the weakness of such metrics in the Final Determination, any suggestion that UR should vary risk-free rate in the downward direction is clearly of concern and appears unnecessarily aggressive, when UR already plans to true-up the value ex-post.

- *iBoxx 10+*

  Similar to risk-free rate, PNGL's financeability metrics are extremely weak as evidenced by the Final Determination, therefore any decision to revise target iBoxx further downward would further weaken an already critical situation for PNGL. As PNGL has previously highlighted, the absence of a within-period trigger mechanism, as suggested by UR, but then dropped by UR in the latter stages of the price control review, has left PNGL exposed to funding any adverse movement between the reference iBoxx within the Final Determination and the market position at the time of refinancing.

  Therefore, given such weak financeability metrics, UR needs to consider not just the current market rate but also build in sufficient headroom to deal with current market sensitivities and avoid any potential negative market movements that could arise in a volatile market.

- *Inflation*

  PNGL is concerned about UR's lack of either consistency or transparency on its chosen forecast inflation factors deployed, making it difficult to understand both the rationale for the inflation forecast chosen and further how this forecast may be updated prior to the issue of the final licence modifications. Following correspondence with UR subsequent to the Final Determination, UR appears to have devised its own set of metrics for the 6-year period by mix and matching data forecasts from different sources - if this forecast is to be updated PNGL would suggest that UR provides a more robust and transparent basis for doing so.

  Further UR has erred in the means by which it has utilised the forecast inflation rate for the GD23 period, by using the profiled rather than average inflation to discount the annual cost of debt, in the knowledge that changes to actual inflation flow through to TRV and not income. This significantly skews income for any year in which the forecast annual inflation is higher or lower than average and artificially alters financeability metrics accordingly.

  This is a matter which PNGL highlighted to UR prior to the Final Determination being issued and it is disappointing that UR has chosen to follow through with such an approach. Further and bearing in mind the misguided logic, PNGL is concerned that the financeability metrics in the final decision paper could materially change and deteriorate with any change in the inflation profile UR chooses to make.

The above commentary on the figures and sources in the Consultation that UR may amend should not be interpreted as PNGL's agreement with other UR cost of capital and wider GD23 assumptions.

In addition, PNGL would flag:

- a typo in Table 10.2 of the Main Document. The equity beta should be 0.69 as detailed in paragraph 10.24;
- Annex T – Rate of Return Adjustment Mechanism, worksheet *“FD and Out-turn ROR”* the reference to Equity Risk Premium should be changed to Total Market Return (TMR).

PNGL's comments on UR's proposed Licence modification drafting

Condition 2.3.8 - Charging methodology for the conveyance of gas

Condition 2.3.8 relates to conveyance charging and therefore the proposed additional drafting after the equation:

> *Save that this formula, and all references in this Condition 2.3 to CPIH shall apply only on and from 1 January 2023, in substitution for the formula and prior references to RPI which shall be treated as having been applicable up to and including 31 December 2022 in accordance with previous versions of this Condition 2.3.*

which applies to condition 2.3 in its entirety, is not transparent. **PNGL would suggest that (i) the proposed additional drafting after the equation is removed; and (ii) the proposed deletion of "commencing Formula Year 2007" in the first paragraph is reinstated with the year 2007 replaced with 2023.** This has the same effect as UR's proposed additional drafting after the equation but is transparent as it makes it specific to the conveyance charging condition 2.3.8.

The remainder of the references to CPIH in condition 2.3 relate to price control. UR is already proposing to address the move to CPIH in licence for price control via condition 2.3.26 where its proposed clarification *"Shall be RPI up to and including Formula Year 2022 and CPIH commencing Formula Year 2023."* is to be added to the indexation base description in the table of designated parameters.

Condition 2.3.9 - Correction Factor

For housekeeping purposes, the equation for $Z_{F,t}$ following the 1st paragraph should remove the term $G_{F,t}$[3]. All other references to the connection incentive revenue arrangements were removed from Licence in the October 2016 licence modifications which implemented the GD17 Final Determination as these arrangements no longer applied. This reference appears to have been missed at that time.

Condition 2.3.22 - Current Designated Parameters

UR is proposing to address the move to CPIH in licence for price control via condition 2.3.26 where its proposed clarification *"Shall be RPI up to and including Formula Year 2022 and CPIH commencing Formula Year 2023"* is to be added to the indexation base description in the table of designated parameters. **The additional drafting proposed in brackets in condition 2.3.22 "(Shall be RPI up to and including Formula Year 2022 and CPIH commencing Formula Year 2023)" after the designated parameter CPIH in the table is not therefore required.** Condition 2.3.22, by its definition, reflects the current designated parameters (i.e. those applicable for GD23) and therefore no reference to previous parameters is required.

[3] This term related to connections incentive revenue

Condition 2.3.23 - Definitions and Interpretation

UR is proposing to retain the definition of RPI in condition 2.3.23. **PNGL believes that the move to CPIH from 2023 negates the requirement for the drafting "each month" and "; or" in the first paragraph and sub-paragraphs (a) and (b).** PNGL is therefore suggesting that this drafting is removed from the definition.

Condition 2.3.24 - Current Determination Values

PNGL has compared the current determination values with the Pi model published at Annex K of the Final Determination and whilst the values agree, we are aware that some of the figures therein do not reflect UR's Final Determination, notably domestic connections capex within the Pi model (and therefore in this condition 2.3.24) is based on a higher level of Owner Occupied connections in the first two years of the control than that ultimately determined by UR for GD23 as detailed in Annex C of the Final Determination:

	2023	*2024*	*2025*	*2026*	*2027*	*2028*	***Total***
GD23 Pi model[4]	4,038	4,159	3,727	3,612	3,502	3,396	**22,434**
GD23 FD Annex C[5]	3,000	3,400	3,727	3,612	3,502	3,396	**20,637**
Variance	**-1,038**	**-759**	**0**	**0**	**0**	**0**	**-1,797**

Table 1: Owner Occupied connections as detailed in UR's GD23 Final Determination

PNGL notes paragraph 1.6 of Annex C states:

> *Connections numbers used to determine volumes of gas consumed were adjusted on the basis of additional information provided by the GDNs as part of the process for setting tariffs for 2023. The numbers used to estimate capital and opex costs were not updated to reflect these changes and the final determination is based on earlier, higher, estimates of connection numbers as these differences do not have a material impact. Capital allowances for meters and services will be corrected through the uncertainty mechanism to reflect actual connections constructed in GD23.*

However, PNGL considers that there are two areas where the differences in connection numbers do have a material impact on the Final Determination:

- **Advertising & Market Development (Owner Occupied) opex** - connection numbers within the Pi model (and therefore the current determination values in licence) have already been corrected and are based on the Owner Occupied connections detailed in Annex C. No further adjustment is therefore required.
- **Connections capex** - the current determination values in licence should reflect UR's Final Determination for connections and therefore Owner Occupied services and meters capex within the Pi model should be based on the Owner Occupied connections detailed in Annex

[4] These are the connection figures upon which UR's **capex** allowances are based, see Tables 6.13 and 6.14 of Annex F

[5] These are the connection figures ultimately determined by UR for GD23 and upon which UR's **opex** Advertising & Market Development (Owner Occupied) allowances are based, see Table 5.20 of Annex D

C. UR should address this inconsistency within its Final Determination prior to its final decision on the proposed licence modifications to ensure transparency.

In terms of the GD23 Uncertainty Mechanism published at Annex V of the Final Determination, PNGL would make the following observations:

- Inputs tab row 13 – this does not reflect the opex efficiency factor within the Final Determination and should be updated
- Inputs tab, Connections, row 22 – this does not reflect the Owner Occupied connections within the Final Determination and should be updated
- Inputs tab, Domestic Meters, rows 64 to 66 – this does not reflect the Owner Occupied connections within the Final Determination and should be updated
- Inputs tab, I&C Meters, row 175 – column B should state that these reflect U4000 meter installations
- Inputs tab, Capex Risk Sharing Mechanism, row 302 – section 5.4 of PNGL's response to UR's GD23 Draft Determination sets out PNGL's detailed comments on UR's application of customer contributions across GD23. In effect UR is continuing to grant GDNs a net overall capex allowance in GD23 and therefore consumers will continue to receive a net capex allowance for any chargeable works. However, UR's decision to determine activity allowances that are not representative of the customer contributions received historically for <u>each</u> activity (i.e. UR has determined gross Basket of Works allowances in GD23 and then applied a one-off adjustment to <u>overall</u> capex for customer contributions) is not accurate or transparent for consumers given that GDNs transpose UR's <u>net</u> allowances into Connection Policy. This change in approach will mean that there will be no transparency for consumers as there will be no direct read across from Connection Policy to the gross Basket of Works allowances quoted by UR in its Final Determination. PNGL will be required to adjust UR's gross Basket of Works allowances when publishing each relevant activity allowance in Connection Policy in the manner it best believes recovers the overall customer contributions assumed by UR in the Final Determination.
- Inputs tab, Network Rates, rows 548 to 554 – this formula will not reproduce PNGL's actual network rates bill each year (e.g. it does not take account of the variability in rate in the £ applied by the district council, the potential for corrections to prior years due to changes in previously estimated numbers nor does it reflect the fact that the percentage factor applied to volumes may change as part of a rating revaluation) and therefore does not reflect the approach to Network Rates set out in Paragraph 5.128 of Annex D which states:

  > *For the final determination we are of the view for the GD23 period that the uncertainty mechanism should be updated to reflect network rates, consistent with the formula used that links to revenue, 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.*

  Rows 548 to 553 should therefore be deleted with the GD23 UM Adjusted Allowance in row 554 containing PNGL's actual network rates each year. UR has determined that this figure will then be verified against PNGL's network rates bills via the Annual Cost Reporting process and therefore there is no requirement to formularise this in Uncertainty Mechanism.
- Uncertainty Mechanism tab, I&C Meters, row 353 – Formula should be row 351 less row 335 <u>not</u> row 350 less row 335

- Uncertainty Mechanism tab, Capex Risk Sharing Mechanism, rows 531 and 533 – both entries reflect the I&C meter installation replacement adjustment. One row needs deleted to avoid double-counting

PNGL has focussed its review of the GD23 Uncertainty Mechanism on the implementation of the retrospective opex and capex adjustments detailed in the Final Determination and reflected within the Inputs and Uncertainty Mechanism tabs. In line with the development of previous uncertainty mechanisms, PNGL advises that the mechanism will only be properly tested when populated with actuals. We therefore look forward to ongoing engagement with UR to ensure that the development of the GD23 Uncertainty Mechanism fully reflects the GD23 Final Determination and that the appropriate adjustments are reflected in opening 2029 TRV.

Condition 2.4.10 - Revising connection charges

UR is proposing to replace the phrase "Retail Prices Index" with "Consumer Prices Index including owner occupiers' housing costs." in subparagraph (b). **PNGL believes that this should be replaced with the generic term "applicable indexation base" as each contract will have its own basis for uplifting costs which may not be CPIH.**

Inclusion of Ballynure and Ballinderry in firmus Licence

We note UR's approach to the inclusion of Ballynure and Ballinderry wards into the firmus Licensed Area. As these wards are already included in the PNGL Licensed Area, PNGL would welcome discussion with UR on shared licence ownership and how this works in practice.