SGN Natural Gas

Response to Licence Modifications Pursuant to the GD23 Final Determination and other Regulatory Decisions

November 2022

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Introduction

In February 2015 SGN Natural Gas (SGN NG) was awarded the licence to build and operate the natural gas distribution network and infrastructure as part of the overall Gas to the West project. GD23 is the second price control for SGN NG since the licence was awarded by the Utility Regulator (UR).

We are proud to serve the west of Northern Ireland and to deliver the essential service of natural gas to our customers, helping to move them away from more carbon intensive fuels in the short term and to then assist them transition to green gases such as biomethane or hydrogen. It is important that the GD23 price control provides an opportunity for SGN NG to support this commitment. Therefore, we welcome the opportunity to respond to the licence modifications published by the UR alongside the GD23 Final Determination (FD) and encourage continued engagement with the UR to ensure the interests of consumers within our network area are appropriately protected.

We recognise the movement in allowances between the publication of the GD23 Draft Determination and the FD, however we also note that this represents a substantial negative movement from our GD23 Business Plan submission.

We also acknowledge the UR's recognition that the Northern Ireland Energy Strategy continues to support connections to the gas network where it is considered economic to do so, but we are disappointed that the UR has not considered the importance of including the cost of carbon within the economic appraisal at this time. SGN NG see the inclusion of the cost of carbon within the economic appraisal as essential to ensuring that the net zero targets for Northern Ireland are met and request that the UR review this area as a matter of urgency to ensure that appropriate economic investments are made that support the delivery of public policy.

Whilst we are disappointed with the UR's decision to maintain the bid position for the years 2023 to 2027 in relation to the Managed Service Agreement for services provided by the SGN Group, we welcome the UR's decision to drop the linkage in the year 2028. We look forward to continuing this approach in future price controls.

We do not believe there was sufficient engagement on marketing allowances throughout the GD23 process. In particular the concept of Marketing efficiency was not discussed prior to the publication of the FD. The application of Marketing efficiency has been applied at 33% which is the non-additionality factor that was applied to PNGL during GD17. Applying this efficiency assumption at such an early stage of network development for SGN NG unfairly penalises consumers in the west of Northern Ireland compared to those in the east of the Provence.

We presented detailed evidence demonstrating the level of funding required per connection highlighting its importance on numerous occasions. Our evidence does not appear to have been incorporated into the decision process in this area nor have UR provided any evidence for their alternative position presented in the FD.

SGN NG do not agree with the UR that the approach to SME incentives during GD29 should be set within the FD for GD23. We believe a better approach for consumers is that all of the evidence available is assessed as part of the GD29 process, without pre-empting what might happen during the GD23 period.

To date we have engaged with the UR on several areas of proposed licence drafting in relation to GD23. Where these comments have been considered within the current drafting, we have not commented further here. The comments within this document relate to the drafting provided alongside the GD23 FD, which SGN NG did not have prior sight of or where previously provided comments have not been addressed.

SGN NG welcomes the opportunity to continue to engage with the UR in advance of the publication of the decision document for GD23 licence modifications.

Connection Numbers

Connection number errors

SGN NG note the use of inconsistent connection numbers throughout the GD23 FD which have resulted in incorrect allowances being proposed. We acknowledge the UR's reference to an 'immaterial' impact on Opex and Capex as a result of the incorrect connection numbers being applied, in Annex C, paragraph 1.6 states that ***"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."***

We investigated this in further detail and estimate that the additional capex 'awarded' arising from the incorrect connection numbers is in excess of £1.3m for the duration GD23 (post frontier shift). This appears to give SGN NG a headline award of £1.3m greater than should be provided for (in excess of 5% of total GD23 allowances). This is significantly greater than the materiality threshold of £120k.

We have engaged with the UR since the publication of the FD on 28th October 2022 seeking clarity on the rectification of this error.

It is important that this is corrected now due to the knock-on implications set out below. SGN NG do not believe it is appropriate to allow such a material error in the FD to be maintained on the basis that it will be adjusted for at the end of the price control period through the uncertainty mechanism.

Consumer tariffs

The use of incorrect connection numbers, which result in inflated capital and opex allowances within the GD23 FD, also results in an inflated conveyance tariff for the period. If not corrected, consumers on the SGN NG network will be faced with paying more for conveyance charges throughout GD23 than they should do. We consider that reducing the charges to our consumers in the next couple of years is very important given the recent volatility in gas prices and the increased cost of living faced by all consumers.

We believe that the correct connection values should be used in the models, and this will ensure that customers are charged appropriately.

Provision of corrected models

The connections numbers flow through to both the Pi Model and the Uncertainty Mechanism model, the supporting documentation relating to the GD23 FD and licences. With incorrect connections numbers then each of these documents are incorrect. Furthermore, with incorrect connection numbers the associated calculations – the Revenue per unit, DAV, depreciation etc – that are included within the licence drafting are also incorrect.

We do not believe it is appropriate for UR to move forward with the proposed licence modifications in their current form.

It is important that the licences, the Pi Model and the Uncertainty Mechanism model are updated and provided in advance of the UR publishing a decision in relation to GD23 to ensure that the Determined Values included in the SGN NG licence.

Formula Clarifications

Updates to specific conditions

In principle, it is fundamental that the proposed modifications are clear and there is no ambiguity in terms of their application. There are several components which roll forward from GD17 to GD23, for example the determined PA, and annually, the 'Z' over/under recovery. Therefore, there will be some overlap with indices required when considering values up to 31st December 2022 on one basis and then on another basis from 1st

January 2023. SGN NG are concerned that the current drafting does not address this crossover period and that further clarification in the following conditions is necessary:

- **Condition 4.2.18 (a) and 4.2.27** – further drafting is required to address the initial cross-over of RPI (Retail Prices Index) to CPIH (Consumer Price Index including Housing), as we are dealing with rolling forward figures from the PY at CPIH. I.e., if t-1 = 2022, there should be some account of RPI to 31st December 2022, and CPIH thereafter. This could be resolved by including some text for clarity in the GD17 to GD23 cross-over.
- **Condition 4.2.18 (b)** – A similar issue arises for use of Bank of England base rate t-1, for t-1 = 2022. Reference to LIBOR (London Inter Bank Offered Rate) will still be necessary to the point of 31st December 2022. As above, additional text for clarity could resolve this.
- **Condition 4.6.7 (b)** – DAV (Depreciated Asset Value) b,a = DAV e,a x CPIH b / CPIH e – If DAV e,a is a determined value on an RPI basis, it is not clear how this would work without further clarity being added to explain what occurs in the cross-over period.
- **Condition 4.6.9** – A similar issue exists when rebasing a previously RPI determined PA, further clarity in the cross-over period is necessary.
- **Condition 4.6.10 and 4.6.11** – The same issue as above arises for any determined values on a RPI basis. However, as these rollers are 'switched off', this is less of an issue in that case as no crossover calculations are necessary. Though for completeness we believe they should be treated the same in the licence irrespective.

It has been our experience during GD17 that where there is not sufficient clarity contained within the licence, it can cause unnecessary confusion for both the UR and SGN NG. Therefore, we believe it is necessary to address any uncertainty as part of the licence modifications so that similar issues do not occur during GD23.

RPI to CPIH Switch

Accounting for RPI to the end of GD17

During the informal query process, we raised the issue of switching from RPI to CPIH on numerous occasions.

Recently a worked example was created by UR to illustrate their methodology in this area and whilst we acknowledge that RPEs readjust allowances to make a consistent base whether RPI or CPIH is the inflation used, we still hold concerns around the initial transition to the end of GD17 not being made on an RPI basis.

As identified in the RPE calculation there is a weighting for costs assumed to be linked only to inflation, and not subject to RPE assessment against an alternative index, for the remaining years of GD17 this cost will increase based on RPI. Therefore, by not including a rebasing adjustment from RPI to CPIH, as is included in the Pi model, there is a loss in value assuming the costs move by CPIH in the final years of GD17. Whilst the Pi Model demonstrates how calculations are performed to components of the opening TRV (Total Regulatory Value) for GD23 in accounting for RPI up to 31st December 2022 we believe it is important that the licence is explicit on this. We also believe that the licence should clarify how the switch from RPI to CPIH, at the end of December 2022, has been accounted for in the conveyance tariff licence formulae.

Cost of Capital

Embedded Cost of Debt Allowance

SGN NG's GD23 embedded cost of debt allowance of 3.10%, stated in table 10.6 of the GD23 FD Main Report, appears to be based on average interest rates from the date of SGN NG's licence award to the end of September 2022. The embedded cost of debt allowance needs to be extended to be an average of interest rates until the end of GD17, i.e. end of December 2022.

Equity Beta

We are surprised that currently the FD references three equity betas, and it is important that the two incorrect ones are changed. Para 10.26 states the equity beta is **0.81,** table 10.2 shows it as **0.78** and cell B80 of the 'FD and Out-turn RoR' tab of Annex T calculates it as **0.82**.

Given that;

- SGN NG's asset beta is 0.41 as stated in para 10.25, Table 10.2 of the GD23 FD Main Report and row 79 of the 'FD and Out-turn RoR' tab of Annex T, and
- notional gearing is 55% and debt beta is 0.075, as stated in para 10.26 of the GD23 FD Main Report

the correct value for the equity beta is **0.82**, as set out and calculated in the equity beta calculations in cell B80 of the 'FD and Out-turn RoR' tab of Annex T.

Rate of Return Adjustment Mechanism

Further to our 18th October 2022 letter, feeding back on the draft Rate of Return Adjustment Mechanism model, we would like to highlight the following points;

Calculation Details

- GDNs need to be provided, for each step of the calculation of cost of equity and cost of debt components, specific source and referencing details (e.g. specific website page, data set etc), for all forecast data, as well as outturn – to minimise the risk of errors and confusion at a later date
- For example, we can't see anywhere setting out the calculations behind the forecast 1.77% Risk-free rate, which is stated in table 10.2 of the GD23 FD Main Report and row 76 of the 'FD and Out-turn RoR' tab of Annex T. Without this we can not verify the forecast used in the FD.
- Given these adjustment mechanisms have not been trialled previously it is important to have a brief explanation of the methodology and the reasoning behind each adjustment mechanism. This is important so that someone other than the original modeller is able to understand and utilise the model without introducing errors.

GD29 True Up

Para 10.50 of the GD23 FD Main Report states there will be an adjustment to the opening GD29 TRV for the impact of the Rate of Return Adjustment Mechanisms. We understand from our engagement with UR that the adjustment to the opening GD29 TRV will occur on the same basis as the calculation that applied to PNGL and FE in GD17 when the cost of debt adjustment mechanism was introduced.

Essentially, our published FD GD23 Pi model will be updated to reflect the final mechanism calculated annual values of the cost of capital, this model will remain 'unsolved' for tariffs and the variation between the TRV in 2028 in this 'unsolved' model and that in the published FD GD23 Pi model, will equate to the GD29 opening TRV adjustment (upwards or downwards).

Financeability Revenue Adjustment

UR has separately raised adjusting revenues in GD23 in anticipation of a Rate of Return adjustment, to aid financeability. As explained in our 18th October 2022 letter we believe this works in theory. However, we understand that no consideration has been given to the practical details of how this adjustment would take place. It is very important that the practical methodology to be applied should be documented and consulted on.

Secondly, it is very important that any potential adjustment mechanisms that impact revenue should be written into the licence along with the materiality threshold that would be applied before an adjustment is made. This is not currently the case.

The lack of guidance and reference within the licence is very concerning as it places considerable risk on SGN NG that current day expectations may reinterpreted in the future, particularly as UR must provide final approval of tariffs. This proposal therefore provides no guarantee that should SGN NG require additional revenues in any given year, then these would be appropriately approved. Conversely, there's no guarantee SGN NG won't be left more exposed to downward adjustment in revenues due to outturn WACC being lower than forecast.

A further concern is the lack of consideration on how any further revenues allowed would fully interact with the 'Z' under/over-recoveries constraints and formulae written into the licence currently (and subject to modification for the FD). Pi Tariffs will probably require 2 versions, one relating to the pre-inclusion of additional revenues and one version post-inclusion, notwithstanding the impacts of out/under-performance on volumes.

UR updates to FD

We note the UR's comment on p3 of the FD Main Report 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.'*** Given the potential impact of these figures, it's necessary that GDNs have the opportunity to provide feedback on any proposed changes to specific figures prior to publication.

District Development Plan

The proposed modification to the SGN NG licence does not include an update to the District Development Plan that is currently set out in Annex 2, Part 3 of the licence. As GD23 will reset the connection targets in respect of each of the calendar years in the remainder of the licence period it will be necessary to update District Development Plan to reflect this.