Firmus Energy
Distribution PC02 (2009 – 2013)
Price Control Consultation

Contents

1. Introduction & Background

The principle objective of the Utility Regulator is to promote the development and maintenance of an efficient, economic and co-ordinated natural gas industry in Northern Ireland. A fundamental part of this process is a five yearly review of the distribution operator's allowed costs for operating, maintaining and growing the distribution network safely and efficiently. Firmus energy (firmus) has a distribution licence to operate a distribution network in Londonderry, Limivady, Coleraine, Ballymoney, Ballymena, Antrim, Craigavon, Banbridge, Newry and Armagh (the 10 towns) and the costs in this report[1] relate to those allowed under that licence.

This distribution price control represents the 2nd regulatory review undertaken for firmus and will form the basis of costs that can be recovered by firmus for the construction and operation of the gas network in the 10 towns during the period 2009 – 2013.

Determination values relating to firmus's capital & operational expenditure as well as volume forecasts have now been derived and are intended to allow firmus to operate and maintain the distribution network safely and efficiently and achieve the growth indicated by approved volumes and connections. It should be noted that the final determination includes a number of reviews that may have a marginal impact on the values outlined in this document.

This consultation seeks to invite views on the determined allowances being proposed for firmus over the next 5 years as well as the capital outputs it is being obliged to produce.

Comments in response to this consultation should be submitted electronically to neil.bingham@niaur.gov.uk or in writing to Neil Bingham, Utility Regulator, Queens House, 14 Queens Street, Belfast, BT1 6ER by Monday 15th December 2008.

2. Methodology for Distribution Price Control

As part of the review into firmus energy's capital expenditure program for PC02, the Utility Regulator engaged consultants Parsons Brinckerhoff Rune (PBR) to provide analysis and expertise into firmus's capital program and cost proposals. The purpose of this analysis was to ensure that firmus energy is developing an appropriately designed gas network that will achieve its development targets in an economic, efficient and coordinated way.

In addition, the Utility Regulator undertook a detailed examination of the capital expenditure incurred by firmus during PC01 (2006 – 2008), compared this with the allowance that was set at the determination and considered this against future requirements.

The process adopted for the development of the 'determined to' position for operational expenditure (opex) has been to review historic expenditure for the years 2006 and 2007 and to consider forecast expenditure (2009 to 2013) against certain cost drivers.

[1] All costs in Jan06 price base unless otherwise stated

Where clarification of costs or other matters was required either with respect to opex or capex, questions were formally raised with firmus, responses received, considered and where necessary issues discussed at meetings.

3. Form of Regulation

Firmus currently operate to a regulatory regime that is based on 'price cap' incentive regulation. Consequently firmus are incentivised to grow the number of connections and outperform volumes targets in the 10 towns as they will be entitled to retain any additional revenue obtained from increasing volumes above the determination forecast.

Firmus also currently operate as a bundled distribution and supply business using a 'netback' mechanism. This means that firmus will set a price to compete with other fuels in the 10 towns, from which wholesale gas costs, transmission costs and supply opex are deducted with the residual revenue being used to pay off the distribution network. If the residual revenue is not sufficient to finance the cost of the network, this difference is accumulated in an under-recovery account to be recovered in the future when there will be more customers and a higher level of volumes being transported through the network.

4. Impact of the Determination

The PC02 price control determination will result in an increase of 53% on the PC01 weighted average conveyance charge[2]. The main reason for this increase is that additional gas mains are now being forecast as well as there being significant increases to capex unit rates.

Determined costs will be apportioned to each customer sector using a volume methodology. Firmus has suggested apportioning costs using a capacity methodology however we see no reason to change the current volume allocation methodology.

It will be firmus's responsibility to decide how to apply the 53% increase in average charges going forward. Costs can be accumulated into an under-recovery account at a 7.5% rate of return and recovered when there will be sufficient customers as well as volumes being transported through the network.

5. Distribution Capex Expenditure

For the 3 years 2006 – 2008, firmus was given a Distribution capex budget of £30.3m. It was intended that this would be used to construct 383 km of mains and connect approximately 5,500 customers to the network. The current expectation is that firmus will spend £30.3m, constructing 396 km of mains to connect approximately 3,600 customers to the network[3].

The determined capex for PC02 will be as follows:

[2] Inclusive of assumed Traffic management act costs.
[3] Subject to receiving audited 2008 data.

£'000's	**2009**	**2010**	**2011**	**2012**	**2013**	**Total**
firmus Submission	£10,076	£8,771	£7,158	£5,538	£4,853	£36,396
Determination	£9,787	£8,406	£6,836	£5,240	£4,536	£34,804
Reduction	£289	£366	£322	£298	£317	£1,591

Note: Costs exclude TMA uplift

Over the next 5 years this expenditure will be used to construct 194km of bulk mains, 191km of infill mains and provide meters and services to over 10,000 properties.

Some of the mains issues considered when determining firmus's capex were as follows:

Unit Rates

firmus under-performed against its target capex unit rates during PC01 due to increases in the cost of polymer. In its submission for PC02 firmus had included these increases and sought a further increase due to the results of a re-tendering exercise for its engineering contract. These increases in unit rates have been verified by our engineering consultants and are in line with benchmark data for similar unit rates in GB although a difference does exists in relation to the depth at which firmus lay gas mains compared to GB standards.

The Utility Regulator has decided to accept the unit rates submitted by firmus subject to receiving a satisfactory response as to why firmus lays gas mains at a greater depth than in GB.

Traffic Management Act

It has been decided to make a provision for 35% uplift in mains and services to reflect the proposed impact of the Traffic Management Act. Due to the uncertainty surrounding the potential consequences of this legislation, it has been agreed to deal with these potential costs as part of the retrospective mechanism and that the financial impact of this legislation will benchmarked against other gas networks in GB.

In anticipation of these costs an amount of £7.6m has been ring fenced and included in the determined charges to take account of the potential introduction of this legislation for the period mid 2009 – 2011 (not included in table above).

Mains

As part of the PC01 determination, firmus was working to a business model that would result in 292km of mains being constructed during the 2009 – 2013 period. As part of its submission for the PC02 review, firmus requested that this quantity of mains be increased to 383km. firmus suggested that it needed these additional mains in order to achieve its annual target of 2000 connections, as experience had shown that the location of new build housing sites was further out of town than originally anticipated.

The Utility Regulator considers that firmus should be able to make more than 2000 connections per year given the amount of gas mains it intends to lay. However we have decided to accept the present forecast for both the quantity of mains as well as connection numbers subject to a re-opener of the price control that may seek to either increase the number of connections or reduce the quantity of mains once the results of a review into how best to develop the natural gas market in Northern Ireland has been completed.

At the end of the price control period, the Utility Regulator will examine all major capex projects that have not been constructed and consider whether the costs should be deducted from the asset base.

6. Distribution Opex Expenditure

During PC01, firmus had an allowance of £12.4m and is currently forecasting to have spent £12.8m by the end of 2008, resulting in an over-expenditure of £0.4m.

The determined opex for PC02 will be as follows:

£000's	**2009**	**2010**	**2011**	**2012**	**2013**	**Total**
firmus submission	£5,225	£5,311	£5,090	£5,095	£4,991	£25,711
Determination	£4,497	£4,337	£4,351	£4,209	£3,946	£21,341
Reduction	£727	£974	£738	£886	£1,045	£4,370

Some of the mains issues considered when determining firmus's allowed opex were as follows:

<u>Manpower</u>

2007 has been adopted as base year for the projection of manpower costs for the PC02 period. When forecasting PC02 manpower expenditure, firmus's forecast manpower numbers have been accepted and a 1.5% real salary increase applied going forward. Firmus had requested a 2% real increase to salaries on top of a 6% real increase between 2007 & 2008.

<u>Parent Company Recharges</u>

Firmus currently utilize resources within its parent company (Bord Gais Eireann) in order to carryout certain activities e.g. HR, procurement and legal services etc.

For the PC02 period, firmus was seeking a 50% increase on the average parent company recharge experienced during PC01.The Utility Regulator has decided to roll forward the average cost experienced during PC01 as we do not agree with firmus that the costs provided by BGE are generally linked to the growing size of the business or to other cost drivers.

<u>Market Development and Advertising</u>

The question of expenditure on Advertising, Marketing and Conversion Grant forecasts for PC02 cannot be addressed without also considering the questions relating to the number of connections to be made, the impact of incentives created by third parties, financing initiatives and the incentives that may be created by changes to the Distribution licence.

Consequently the current allowance for Market Development and Advertising may change depending on the outcome of a review to be completed on how best to develop the natural gas market in Northern Ireland.

However, for the purposes of this determination, reductions have been made to the amount of sponsorship as well as direct mailing costs which have been linked to the number of connections made. In addition, the current owner occupier domestic connection incentive has been reduced by 50% in order to ensure that a domestic connection makes a contribution to paying off the network.

Efficiency factor

It has been decided to apply a 2.5% efficiency factor to both firmus's capex and opex. This is in line with efficiency factors applied to gas distribution companies in GB, and will be offset by a 1.5% allowance for real price effects producing a net 1% efficiency factor.

7. Volume Forecasts

PC01 actual volumes are approximately 19% less that those originally forecast with a 26% reduction in the interruptible sector, a 27% reduction in the large firm sector and a 43% reduction in the domestic sector.

Firmus has suggested that volumes for the PC02 period will be lower than originally anticipated at the time of the PC01 review as factories are closing, average burn is lower and domestic connections have not materialized due to the downturn in the housing market as well as a lack of funding for NIHE conversions.

Determined volumes for the PC02 period will be as follows:

000's therms per annum	**2009**	**2010**	**2011**	**2012**	**2013**	**Total**
firmus submission	25,918	32,173	35,402	37,113	37,922	168,529
Determination	27,234	34,426	38,496	40,959	42,473	183,589
% increase	5%	7%	9%	10%	12%	9%

The Utility Regulator has calculated the determined volumes by applying different assumptions to firmus in relation to:

- Volumes lost due to interruption
- That businesses will both open and close over the period resulting in net zero percent growth (cf firmus's assumption of 2.42% net reduction due to business closures that are not replaced with new businesses)

firmus's connection targets over the same period are as follows:

Sector	**2009**	**2010**	**2011**	**2012**	**2013**
Interruptible	2	0	0	0	0
Large Firm	10	7	2	0	0
Large Firm CHP	0	0	0	0	0
Medium I/C	13	15	10	10	2
Small I/C	90	65	70	40	30
New Build	1200	1200	1200	1200	1200
NIHE	400	400	400	400	400
Existing	400	400	400	400	400

The above connection and volumes targets will ultimately depend on the review into gas market development mentioned in section 6 above.