Neil Bingham
NIAUR
Queen's House
Queen Street
Belfast
BT1 6ED

21 September 2010

Re: Consultation on the options for co-ordinating the relinquishing of firmus energy's supply exclusivity in the 10 towns area

Dear Neil

Thank you for providing firmus energy with this opportunity to respond to the above consultation.

We welcome this consultation which considers the optimum timing for supply competition across the 10 towns franchise area. Under current licence arrangements, supply competition is due to be phased in each of the 10 towns depending on the date of the first connection in each of the towns. The result of this would be that different towns and sectors would 'open' in different years between 2011 (for ICs in Ballymena) to 2019 (for domestics in Armagh).

In considering the merits of both the contractual arrangements and timetable for market opening we continue to be guided by the principles of efficiency and, most importantly, consumer benefit.

Whilst we support the principle of competition, and indeed recognise that competition needs to happen, this should be at a cost and timing that does not adversely impact on customers or indeed cause confusion for customers whereby different towns and different market sectors would open over a prolonged period.

There have been significant developments since the firmus energy licence conditions were introduced, including the recession that has significantly disrupted our business plans within the industrial and commercial sector, the downturn in the housing sector and reduced funding for Housing Executive conversions. Coupled with the well documented slowness of a significant number of Public sector entities to convert their premises to natural gas, gas availability and indeed gas flows have been depressed across the franchise area compared to the original business plan.

In line with the discussions we have had with DETI and NIAUR we feel that it is important to open the10 towns market at the appropriate time and at a reasonable cost to consumers.

The current licence requirements for the introduction of supply competition are understood but should not be considered cast in stone, especially in view of earlier precedents including the fact that full opening of the Greater Belfast market was reviewed and subsequently delayed following consultation by DETI in 2005.

The Greater Belfast precedent is informative in this context. Following initial licence award in 1996, full market opening was delayed from 2005 until 2007 in order to defer the costs of implementation, to keep tariffs down and allow the incumbent to maintain focus on the development of the gas market in Greater Belfast.

firmus energy has considered the questions outlined in the consultation and provided comment below:

Q.1. Do respondents agree that the current staggered market opening timetable presents potential difficulties and confusion for customers, in understanding the different tariffs across the same sectors in different towns? What impact if any, do respondents consider this could have on the development of competition in the ten town's area?

firmus energy agrees that the current staggered approach will be confusing for customers. This could be particularly problematic if this results in different tariffs being applicable at the same time, as would be the case if one town is operating under a gas-on-gas published tariff price and a neighbouring town is still operating under firmus energy's oil price guarantee. Any customer confusion arising from a staggered marketing opening of the towns could result in a slowing down of connections and gas uptake in the new gas towns, which would adversely affect the development of the fledgling gas market in the NW and SN of the province.

During exclusivity firmus energy is committed to continuing with its price commitment against oil. This price commitment is key to ensuring that customers are confident that the costs of converting to natural gas from oil are quickly recovered. This price commitment can only be managed IF market opening in the tariff sectors happens on one date.

This confusion, whilst perhaps not as evident in the IC sector, also applies to larger commercial users. Given the unprecedented economic circumstances over the last few years, and the resultant slow down (vs. plan) on both connections and gas flows, it is critical that firmus energy continues to drive large user connections in each of the towns, particularly Ballymena and the other NW towns. We can only do so by continuing to offer discounts against displaced fuels, particularly oil, to ensure a quick recover of conversion costs by the customer. It would be inequitable, and in fact counter-productive, to be able to do so in one or more of the towns but not in others. The key requirement for the economic development of the network over the next few years should be to encourage small and large users to convert to natural gas. Only by doing so can we maximise gas flows in the NW & SN gas network and ensure sustainable long term use of system charges.

It should also be noted that the recommendation in the consultation for the I&C sector is in fact an equitable solution for all of the towns – some are delayed and others are brought forward. We believe that this is a fair and important compromise position given the need to balance the requirement to open the 10 towns markets and the requirement to do in a way that gives best value and optimal clarity for consumers.

Of particular importance is the incidence and application of the direct implementation costs of market opening. If implementation is phased then initial costs may be lower and first implementation quicker, but total costs could be higher. If competition is introduced at one time across the towns, then more time and initial outlay could be required to develop a more comprehensive solution. Fortunately, in the case of firmus energy, there is the opportunity to obtain this more comprehensive solution at relatively modest cost by sharing the approach adopted by its parent company BGE in supporting the all island gas market.

Even where initial costs are lower with a phased opening, they will be applied to a smaller eligible customer base, which puts upwards pressure on unit charges and discourages future customer conversions. It should be noted that it is generally inappropriate to attempt to recover implementation costs from the whole customer base rather than the eligible beneficiaries of competition, especially where supply competition is phased over a long period.

Although it is perhaps tempting for potential new entrants to argue that the early phases of supply competition can be introduced with modest IT and logistical consequences "on the back of a spreadsheet", this neglects the wider implications of any level of competition.

A contractual and regulatory framework for open access must be established that demands proper consideration, even for just one customer. Whatever the suitability of any existing distribution price control, an equitable and cost reflective methodology for applying charges must be established that is robust to future requirements and not just temporarily expedient. There will be inevitable challenges for the organisation and operation of the integrated supply business as it faces up to the classic dilemma of whether new entrants are customers or competitors. Business and regulatory focus will be distracted from the goal of further promoting gas conversion in order to facilitate limited but resource-consuming supply competition.

It might be argued that more suppliers can be expected to advance the cause of all forms of competition, including gaining new gas customers. However, this ignores the lessons of other regimes where new supply entrants tend to focus on "cherry-picking" the existing market to the exclusion of the far greater challenge of growing the whole market.

In addressing the question over how supply costs could be apportioned across different towns, dependent on which had opened, firmus energy agrees that this would be difficult if not impossible. If market opening was delivered in a staggered way, it would be extremely difficult to accurately determine how supply operating costs would be apportioned between each of the towns on the basis that there may be a regulated tariff in one town but a 'guaranteed cheaper than oil' tariff in another town.

This is another reason why a staggered approach to market opening is not sensible.

Q.2. Do respondents consider that under the current arrangements there is potential for confusion for customers in understanding which sectors in which towns are open to competition? If so, what is the impact on the different sectors and how suppliers advertise?

The current arrangements clearly create the potential for customer confusion in understanding which sectors in which towns are open to competition. It would be in customers' interests, and indeed suppliers, if one market opening date is used for each sector.

This would eliminate any possibility of confusion and allow new suppliers to more efficiently market their services across what is a very diverse geographic region. A single market opening date would allow suppliers to market their offer at much lower cost and would ensure that any advertising done in, for example, Ballymena, would not cause confusion in Ballymoney.

It should be recognised that dates proposed in the consultation will in fact bring forward competition in the tariff sector across ALL of the towns. On that basis, there is no impact on consumers who have already connected for natural gas.

A single market opening date, which is well managed and which is done at a lower cost for consumers, will eliminate any potential for customer confusion. This is critical in allowing firmus energy to continue to focus on driving connections and volume up-take across the new gas network. As can be clearly seen in the Greater Belfast gas market, 14 years after first connections Phoenix are still educating consumers on the benefits of natural gas through their TV campaigns. This highlights that there is still considerable work to be done in the 10 towns to encourage consumers to convert to gas. Before rushing headlong into market opening, we should consider what the best interests of the gas industry are in terms of maximising gas penetration in the new gas towns.

<u>Tariff sector market opening date – alternative proposal:</u>
firmus energy is supportive of NIAUR's recommendation for a single date for market opening in the domestic sector. We are concerned that a date of April 2015 may be a little early across all of the towns. First domestic connections in Ballymena (the first of the towns) were only made in 2006 and the first domestic gas connections in the South North towns were not made until the completion of the SN pipeline in 2008. On this basis, domestic market opening will happen less than 7 years after the first connections in these towns.

firmus energy is concerned that market opening is imposed on the market before a critical mass of homes have been converted to gas – to do so too early may slow down conversions from oil to gas.

Given that domestic competition in Greater Belfast did not happen until 10 or 11 years after first connections, presumably to allow Phoenix to focus on driving connections, we would ask NIAUR to consider adopting this precedent. If this rationale is accepted, firmus energy would recommend a market opening date for the tariff sector of April 2016. Should domestic exclusivity ends in 2015, the price commitment against oil would also have to end. ***We feel that it would be better to introduce competition in the tariff sector from 2016 in order to avoid the premature slow down of customer connections due to the relinquishing of the price guarantee against oil.***

This would also allow for a more efficient market opening processes and allow for the lessons of market opening in Belfast as well as CAG developments to be incorporated within the process.

Q.3. What are the views of respondents on the choice of network codes and associated costs? What considerations are most pertinent for switching systems implementation and the associated costs?

Four contracting solutions have been considered. These include;

1. Adopt the present Phoenix Code with minimum possible amendment
2. Adopt the present RoI Code with minimum possible amendment
3. Develop a firmus Code appropriate to its current business – ruled out by Utility Regulator as does not wish to see a third distribution code
4. Adopt the BGE Code that emerges from the CAG outcome

The criteria used for evaluation of contracting options include:

- Code development costs
- Implementation costs of IT and business processes
- Consistency of arrangements for Shippers
- Long term viability

Each of the three options has been considered in turn;

1. Adopt the present Phoenix Code with minimal possible amendment

Pros:

a. Code development costs restricted to legal review and incorporation
b. Consistent contractual solution for NI shippers

Cons:

a. Phoenix code differs from existing firmus (and BGE Networks) business practice in key areas such as supply point definition, metering and reconciliation
b. Phoenix code differs from existing firmus business practices, which are in line with BGE practices. These business practices are delivered on behalf of firmus energy by BGE Networks, via a Service Level Agreement, ensuring that BGE's economies of scale (given their operation of gas networks across the island) can be utilised by firmus energy, for the benefit of customers. This means that firmus energy do not need to have their own in-house Grid Control, Transportation Services etc. in Northern Ireland, thereby minimising ongoing costs for customers
c. Will result in relatively high IT and process costs to adapt
d. Not a viable long term solution (rejected by Gemserv analysis)

2. Use the current RoI Code

Pros:

a. Code development costs low
b. Implementation costs should be reasonably low via Service Level Agreement with BGE
c. Consistent solution for shippers supplying RoI and towns only
d. May form the basis for a longer term regime

Cons:

a. Need to extract distribution provisions from integrated RoI code
b. Potential jurisdictional issues before CAG?
c. Inconsistent solution for NI shippers (at least pre-CAG). However, CAG will require further development which will bring transmission codes on the island into line

3. Use the BGE Code post CAG

Pros:

a. Likely low cost to develop Code as "piggy-backing" on parent company solution
b. Similarly for shared costs of IT & process implementation via appropriate service level agreements
c. Potentially consistent solution for all island Shippers (subject to CAG outcome)
d. Viable long term solution as will be developed in response to CAG outcome

Cons:

a. Only available after CAG outcome

4. Conclusion on contracting options

Adopting the present Phoenix Code might appear to be an attractive solution for short-term shipper consistency in NI but this is seriously outweighed by the immediate IT and process implementation costs and the lack of long-term viability as an all island solution, as confirmed by the Gemserv report.

Adapting the current RoI Code should be cheaper to implement overall than the Phoenix Code, even allowing for some cost of Code development. The Gemserv report (1st October 2009) acknowledges that the RoI regime retail interface is generally supported by shippers, but it cannot be assumed that the current RoI regime will become the all island standard without further review and development.

The Gemserv report recognises the significant contractual and technical differences between the current Phoenix and RoI regimes, which cannot be overcome quickly or cheaply. It is pointed out that any interim solutions for NI will require additional costs to align regimes, including the appointment of a NI Change of Supply Agent to manage both Phoenix and firmus supply points, and it is acknowledged that there is "… a high likelihood for stranded systems and costs."

The adoption of the BGE code & IT systems solution emerging from CAG offers considerable advantages over other options in terms of cost of implementation, consistency for shippers and long term viability. Its only potential disadvantage is that it cannot be delivered in the short term.

Contracting options analysis summary table

Key to total costs: Low < £250k; Medium ~ £250k - £1m; High > £1m

	1. Phoenix Code	**2. RoI Code**	**3. Wait for CAG**
Description	Adopt Phoenix code as is without any fe refinements	Adopt current BGE code with minimum amendments	Use BGE code & systems for all island solution
Costs:			
Code development	Minimal	Low?	Shared – low?
IT systems	High	Medium	Shared – low?
Staff costs	High	Low	Low
Total costs	High	Medium	Low?
Shipper consistency	NI consistent	RoI consistent	Consistent with RoI (and all island?)
Applicability	Short-term	Longer-term?	Longer-term
Issues	Significant conflict with existing processes eg supply points, metering and reconciliation	Jurisdictional issues pre-CAG? May only be a short-term solution dependent on CAG outcome	Not available as an interim solution; even if not adopted as an exclusive all island solution, will be compatible with CAG outcome

1. External legal review/preparation would still be required for the Phoenix & RoI Code options, which might easily be of the order of £50k, and the RoI Code option may require extraction of distribution provisions, increasing legal drafting costs

2. A temporary spreadsheet-based implementation with manual work-arounds on existing systems could perhaps be implemented at around £100k or so, but risks errors and will require continual revisions as the eligible market size increases

3. Staff costs for a dedicated transportation services team providing 24/7 cover could be of the order of £250k per annum – a service level agreement with parent company should be considerably cheaper provided processes are consistent

4. The analysis above does not include the indirect or opportunity costs associated with market opening, such as diversion of management time, adverse impact on market growth and consequent loss of potential distribution revenue. Such costs are difficult to estimate but could conservatively be worth at least £100k per year

5. In all options it is assumed that costs would also need to be incurred in order to establish and operate consistent arms length arrangements between the supply and distribution businesses – costs may vary depending on option taken (Option 1 likely to be most expensive) and will probably require further expense later except under Option 3. These costs are not included in the analysis but would need to be recovered by the firmus business as a direct consequence of market opening

Q4. Which option do respondents consider presents the best alternative, based on considerations of minimal costs, least confusion for customers and availing of effective competition at the earliest possible opportunity for customers? What arguments are there (based on cost, market clarity and competition considerations) for alternative options? Is there an alternative option not presented in this paper or a refinement of one of the options that might be more optimal?

In view of the Utility Regulator's wish to avoid creating another distribution code, we believe the basis of adopting a code should be based on the current Gaslink code. We think this is the only realistic option, since to adopt the Phoenix code without material amendments would result in considerable cost (and delay) in view of the impact on our existing business practices.

It should be noted that these implementation costs would be borne initially by a very small eligible customer base, significantly undermining the prospects for supply competition, and would then become stranded in the light of the subsequent CAG initiative.

We favour the choice of Gaslink rather than the Phoenix code not only because of its greater compatibility with firmus energy's current business practices, but also the greater likelihood of longer term synergies with an all-island solution. We appreciate that it is vital to keep the costs of implementation for the initial eligible I&C customers to a minimum, since we think it would be quite unreasonable to expect all I&C and residential customers to bear such costs.

The current licence schedule meets none of the general conditions for a sensible phased programme, as it is essentially a succession of arbitrary anniversaries falling one upon another.

We fervently believe that the current licence timetable is not advisable for the following main reasons;

- the approach is piecemeal and will be inefficient, may confuse consumers and will cut across the CAG initiative
- it would cut short our ability to offer a "guaranteed cheaper than oil" price commitment to new customers consistently across each of the 10 towns
- it will also distract scarce resources from the task of gaining a greater penetration of gas in the towns, which will in turn help ensure sustainable use of system charges.
- implementation costs are likely to be inefficient and will have to be met by small numbers of eligible customers, deterring switching and risking stranded costs

Importantly, given the 3rd directive requirements for unbundling within the BGE group, there are now significant IT development works required to protect the integrity of customer data and efficiently support network construction, operation and maintenance activities within firmus. On the basis of business separation, both BG Energy and BG Networks are moving away from the IUS system (felive in firmus) which was implemented in firmus energy in 2005. This will mean that firmus energy will have a legacy system which is unsupported within the parent company. Without an IT change programme between 2011 and 2013, network development activities and customer management are at risk from business failure.

Our analysis of contracting options and review of the Gemserv report confirms that there is no satisfactory “quick fix” interim solution. Overall we estimate that total incremental direct and opportunity costs arising from the licence timetable could be in the range of £1.3m - £2.4m by 2015, with a real risk of much of these costs becoming stranded in a post CAG environment.

The initial Ballymena opening scheduled for April 2011 would apply to a handful of customers. Even ignoring opportunity and other indirect costs of market opening, and assuming an unsustainable “back of spreadsheet” implementation, we might still easily be looking at incremental costs for 2011 alone averaging well over £20,000 per eligible customer.

This option of splitting opening between April 2013 and 2015 (or 2016 as proposed by firmus energy in this response) by market sector has the potential attraction of allowing for the application of learning from phase 1 implementation, with sufficient time to put that experience to good effect. A proposed date for tariff market opening of 2016 would also allow for sufficient time to ensure that the learnings from the IC market opening could be incorporated into the domestic opening process.

New entrants might argue that firmus energy is simply seeking to protect its own commercial position rather than benefit the market. This is a spurious argument given that during exclusivity firmus energy is forbidden to earn profits on the sale of gas. There is no financial gain to firmus in delaying the onset of competition. The sole focus of our Supply business during exclusivity is to ensure that we compete with displaced fuels and support the early connection of customers. Given the immaturity of the gas network in the 10 towns, firmus energy needs to remain focussed in driving the necessary conversions which can support recovery of its network and maintain lower long-term conveyance charges for customers, especially given the serious impact of the recession on our business plans. This approach is designed to support the promotion of the gas industry to the mutual benefit of ourselves and gas customers, and indeed to the longer term cause of supply competition.

Whilst there are a small minority of customers for whom the theoretical opportunity to seek an alternative gas supplier may be delayed, as compared with the licence timetable, this is offset by the imposition of inefficient implementation costs and firmus energy’s continued guarantee against their displaced fuel (oil). By working to consolidated market opening dates of 2013 and 2016, it will allow firmus to focus on optimising further conversions to gas from oil which in turn will benefit the environment, the local economies in which it operates and all of our customer base by helping to reduce the unit distribution costs that future competing suppliers would otherwise face.

It must also be noted that a significant number of large I&C customers in the NW towns are still benefiting from an oil-related, discounted gas price to allow them to recover the costs of conversion of their sites. Should market opening take place ahead of the recommended single date of 2013, many of these customers could see their gas prices rise as a full ‘market opening’ conveyance charge being applied. These large I&C customers are in many cases the largest employers in their towns and this resultant gas price increase will undoubtedly put pressure on operating costs and local jobs. At a time of severe economic pressure for NI manufacturers and large commercial organisations, every penny counts in terms of energy cost savings, particularly for those businesses who have ‘done the right thing’ by investing in high efficiency, lower carbon gas systems.

firmus energy is mindful that the future success of the network in the 10 towns relies on the economic sustainability of I&C customers, which are the anchor loads for each of the towns. Given the comparatively small size of many of our towns, it is imperative that we do everything we can to ensure that these few customers connect, recover their costs of conversion and are economically sustainable enough to contribute long term to the recovery of use of system charges.

I trust you will find these comments useful.

Yours sincerely

Michael

Michael Scott
Head of Business Development