Utility Regulator
ELECTRICITY GAS WATER

Phoenix Natural Gas Limited Price Control Review 2012-2013

Final Decisions

January 2012

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Acronyms and Glossary

A+M+PR mechanism	Advertising, marketing and PR mechanism.
CAG	Common Arrangements for Gas.
Capex	Capital expenditure.
COPI	Construction Output Price Index.
DPCR5	Distribution Price Control Review 5 – Ofgem's most recent price control of the electricity distribution networks in Great Britain.
DRD	Department for Regional Development.
DSEAR	The Dangerous Substances and Explosive Atmospheres Regulations 2002.
EBITDA	Earnings before interest, tax, depreciation and amortisation.
FTE	Full time equivalent.
GDN	Gas distribution network.
I&C	Industrial and commercial.
IRR	Internal rate of return.
NIHE	Northern Ireland Housing Executive.
NRSWA	New Roads and Street Works Act.
OO	Owner Occupier – refers to connections of domestic properties that are not New Build or NIHE properties. Sometimes also referred to as Existing Housing.
Opex	Operating expenditure.
PC03	This is the name given to the current price control for PNGL, which runs from 2007 to 2011 (calendar years).
PNGL	Phoenix Natural Gas Limited.
PNGL12	This is the name given to this forthcoming price control for PNGL, covering calendar years 2012 and 2013.
ppt	Pence per therm – herein used to refer to the conveyance tariff charged by PNGL per therm of gas (for transportation through its network).
PMICR	Post-maintenance Interest Cover Ratio.
Price Base	All monetary figures presented herein, unless otherwise stated, have been rebased using the Retail Price Index (RPI) as at September 2010.
PSL	Phoenix Supply Limited.
TMA	Traffic Management Act.
TRV	Total Regulatory Value.
tpa	Therms per annum – a commonly used measure of gas consumption.

1 EXECUTIVE SUMMARY

Introduction

1.1 Phoenix Natural Gas Limited (PNGL) is the owner and operator of the distribution network in the Greater Belfast Area and Larne, and is the larger of the two gas distribution companies in Northern Ireland (the other business being firmus energy, which owns and operates the network off the North-West and South-North transmission pipelines). PNGL's network extends to around 3,000 kilometres of laid pipeline, and the company has around 140,000 customers.

1.2 As PNGL is the sole provider of gas distribution services in its licensed area, we impose a price control to ensure the company offers gas consumers a quality service at a fair price. This price control review, referred to from hereon as "PNGL12", is the fourth price control we have imposed on PNGL since the company's creation in 1996.

1.3 PNGL12 will focus on the calendar years of 2012 and 2013. We have opted for a shorter duration than is normal for a network price control in order to align the timing of PNGL's fifth price control with the next price control of firmus. Alignment of both distribution companies' control periods will therefore occur in 2014.

1.4 Whilst the focus of this review is on 2012 and 2013, it should be noted however that as part of every price control, we do determine costs and revenues etc right through to 2046 (the end of PNGL's licence recovery period) but at the same time recognise that there will be further reviews in future years e.g. 2014-18, 2019-23 etc. This is necessary by virtue of the price control formulae in PNGL's licence, which reflects the PNGL business model to defer receipt of some current entitled revenues into the future. This helps keep conveyance charges lower now which in turn encourages the continued growth of the gas market.

1.5 Our consultation on the draft proposals for PNGL12 closed on 21 October 2011. We received a number of responses to the consultation and have posted these on our website alongside this document[1].

1.6 The most important points made in each of the responses, and our response in turn to these, have been presented in a separate document and also posted on our website alongside the consultation responses.

1.7 The responses can be generalised as being:

- Supportive of our efforts to apply downward pressure on energy prices; and/or
- Concerned about an adjustment to the regulatory asset base.

1.8 PNGL's main concern was over our proposed adjustment to its regulatory asset base, and the majority of its response was focused on this single issue. The argument centred on what was or was not agreed in the 2006 discussions and subsequent 2007 licence modifications. PNGL suggested that our actions would be detrimental to the company's ability to finance its operations.

[1] With the exception of one respondent that asked for its response to remain confidential.

1.9 In formulating our final decisions we have fully and carefully considered each of the responses, in particular any new information submitted to us and any comments made on our draft proposals. We have assessed the responses in the light of our statutory duties. As stated above, a statement of our views in respect of the most important points raised in each response can be found in a separate document which is also posted on our website.

Our Statutory Duties

1.10 A full discussion of our statutory duties is set out in Section 3.2. The paragraphs below summarise the main points.

1.11 Our principal objective in carrying out our gas functions is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland, and to do so consistently with our fulfilment of the objectives set out at Article 40 of the Gas Directive[2].

1.12 In fulfilling our functions, we must act in the manner that we consider best calculated to further this objective, and have regard to a number of matters set out more fully at Article 14 of the Energy (Northern Ireland) Order 2003.

1.13 Our initial proposals for the price control were shaped by these duties, and we have carefully considered all of the consultation responses by reference to them. We are now making final decisions which are consistent with the statutory requirements placed on us. Our proposals for the price control are best calculated to further the principal objective, and have full regard to the relevant matters specified at Article 14 of the Energy Order.

1.14 The fulfilment of our duties requires us to give weight to each of their different elements, and to consider their relationship to each other, and we have done this carefully. We have considered that weight should be given in particular to the following matters:

- PNGL should be granted sufficient revenues to allow it to maintain its existing network and continue with its growth plan, furthering the objective of developing and maintaining the gas industry in Northern Ireland.
- The allowances should be those that we consider to be efficient, economic and (Article 40(d) of the Gas Directive) cost-effective in all the circumstances.
- Our decisions must have regard to 'the need to ensure a high level of protection for the interests of consumers' (Article 14(2)(a) of the Energy Order) and generally ensure that consumers benefit from an efficient market which helps to ensure consumer protection (Article 40(g) of the Gas Directive).
- PNGL should be able to recover revenue that is sufficient, having regard to the need to ensure that it can finance the activities which are the subject of obligations placed on it under the legislation (Article 14(2)(a) of the Energy Order).

1.15 Our decisions fulfil these requirements, and are consistent with our statutory duties taken as a whole. In making these decisions we have carefully considered each of the representations

[2] Directive 2009/73/EC of the European Parliament and the Council of 13 July concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC.

made to us by way of consultation response. No evidence has been provided in those representations to cause us to significantly amend the proposals on which we consulted.

Other considerations

1.16 We have carefully considered our final decisions, especially as several responses to our consultation questioned the impact that our draft proposals would have on perceived regulatory certainty in NI. We have carefully considered these representations. The full narrative detailing our considerations can be seen in the responses document posted on our website alongside this document.

1.17 However to summarise, the areas of concern in this review originate from the 2006 discussions and subsequent 2007 licence modifications. This makes our decisions unique to the context of PNGL in this price control. They will have no direct or indirect bearing on either other regulated companies' price controls or future PNGL price controls.

1.18 In making our final decisions, we have secured the most efficient outcome in the interests of consumers which also ensures that the company will be able to finance the activities which are the subject of obligations placed on it.

1.19 The interests of consumers and the company are not necessarily inimical to each other. It is important for consumers that PNGL is able to finance the activities which are the subject of obligations placed on it, so that it can deliver an appropriate level of service at a reasonable price. It is equally important to the company that consumers are required only to pay fair and efficient prices so that the market for natural gas in Northern Ireland continues to be developed and maintained. Our aim is to strike an appropriate balance between the different elements of our duties, so that we optimise the extent to which they are fulfilled.

1.20 In having regard to the need to ensure a high level of protection for gas consumers, we have of course considered the wider economic circumstances in which the consumer interest is framed, and in particular the interests of vulnerable customer groups such as the elderly, the disabled and sick, and those on low incomes.

1.21 Whilst gas conveyance charges typically constitute less than half of final end tariffs, we would highlight the sensitivity of both domestic and business customers to energy prices. This is particularly important for those domestic customers in fuel poverty and for businesses struggling to compete in internationally competitive markets[3].

1.22 PNGL's proposals for this price control would result in upward pressure on energy prices. Where it is possible to do so consistently with our duties, we seek to avoid this. We are content that our decisions properly balance all of these factors.

[3] By way of example, in its consultation response to our draft proposals, National Energy Action (NI) presented statistics to demonstrate the increasing prevalence of fuel poverty in Northern Ireland. And recently published reports on the economic outlook from organisations such as the Northern Bank, Ernst & Young and PwC support the notion that conditions will remain challenging throughout 2012 and beyond. Furthermore, the results of a recent survey published by the CBI and KPMG found that 80 per cent of UK companies have significant concerns about energy costs, with 43 per cent seeing them as very significant to their business operations. The survey can be found here: http://www.cbi.org.uk/media/1052324/2011.09-cbi-kpmg-infrastructure-report.pdf

Update from Draft Proposals

1.23 This document sets out our final decisions. For ease of reading, we have highlighted at the beginning of each section where we have made any changes from the draft proposals consultation.

1.24 We have taken on board all comments on the draft proposals and made some changes where it was appropriate to do so. We have amended the adjustment to the regulatory asset base as a result of comments from PNGL on the detail of the deferred capex information set, reducing the proposed adjustment for deferred capex and outperformance by around £6 million. We have also made a few changes to a number of opex cost lines, and corrected a minor transposition error in the capex allowances. We have also expanded our assessment of financeability. Full details can be seen in each respective section.

1.25 Otherwise our decisions remain largely the same as our draft proposals. The resulting tariffs from our decisions will see prices fall from their 2011 levels, mainly driven by the end of the reward to PNGL for historical outperformance. For the average domestic customer, the saving is approximately £10 per annum[4], which is projected to continue to 2046 under the current price control formulae.

1.26 Compared to the PNGL submission, our decisions will result in the average domestic customer paying around £25 less per annum.

1.27 For industrial and commercial (I&C) customers, particularly large ones, the difference will be greater given their higher consumption levels. We estimate savings for the larger I&C customers may amount to tens of thousands of pounds, and for the very largest it may even exceed £100k per annum.

Summary of Approach

1.28 We have used a standard RPI-X framework to develop the price control, which will incentivise PNGL to control its costs. This has required us to set an allowance for operating expenditure (opex) and capital expenditure (capex) for PNGL in each year of the control period.

1.29 Our assessment of appropriate opex allowances has focused on the six largest cost lines which account for around 75 per cent of total opex. For reference these six cost lines are:

- Advertising, marketing and PR;
- Emergency costs;
- Incentives (for customers);
- Insurance;
- Manpower; and
- Network maintenance.

[4] Customer savings are intended to be indicative only, as the exact quantum of savings is very sensitive to the assumptions used in the calculation e.g. assumed inflation, assumed consumption levels.

1.30 Each of the above cost lines have been considered separately. A full explanation of the approach and rationale behind the allowances is set out later in the relevant sections of the paper.

1.31 For the remaining (smaller) opex cost lines we have set an allowance using an average of actual spend during the three most recent years for which we had audited data at the time of writing (2007 to 2009).

1.32 For capex, we commissioned engineering consultants PB Rune to advise on the appropriateness of PNGL's submission. PB Rune examined the company's capital programme, benchmarking PNGL's costs against suitable comparators. We have used the findings from PB Rune's review to inform our allowances.

1.33 The RPI-X framework will result in an annual uplift of RPI to all allowances. PNGL should be able to contain increases in opex and capex below RPI-measured inflation and we have applied an ongoing efficiency factor of one per cent per annum to these expenditures.

1.34 PNGL has a fixed cost of capital[5] embedded in its licence, set at 7.5 per cent (in real terms and pre tax) until the end of 2016. For this price control, we considered reviewing the appropriateness of PNGL's existing cost of capital, as there are arguments as to why 7.5 per cent may not reflect the risks facing the company (see Appendix 1 for more details). However on reflection, and when viewed against the overall price control package we have put together for PNGL12, we have decided to retain PNGL's cost of capital at 7.5 per cent over the control period.

1.35 In the next price control review (to take effect from 2014) we expect to set a revised cost of capital from 2017 onwards, most likely using a standard methodology such as the capital asset price model (CAPM). We envisage that this will entail a full assessment of all the building blocks comprising a weighted average cost of capital (WACC), including consideration of PNGL's risk profile versus that of comparable gas distribution networks (GDNs) in Great Britain (GB).

Adjustment to the asset base

1.36 In developing PNGL12 we have reviewed the value of PNGL's regulatory asset base (defined in PNGL's licence as the Total Regulatory Value, or TRV). As part of this review we have considered how best to address two specific issues, the first in respect of deferred capex and the second in respect of the treatment of historical outperformance.

1.37 Regarding deferred capex, PNGL has in the past been granted allowances for projects it has yet to complete, or which were completed later than originally anticipated. As a result PNGL's asset base has increased by more than it would otherwise have if allowances were (or are) included only at the time of actual spend. Gas consumers should not have to pay for assets before they are built and we are therefore making an adjustment to the TRV to account for this.

1.38 Regarding outperformance, at the commencement of the current price control we agreed to include an amount in the TRV to reward PNGL for historical outperformance (i.e. the difference between PNGL's actual and allowed spend in previous price controls). Including this sum in respect of outperformance has allowed PNGL to generate additional revenues from 2007.

1.39 It is standard regulatory practice that the benefits from outperformance are shared between companies and consumers. For example, Ofgem's approach to capex outperformance has in the

[5] Note that we use the terms "cost of capital" and "rate of return" interchangeably.

past been to allow projected expenditure to remain in the asset base for a period of five years, during which time the company enjoys the depreciation and return on unspent capex. However after the five years have passed actual expenditure replaces projected expenditure in the asset base, which ensures that consumers also share in the benefits. In principle this is designed to reflect the position of competitive markets where companies can retain the benefits of outperformance for a limited number of years before they are competed away.

1.40 Consistent with the Ofgem historical approach to capex outperformance, we will allow PNGL to retain the outperformance sum in its TRV until the end of 2011, by which time PNGL will have enjoyed five years of reward (by way of depreciation and return) from its inclusion, amounting to c£35 million. We will then remove the outperformance (suitably depreciated) from the TRV in 2012[6].

1.41 We recognise the concerns raised in some of the responses to the consultation, in particular those from PNGL, in relation to the regulatory asset base adjustment. We acknowledge that there could have been greater detail in the 2007 licence modifications public consultation on exactly how the sharing of historical outperformance would be implemented. This may explain why there is a difference of interpretation with respect to how we would treat deferred capex and historical outperformance.

1.42 Having carefully reviewed the documents from the 2006/7 period, we are satisfied that we did not make any commitment that the outperformance sum would remain in the asset base until 2046 (which PNGL asserts). In fact, the public consultation referred to the sharing of outperformance consistent with regulatory practice elsewhere, which is why we have adopted the GB precedent of five years.

1.43 Some questions were raised in the consultation responses surrounding perceived regulatory certainty in Northern Ireland. In formulating our final decisions, we have given these representations serious consideration.

1.44 As a starting point for these considerations, we took into account that PNGL's cost of capital is fixed in the licence at 7.5 per cent (real and pre tax) until the end of 2016, which is the highest cost of capital allowance among all the gas distribution networks in the United Kingdom.

1.45 If we were to make no adjustment to the TRV, this would effectively result in PNGL retaining all of the benefit of deferral and underspend, creating a transfer of value of around £74.4 million[7] from customers to shareholders that will earn the full rate of return going forward. It is clearly inappropriate that customers should pay PNGL such an outsize reward, remembering of course that this relates to investments that were never made and did not need to be financed.

1.46 We do not consider the harm that PNGL has claimed results from our proposals (even if we were to accept its arguments at face value) can come anywhere close to matching and offsetting the c£74.4 million of customer benefit. We are dealing with a unique situation pertaining to the setting of the opening asset value, and the decisions that we take on this matter in no way

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[6] PNGL will still retain an element of historical outperformance in its asset base because of the Profile Adjustment. This is included in the c£35 million figure cited above in paragraph 1.40. For a more detailed explanation see the shaded box below paragraph 7.4.

[7] Since our draft proposals we have taken on board responses to the draft proposals consultation and altered the calculation of the TRV adjustment, hence this lower figure than the £80.8 million in the draft proposals. The build-up of the £74.4 million figure is set out in Section 7.

diminish our commitment to ensure that customers pay back in full the cost of efficient investment.

1.47 As part of the considerations for these final decisions, we did consider alternative options such as leaving historical outperformance in the asset base for more than five years. We remain satisfied however that the GB precedent of five years is appropriate. We also considered options that would increase the share of value transfer to customers, but concluded our original proposals strike a fair balance of value sharing between customers and PNGL.

1.48 We have concluded that on balance, and applying our statutory duties, we should adjust the asset base taking into account the updated figures as set out in Section 7, for without the adjustment there would be an unwarranted burden left on consumers.

1.49 This adjustment in effect represents the closing off of a range of historic issues relating to PNGL. We have reviewed the build-up of the TRV after our adjustment and recognise that it still includes significant elements of historical underrecoveries and some historical outperformance (as explained in footnote 6). These will continue to be part of the TRV and do not require any future adjustment. Once implemented by way of a licence modification, we consider these historic issues to be finalised and closed. This should provide a significant element of certainty to investors.

Financeability

1.50 Consistent with our statutory duties, we have also carefully considered how these decisions impact on PNGL's ability to finance the activities which are the subject of obligations placed on it. We additionally recognise that maintaining financeability is in the consumer interest (as consumers are in future exposed to PNGL's resulting cost of capital).

1.51 We have modelled the key financial ratios (gearing and debt interest cover) with a focus on 2012 and 2013, although our regulatory and financial model provides analysis in every year to 2046. We have formed our assessment of financeability using three sets of criteria, namely the financial ratios required to satisfy:

- An investment grade credit rating (the requirement in the licence);
- The specific bond covenants in PNGL's existing debt; and
- PNGL's existing credit rating (which is one notch above investment grade).

1.52 Under a central case scenario, debt interest cover in 2012 and 2013 is comfortably satisfied under all three sets of criteria, and remains so in all years to 2046, even after assuming the commencement of substantial dividend payments in the medium to long term.

1.53 Gearing in 2012 and 2013 is calculated to be 70.5 per cent and 69.5 per cent respectively, which satisfies the requirements for an investment grade credit rating and the bond covenants, and is on the threshold of the requirements for PNGL's existing credit rating[8]. Our modelling further indicates that gearing falls progressively from 2012.

1.54 We have also modelled a number of downside scenarios, which assume an unanticipated decrease in the rate of connections and increase in costs from the start of 2012. We found that

[8] Note that this gearing is based on an assessment of nominal debt that includes a c£12 million provision for Phoenix Supply Limited (PSL), a sister company of PNGL, which may be more appropriate to exclude. Excluding this provision would result in gearing in 2012 of around 67.5 per cent. See Section 9 for full details.

the financial ratios still satisfy the requirements of our three sets of criteria, and PNGL remains financeable assuming it adopts a prudent dividend policy.

1.55 Fundamentally the underlying financial resilience in the short, medium and longer term means that the business is inherently robust. We remain satisfied that our final decisions leave the company on a financially sustainable trajectory.

Summary of Decisions

1.56 A summary of our overall decisions for PNGL12 is presented in the table below[9].

1.57 It should be noted that our decisions are based on a higher connection target for domestic owner occupiers (4,200 per year instead of 3,700 proposed by PNGL). The effect of using a higher target is to grant a higher allowance, particularly for capex, since allowance levels for certain cost items are driven by forecast connections. If we had used PNGL's target, the overall allowances would be around £1-2 million lower.

Table 1 – Allowances, £m

Cost Item	*PNGL Submission*			*UR Decision*			*Difference*	
	2012	*2013*	*Total*	*2012*	*2013*	*Total*	*Total*	*Total, %*
Opex allowance	15.9	16.2	**32.1**	13.2	13.4	**26.5**	**-5.6**	**-17%**
Capex allowance	12.5	11.7	**24.2**	12.5	11.7	**24.2**	**0.0**	**0%**
Total	**28.4**	**27.9**	**56.3**	**25.7**	**25.1**	**50.7**	**-5.6**	**-10%**
In setting a determination we grant PNGL what we consider to be efficient allowances for future opex and capex. The allowances are then fed into our regulatory model, which calculates a revenue requirement to ensure the company recovers the value of future as well as past investments, plus a return on this investment. The calculated revenue stream that PNGL is allowed to recover from consumers is then used to determine conveyance charges for the use of the PNGL network. The allowed revenues for 2012 and 2013 are detailed in the row below.								
Allowed revenues	46.8	48.3	**95.1**	39.9	41.2	**81.1**	**-14.0**	**-15%**

Note that some rows/ columns in ALL tables throughout this report may not appear to sum correctly. This is due to rounding.

Source: PNGL and the Utility Regulator

1.58 The resulting tariffs from our decisions will see prices fall from their 2011 levels, mainly driven by the end of the reward to PNGL for historical outperformance. For the average domestic customer, the saving is approximately £10 per annum[10], which is projected to continue to 2046 under the current price control formulae.

[9] First, note that all monetary figures throughout this paper, unless otherwise stated, are in 2010 prices (specifically, all figures have been rebased using the Retail Price Index as at September 2010).
Second, this table sets out allowances for the control period only i.e. 2012 and 2013. However, it should be noted that as part of every price control we do determine costs and revenues etc right through to 2046 (the end of the PNGL's licence recovery period). This is necessary since the PNGL business model requires the deferral of some of its entitled revenues, to be recovered in future. This helps keep conveyance charges lower now which in turn encourages the continued growth of the gas market.

[10] Customer savings are intended to be indicative only, as the exact quantum of savings is very sensitive to the assumptions used in the calculation e.g. assumed inflation, assumed consumption levels.

1.59 Compared to the PNGL submission, our decisions will result in the average domestic customer paying around £25 less per annum.

1.60 For industrial and commercial (I&C) customers, particularly large ones, the difference will be greater given their higher consumption levels. We estimate savings for the larger I&C customers may amount to tens of thousands of pounds, and for the very largest it may even exceed £100k per annum.

Next Steps

1.61 In order to implement our final decisions, it will be necessary to modify the PNGL licence under Article 14 of the Gas Order. We have therefore published the required statutory consultation on the licence modification alongside this document.

1.62 Pending the outcome of this consultation, and assuming that PNGL consents to the licence modification and/or does not disapply our final decisions herein, the price control for 2012 and 2013 can then be implemented.

1.63 In the event that PNGL rejects the licence modification and/or disapplies our final decisions, the licence allows us 56 days from the date of rejection to refer the matter to the Competition Commission.

2 INTRODUCTION

Update from Draft Proposals

2.1 This document sets out our final decisions. For ease of reading, we have highlighted at the beginning of each section where we have made any changes from the draft proposals consultation.

2.2 This section has not changed since the draft proposals.

Company Overview

2.3 PNGL is the owner and operator of the distribution network in the Greater Belfast Area and Larne, and is the larger of the two gas distribution businesses in Northern Ireland (the other business being firmus energy, which owns and operates the network off the North-West and South-North transmission pipelines). The company is responsible for the development of the pipeline network and also for providing a 24/7 operational and transportation service platform to gas suppliers under the rules of the company's network code.

2.4 The PNGL network extends to around 3,000 kilometres of intermediate, medium and low pressure mains, which distribute natural gas throughout the licence area. PNGL manages the development of the both the physical network and market in Greater Belfast; around 140,000 customers have been connected to natural gas.

2.5 A brief narrative which summarises the relevant regulatory history of the company is set out in Appendix 1.

Background to the Price Control

2.6 As mentioned above, Northern Ireland has two gas distribution networks, PNGL and firmus. Both companies are price controlled by us. PNGL's current price control (referred to as "PC03") commenced in 2007 and will continue until the end of 2011, so a new price control is needed for PNGL to take effect in 2012. The current price control period for firmus runs from 2009 to the end of 2013, so a new price control is needed for firmus to take effect in 2014.

2.7 In late 2009 we began scoping and planning the work necessary to develop the price control. In considering the issues involved, we also considered the merits of aligning the timing of the price controls of the two companies and how we might go about this.

2.8 The merits of aligning the price controls and the potential options to pursue to achieve this were consulted on in January 2010[11]. A decision then followed to align the price controls by way of

[11] "*Aligning the Price Control Reviews of Northern Ireland's Gas Distribution Networks*," the Utility Regulator, January 2010.

imposing a two year price control on PNGL for 2012 and 2013, thereby achieving alignment in 2014. This price control therefore covers the calendar years of 2012 and 2013.

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http://www.uregni.gov.uk/uploads/publications/NI_GDNs_Price_Control_Alignment_v10_FINAL.pdf

3 APPROACH

Update from Draft Proposals

3.1 Since the draft proposals we have expanded the discussion around our statutory duties, regulatory principles, and indexation.

Our Statutory Duties

3.2 Our approach to this price control has been guided by our statutory duties. These are set out in italic text below.

The principal objective of the Department [DETI] *and the Authority* [NIAUR] *in carrying out their respective gas functions is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland, and to do so in a way that is consistent with the fulfilment by the Authority, pursuant to* ***Article 40 of the Gas Directive****, of the objectives set out in paragraphs (a) to (h) of that Article.*

3.3 Article 40 of the Gas Directive[12] reads as follows:

General objectives of the regulatory authority
In carrying out the regulatory tasks specified in this Directive, the regulatory authority shall take all reasonable measures in pursuit of the following objectives within the framework of their duties and powers as laid down in Article 41, in close consultation with other relevant national authorities, including competition authorities, as appropriate, and without prejudice to their competencies:

> ***(a)*** *promoting, in close cooperation with the Agency, regulatory authorities of other Member States and the Commission, a competitive, secure and environmentally sustainable internal market in natural gas within the Community, and effective market opening for all customers and suppliers in the Community, and ensuring appropriate conditions for the effective and reliable operation of gas networks, taking into account long-term objectives;*
>
> ***(b)*** *developing competitive and properly functioning regional markets within the Community in view of the achievement of the objectives referred to in point (a);*
>
> ***(c)*** *eliminating restrictions on trade in natural gas between Member States, including developing appropriate cross-border transmission capacities to meet demand and enhancing the integration of national markets which may facilitate natural gas flow across the Community;*
>
> ***(d)*** *helping to achieve, in the most cost-effective way, the development of secure, reliable and efficient non-discriminatory systems that are consumer oriented, and*

[12] Directive 2009/73/EC of the European Parliament and the Council of 13 July concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC.

promoting system adequacy and, in line with general energy policy objectives, energy efficiency as well as the integration of large and small scale production of gas from renewable energy sources and distributed production in both transmission and distribution networks;

(e) *facilitating access to the network for new production capacity, in particular removing barriers that could prevent access for new market entrants and of gas from renewable energy sources;*

(f) *ensuring that system operators and system users are granted appropriate incentives, in both the short and the long term, to increase efficiencies in system performance and foster market integration;*

(g) *ensuring that customers benefit through the efficient functioning of their national market, promoting effective competition and helping to ensure consumer protection;*

(h) *helping to achieve high standards of public service for natural gas, contributing to the protection of vulnerable customers and contributing to the compatibility of necessary data exchange processes for customer switching.*

3.4 In carrying out our gas functions, we are required to act in the manner that we consider is best calculated to further the principal objective whilst also having regard to a number of other considerations, as set out in Article 14 of the Energy (Northern Ireland) Order 2003. The text below, an extract from Article 14, sets these out.

(2) *The Department and the Authority shall carry out those functions in the manner which it considers is best calculated to further the principal objective, having regard to—*

(a)*the need to ensure a high level of protection of the interests of consumers of gas;*

(b)*the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Gas Order or this Order;*

(c)*the need to secure that the prices charged in connection with the conveyance of gas through designated pipe-lines (within the meaning of Article 59) are in accordance with a common tariff which does not distinguish (whether directly or indirectly) between different parts of Northern Ireland or the extent of use of any pipe-line; and*

(d)*the need to protect the interests of gas licence holders in respect of the prices at which, and the other terms on which, any services are provided by one gas licence holder to another.*

(3) *In performing that duty, the Department or the Authority shall have regard to the interests of—*

(a)*individuals who are disabled or chronically sick;*

(b)*individuals of pensionable age; and*

(c)*individuals with low incomes;*

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

(4) *The Department and the Authority may, in carrying out any gas functions, have regard to the interests of consumers in relation to electricity [and in relation to water or sewerage services].*

(5) *Subject to paragraph (2), the Department and the Authority shall carry out their respective gas functions in the manner which it considers is best calculated—*

(a)*to promote the efficient use of gas;*

(b)*to protect the public from dangers arising from the conveyance, storage, supply or use of gas;*

(c)*to secure a diverse, viable and environmentally sustainable long-term energy supply; and*

(d)*to facilitate competition between persons whose activities consist of or include storing, supplying or participating in the conveyance of gas;*

and shall have regard, in carrying out those functions, to the effect on the environment of activities connected with the conveyance, storage or supply of gas.

(5A) *In carrying out their respective gas functions the Department or the Authority shall not discriminate between persons whose activities consist of or include storing, supplying or participating in the conveyance of gas as regards either rights or obligations.*

(6) *In this Article "gas functions" means—*

(a)*functions under Part II of the Gas Order; and*

(b)*functions under this Order relating to gas.*

(7) *For the purposes of paragraph (5)(c) environmental sustainability includes the need to guard against climate change.*

3.5 Our principal objective is focused on the promotion, development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland. Our decisions for PNGL12 are consistent with, and best promote, this. PNGL has been granted sufficient revenues to allow it to maintain its existing network and continue with its growth plan, fulfilling the requirement to promote, develop and maintain the market. Furthermore, the allowances we have granted are those that we consider to be efficient and economic.

3.6 We have had full regard to the objectives set out in Article 40 of the Gas Directive, which we believe are entirely consistent with the other elements of the principal objective, and have noted objectives (d) and (g) as being particularly relevant in this context.

3.7 With regards to the other considerations cited above in Article 14 of the Energy (Northern Ireland) Order 2003, our decisions in particular:

- Ensure a high level of protection of the interests of consumers of gas, as required under Article 14(2)(a);
- Deliver sufficient revenues to allow PNGL to secure that it can finance the activities which are the subject of obligations placed on it, as required under Article 14(2)(b); and
- Are generally consistent with, and have due regard to, the other considerations set out under Article 14.

3.8 In summary, taken in the round, we interpret our duties, in the context of carrying out price controls, as a broad mandate to secure the most cost efficient outcome – for the protection of consumers and the promotion of the gas industry in Northern Ireland – that also secures that

the company can continue to finance the activities which are the subject of obligations placed on it, and that has due regard to all relevant factors.

3.9 Furthermore we consider that relaxing the control further would unnecessarily jeopardise the interests of gas consumers, inconsistently with duties (f) and (h) in paragraph 3.3 above, whilst imposing a significantly tighter control would be likely to jeopardise PNGL's financial viability and the future of a key part of the gas industry in Northern Ireland, inconsistently with duties (d) and (f).

Regulatory Principles

3.10 The principles underpinning the decisions herein are to ensure the revenues and resulting tariffs are:

- Sustainable;
- Stable;
- Transparent;
- Predictable; and
- Cost-reflective.

3.11 These are based on best practice regulation of natural monopolies. Our task essentially consists of creating a framework within which, in return for providing monopoly services to an acceptable quality, the company receives a reasonable assurance of a revenue stream in future years that will cover its costs.

3.12 We do recognise and acknowledge the issues raised in the responses to our draft proposals consultation, regarding the perceived regulatory certainty surrounding gas distribution networks in NI. However we would emphasise that the areas of concern originate from the 2006 discussions and subsequent 2007 licence modifications. This makes our decisions unique to PNGL in this price control, and they will have no direct or indirect bearing on either other regulated companies' price controls or future PNGL price controls.

3.13 Nevertheless we do recognise the importance of continually improving how we carry out our functions, particularly around the development of price controls. For this reason we initiated sometime ago a cross-directorate project (internally referred to as Project Zeus) that aims to ensure our network price controls are developed in a more consistent and coherent manner, where appropriate. A consultation on the subject was published in September 2011[13].

3.14 The responses from this consultation will help inform the appropriate way forward as we seek to develop common policies and processes for the development of price controls across our office. It is likely that we will in due course be publishing more documents as part of Project Zeus, including policy statements on key aspects of price control development.

[13] *"Network price controls: Proposals for a Cross-Utility approach,"* the Utility Regulator, September 2011. http://www.uregni.gov.uk/uploads/publications/Proposals_for_a_cross_utility_approach_to_network_price_controls.pdf

3.15 Finally, we will consider the appropriateness of issuing a Statement of Regulatory Policy and Intent in relation to gas distribution networks[14]. It is intended that this, along with the other outputs from Project Zeus, will among other things, continue to improve transparency and predictability of the regulatory framework.

Form of Price Control

3.16 We have developed this price control using a standard RPI-X framework, which will incentivise PNGL to control its costs. This has required us to set an allowance for operating expenditure (opex) and capital expenditure (capex) for PNGL in each year of the control period. A full explanation of the rationale behind our opex and capex allowances is set out later in the relevant sections of this paper.

3.17 Our allowances for opex and capex are that which we consider efficient for PNGL to deliver the required outputs over the control period. Whilst we do intend to scrutinize at an individual cost line how the company actually spends its allowance (via our annual cost reporting regime), the most important consideration is that PNGL delivers the necessary outputs whilst keeping within its *overall* cost allowance.

Duration

3.18 As mentioned in Section 2, this price control will last for two years, those being calendar years 2012 and 2013.

3.19 Whilst the focus of this review is on 2012 and 2013, it should be noted however that as part of every price control, we do determine costs and revenues etc right through to 2046 (the end of PNGL's licence recovery period) but at the same time recognise that there will be further reviews in future years e.g. 2014-18, 2019-23 etc. This is necessary by virtue of the price control formulae in PNGL's licence, which reflects the PNGL business model to defer receipt of some current entitled revenues into the future. This helps keep conveyance charges lower now which in turn encourages the continued growth of the gas market.

Indexation and Efficiency Targets

3.20 The standard regulatory RPI-X framework inflates the price control year-on-year by an appropriate index (usually the Retail Price Index, or RPI).

3.21 The RPI is a broad measure of inflation for the economy. There are some instances where it can be argued that the RPI is not a good measure of inflation facing a particular regulated company. For example, in recent years the price of commodities and hence materials has increased at a

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[14] This would be similar in principle to a statement published by our Water Directorate: "*Regulation of the Northern Irish water and sewerage industry: Statement of Regulatory Principles and Intent*," the Utility Regulator, April 2007. http://www.uregni.gov.uk/uploads/publications/Water_SORPI.pdf

rate above that of the RPI. On the other hand, many companies have also experienced wage inflation of less than the RPI, owing mainly to the challenging economic environment.

3.22 To correct for things like this, the regulator can build in an allowance for the differential rate of inflation affecting opex and capex. By way of example, in its most recent price control for the electricity distribution network operators (DPCR5) in GB, Ofgem allowed for positive real input price inflation (or real price effects) of 1.1 per cent for network investments (capex) and 1.4 per cent for opex. With an ongoing efficiency assumption of one per cent per annum, the net effect was to offer annual expenditure increases above RPI (RPI+0.1 per cent for capex and RPI+0.4 per cent for opex)[15].

3.23 For the purposes of this price control, we expect PNGL to continue achieving efficiency gains. Having reviewed the analysis presented by Ofgem as part of DPCR5, we have decided to apply the same ongoing efficiency assumption of one per cent per annum[16].

3.24 With regards to real price effects, over this control period PNGL will continue outsourcing the majority of its capital works to McNicholas Construction Limited. As PNGL's contract costs with McNicholas are linked to the RPI, capex costs overall are not anticipated to increase by more than the RPI.

3.25 Similarly, as manpower constitutes the largest element of opex and wage pressures are likely to remain subdued for the foreseeable future, we do not anticipate opex input price inflation rising by more than the RPI.

3.26 We will therefore escalate opex and capex by an overall RPI minus one per cent per annum for PNGL12.

[15] Full details on the arguments presented in DPCR5 can be seen in the allowed revenue cost assessment paper published as part of Ofgem's final proposals.
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=370&refer=Networks/ElecDist/PriceCntrls/DPCR5

[16] In its most recent Transmission Price Control (TPCR04) Roll-over, Ofgem adopted an efficiency factor of 1.5 per cent.

4 PNGL PRICE CONTROL SUBMISSION

Update from Draft Proposals

4.1 This section has not changed since the draft proposals.

Introduction

4.2 PNGL is required as a condition of its gas conveyance licence to submit to the Utility Regulator all relevant information necessary for us to complete a price control review.

4.3 In late 2010 PNGL fulfilled this requirement. This section presents a summary of the information submitted by PNGL, focusing in particular on the resource requirements stated as necessary by PNGL to develop and operate its network over the control period.

Operating Expenditure

4.4 The table sets out a summary of the overall opex allowance requested by PNGL. More detail of the build-up of many of the individual cost lines was also provided by PNGL.

Table 2 – Operating Expenditure Submission, £k

Cost Item	*2012*	*2013*	*Total*
Advertising, marketing and PR	785	788	**1,572**
Billing	217	221	**438**
Emergency costs	2,069	2,139	**4,208**
Entertainment	60	60	**120**
Fleet costs	268	269	**536**
Human resources	121	107	**227**
Incentives	847	847	**1,693**
Information Technology	305	285	**590**
Insurance	909	933	**1,842**
Licence fees	293	293	**585**
Manpower	5,016	5,058	**10,074**
Network maintenance	2,408	2,456	**4,864**
Office costs	492	486	**978**
Own use gas	17	17	**34**
Professional and legal fees	605	569	**1,174**
Rates	1,261	1,479	**2,740**
Stationery	46	47	**93**
Telephone and postage	103	104	**207**
Travel and subsistence	78	78	**157**
Total	**15,899**	**16,234**	**32,133**

Source: PNGL

Capital Expenditure

4.5 The table sets out a summary of the overall capex allowance requested by PNGL. More detail of the build-up of many of the individual cost lines was also provided by PNGL.

Table 3 – Capital Expenditure Submission, £k

Cost Item	*2012*	*2013*	*Total*
7 bar mains	0	0	**0**
4 bar mains	471	0	**471**
Pressure reduction stations	0	0	**0**
Feeder mains	254	168	**422**
Infill mains	2,501	2,501	**5,002**
Domestic services	3,210	3,210	**6,421**
Domestic meters	1,747	1,742	**3,489**
I&C services	642	642	**1,284**
I&C meters	566	566	**1,132**
Network code	100	100	**200**
Fixtures and fittings	40	40	**80**
*** Titanic Quarter project**	169	0	**169**
IT	150	150	**300**
Management fee	2,631	2,574	**5,205**
Total	**12,481**	**11,694**	**24,175**

* In 2011, PNGL was approached by Titanic Quarter Limited and asked to make gas available to the Titanic Quarter site. As this occurred *after* the PNGL submission, the costs associated with this project were not originally included. We have opted to include the requested costs of this project as part of this price control.

Source: PNGL

PNGL Connection Assumptions

4.6 PNGL's assumed level of connections over the control period is set out below.

Table 4 – Proposed Annual Connections

Cost Item	*Annual Connections*
Domestic – Owner Occupier (OO)	3,700
Domestic – New Build (NB)	3,000
Domestic – Northern Ireland Housing Executive (NIHE)	500
Industrial and Commercial (I&C)	378
Total	**7,578**

Source: PNGL

Environmental Benefits

4.7 In its submission, PNGL highlighted the positive impact that converting to natural gas from other fuels such as coal, oil and electricity (for heating) has on the environment. The company correctly pointed out that the government does recognise that an increase in take up of natural gas can deliver significant environmental benefits through a reduction in the level of carbon emissions.

4.8 PNGL further cited the recently published feasibility study which examined the possibility of extending the natural gas network in Northern Ireland[17]. Using the methodology set out in the study, PNGL suggests that the financial benefit of the carbon reduction arising from each additional domestic connection is in the region of £1,200 (present value).

4.9 We have taken this into consideration when formulating our allowances for this price control. Our considerations include the fact that in the absence of a platform to trade carbon, the financial benefit is notional only and cannot be realised in actual cash terms. However, we view our duty to promote the industry as being relevant here. Given we have set out that our decisions will further the development of the industry, this will include the environmental benefits associated with consumers switching from oil to gas.

PNGL12 Outputs versus PC03 Outputs

4.10 As part of its submission, PNGL also provided information on the level of outputs it plans to deliver over the control period, the main ones being:

- Kilometres of mains laid;
- Number of properties passed; and
- Number of properties connected.

4.11 For illustrative purposes, we set out below PNGL's actual performance in calendar years 2007 to 2009 (2009 was the most recent year for which we had audited data at the time of writing) and compare this with its allowance requests and forecast outputs for 2012 and 2013.

[17] "*Consultation on the potential for extending the natural gas network in Northern Ireland*," Department of Enterprise, Trade and Investment, June 2011. http://www.detini.gov.uk/consultation_on_the_potential_for_extending_the_natural_gas_network_in_northern_ireland

Table 5 – PC03 Actuals versus PNGL12 Submission

Allowances and Outputs	*2007*	*2008*	*2009*	*Average 2007-09*	*2012*	*2013*
	Actuals				*PNGL Submission*	
Capex, £m	13.4	11.1	12.7	12.4	12.3	11.7
Opex, £m	13.1	11.2	11.9	12.1	15.9	16.2
Total cost, £m	**26.5**	**22.3**	**24.6**	**24.5**	**28.2**	**27.9**
Pipe laid, km	80.2	60.7	78.2	73.1	58.3	51.3
Properties passed	8,438	8,027	8,168	8,211	5,250	5,250
Connections (domestic)	10,370	7,394	7,661	8,475	7,200	7,200
Connections (I&Cs)	532	506	457	498	378	378

All monetary figures above are in 2010 prices.

Source: PNGL and the Utility Regulator

4.12 From the figures above there are two main observations:

- First, overall allowances sought by PNGL in 2012 and 2013 are higher than in PC03. PNGL's capex allowance request for 2012 and 2013 is broadly comparable to its actual capex spend in 2007 to 2009, but the opex allowance request is significantly higher. In total PNGL is seeking nearly £4 million more allowance in each year of PNGL12 than it has actually spent on average per year in PC03 which represents an increase of 33 per cent in real terms.
- Second, the outputs that PNGL forecasts to deliver in 2012 and 2013 are significantly lower than that which was actually delivered in each year of PC03.

4.13 This high-level review of PNGL's submission demonstrates that PNGL is seeking higher overall allowances to deliver fewer outputs than it has historically been able to.

4.14 It is worth noting that PNGL did provide some detail and supporting commentary to explain why costs are forecast to increase. More detail and discussion is provided in the sections to follow.

5 OPERATING EXPENDITURE

Update from Draft Proposals

5.1 We have made changes to two cost lines since our draft proposals. The changes are in respect of:

- Information technology; and
- Advertising, marketing and PR.

5.2 With respect to IT, in our draft proposals we had considered granting PNGL its full allowance request. However in recognition of the company's track record of outperforming on its IT costs, we stated that we would be unlikely to grant any further IT allowances in the event of further or unexpected costs.

5.3 A number of respondents challenged this proposal, and questioned why we felt it appropriate to grant the full allowance request when the company has such a strong track record of outperformance. Similarly, PNGL expressed some concerns that our proposal left it potentially exposed to unpredictable costs, in particular those that may be imposed by the Common Arrangements for Gas (CAG) project.

5.4 We will now treat IT in the same manner as other smaller cost items. The allowance will be set using an average of actual spend from 2007 to 2009. If during the course of this control period PNGL needs to undertake any large IT projects that are driven by external factors beyond its control (such as the CAG project), the company may approach us to discuss the details. If we are satisfied with the business case for additional monies, it is likely that we would grant an additional efficient allowance.

5.5 With respect to advertising, marketing and PR, we have deducted a sum of £75k from PNGL's overall allowance to in part reflect the value bestowed on its sister companies, Phoenix Supply Limited (PSL) and Phoenix Energy Services (PES), of marketing the "Phoenix" brand. This is consistent with the approach in PC03.

5.6 In its allowance request for its forthcoming price control PSL has been granted a sum of £50k per annum as an allowance for a recharge from PNGL in respect of advertising and marketing. PES is not price controlled but we consider that a sum of £25k is an appropriate equivalent. We therefore consider that PNGL should recover directly from PSL and PES £75k for the advertising and marketing services it provides, and have reduced the overall allowance by this amount.

Introduction

5.7 Historically PNGL has categorised its operating expenditure into 19 different cost lines. These are:

Advertising, marketing and PR	**Human resources**	**Manpower**	**Rates**
Billing	**Incentives (for customers)**	**Network maintenance**	**Stationery**
Emergency costs	**Information Technology**	**Office costs**	**Telephone and postage**
Entertainment	**Insurance**	**Own use gas**	**Travel and subsistence**
Fleet costs	**Licence fees**	**Professional and legal fees**	

5.8 Of the above cost lines, six out of the 19 items have accounted for about 75 per cent of opex allowances granted in previous price controls. As PNGL's submission for the forthcoming price control continues to mirror these proportions, we have focused our attention on the six larger cost lines. For reference the six larger cost lines are:

- Advertising, marketing and PR;
- Emergency costs;
- Incentives (for customers);
- Insurance;
- Manpower; and
- Network maintenance.

5.9 For the remaining (smaller) cost lines we have considered these collectively (with a few exceptions, more details below), adopting what we consider to be a reasonable blanket approach to setting an allowance for these items.

5.10 We begin by considering the smaller cost lines. The larger cost lines are then considered one by one.

Our Connection Assumptions

5.11 Before examining in detail our allowances, we set out the connection assumptions we have used in our modelling. This is necessary since some opex and capex allowances will vary explicitly with the number of connections, both in the setting of an *ex ante* allowances and later in the retrospective adjustments that are made *ex post* once actual connections are known. (The way we will make retrospective adjustments is discussed later in Section 8).

5.12 We have accepted PNGL's proposed connections assumptions, with the exception of domestic owner occupiers (OO). In the period 2007 to 2009 PNGL outperformed on its domestic OO targets, achieving connections averaging around 4,200 per annum. We believe PNGL can continue to achieve connections at this level, and will therefore use 4,200 instead of PNGL's proposed 3,700 per annum.

5.13 Our connection targets are set out in the table below.

Table 6 – Annual Connections

Cost Item	*PNGL Submission*	*UR Decision*
Domestic – OO	3,700	4,200
Domestic – NB	3,000	3,000
Domestic – NIHE	500	500
I&C	378	378
Total	**7,578**	**8,078**

Source: PNGL and the Utility Regulator

Smaller Items

5.14 The 13 smaller cost lines *originally* considered suitable for dealing with collectively were as follows:

~~Advertising, marketing and PR~~	**Human resources**	~~Manpower~~	**Rates**
Billing	~~Incentives (for customers)~~	~~Network maintenance~~	**Stationery**
~~Emergency costs~~	**Information Technology**	**Office costs**	**Telephone and postage**
Entertainment	~~Insurance~~	**Own use gas**	**Travel and subsistence**
Fleet costs	**Licence fees**	**Professional and legal fees**	

5.15 A further revision was then necessary, requiring the removal of the following cost lines and for the following reasons:

- **Billing** – PNGL's submission indicated an increase in costs because of supply competition. This warranted further investigation.
- **Entertainment** – we reconsidered the appropriateness of this cost line.
- **Information Technology** – IT costs for 2012 and 2013 were forecast to increase, and reasons were provided. Further investigation was therefore necessary.
  Note however that in our final decisions, we have opted to treat IT as one of the 13 smaller cost lines.
- **Professional and legal fees** – PNGL's submission indicated a substantial increase in costs, again warranting further investigation.
- **Rates** – historically a Rates allowance has been determined using a set formula; as we plan to continue with this methodology, Rates cannot be dealt with in a collective approach.

5.16 Therefore the remaining eight cost lines considered appropriate to deal with collectively are as follows:

~~Advertising, marketing and PR~~	**Human resources**	~~Manpower~~	~~Rates~~
~~Billing~~	~~Incentives (for customers)~~	~~Network maintenance~~	**Stationery**
~~Emergency costs~~	~~Information Technology~~	**Office costs**	**Telephone and postage**
~~Entertainment~~	~~Insurance~~	**Own use gas**	**Travel and subsistence**
Fleet costs	**Licence fees**	~~Professional and legal fees~~	

5.17 Note further that "Licence fees" are to be treated as pass-through and will therefore be adjusted retrospectively to reflect the actual fee levied on PNGL by our office. However for the

purposes of setting an *ex-ante* allowance, we have included this cost line in the collective approach used for the smaller cost lines.

Collective approach to smaller items

5.18 We considered a number of approaches for setting allowances for all of these smaller cost lines bearing in mind that historically and going forward, these items together account for no more than ten per cent of **total** PNGL expenditure.

5.19 We considered two main possibilities: (1) applying an average of the most recent actual spend over a desired number of years; or (2) using recent actual spend to determine a trend, and then using this trend to extrapolate forward through 2012 and 2013. Both techniques were examined using data on actual spend over a two, three and five year period spanning 2005 to 2009.

5.20 Having considered the results of both approaches, we conclude that using a trend is less credible than using an average, since trending tends to exaggerate expenditure anomalies in any one particular year. Furthermore there is no evidence to support an argument that these costs are rising in line with the expanding customer base. We will therefore set allowances for these cost lines using an average, and have selected the most recent three year timeframe for our calculations (2007 to 2009).

5.21 The allowances can be seen in Table 7 later in this section.

Billing

5.22 PNGL's allowance request is for £217k and £221k in 2012 and 2013 respectively. This compares to actual spend averaging £89k from 2007 to 2009.

5.23 PNGL explained the substantial increase is due to supply competition in the domestic market, which will increase the number of meter exchanges and meter reads that the distribution business will have to undertake.

5.24 PNGL provided us with the build-up of its cost estimates, including the assumptions it is making. We have considered these assumptions, and adjusted them based on our own views of the level of switching activity the market is likely to experience. These views have been formed based on actual switching experience to date in electricity supply and gas supply.

5.25 This reduces the allowance for supply competition related costs from £175k in 2012 and £179k in 2013 to around £100k in each year respectively.

5.26 We have added on to this a further allowance (based on the three year average of actual costs) for business-as-usual billing activities. This amounts to c£45k, giving a total allowance overall for Billing of c£145k per annum.

Entertainment

5.27 PNGL's allowance request is for £60k per annum for 2012 and 2013. This compares to historic actual costs from 2007 to 2009 averaging around £53k per annum.

5.28 Historically we have always granted PNGL an allowance for entertainment, but in this review we reconsidered its appropriateness altogether. We conclude that PNGL should still be granted an allowance for entertainment but at a reduced level.

5.29 We will therefore set an allowance of £20k per annum, based on offering around £150 per employee in line with HMRC guidance on non taxable employee benefits.

Information Technology

5.30 PNGL has requested an allowance of £305k and £285k in 2012 and 2013 respectively.

5.31 For comparison historic actual costs from 2007 to 2009 have averaged around £185k per annum, versus an average annual allowance granted in PC03 of c£251k. This demonstrates that PNGL has successfully achieved efficiencies on its IT costs.

5.32 In addition, over the course of PC03 we have granted PNGL further IT allowances for the development of a switching system for domestic customers. It could be argued that rather than grant these additional allowances in full, we could have reduced them by the amount of outperformance achieved on the general IT budget; the rationale for this approach being that IT expenditure on the switching system could be paid for from this surplus.

5.33 However we have not to date adopted such an approach.

5.34 In its submission PNGL explained that costs for IT are expected to rise over the control period, owing mainly to an increasing requirement to provide adequate security to business support systems as they grow and develop. PNGL's submission indicated that rising costs are driven specifically by items not previously a cost to the business, most notably:

- Additional system support costs;
- Tape storage (security);
- GIS/ Network analysis;
- Internet hosting; and
- Additional software system upgrades.

5.35 In our draft proposals we had considered granting PNGL its full allowance request. However in recognition of the company's track record of outperforming on its IT costs, we stated that we would be unlikely to grant any further IT allowances in the event of further or unexpected costs.

5.36 A number of respondents challenged this proposal, and questioned why we felt it appropriate to grant the full allowance request when the company has such a strong track record of outperformance. Similarly, PNGL expressed some concerns that our proposal left it potentially exposed to unpredictable costs, in particular those that may be imposed by the CAG project. Our detailed consideration of each of these submissions can be found in a separate document which is also posted on our website.

5.37 We will now treat IT in the same manner as other smaller cost items and have set the allowance using an average of actual spend from 2007 to 2009, amounting to c£185k per annum.

5.38 If during the course of this control period PNGL needs to undertake any large IT projects that are driven by external factors beyond its control (such as the CAG project), the company may approach us to discuss the details. If we are satisfied with the business case for additional monies, it is likely that we would grant an additional efficient allowance.

Professional and legal fees

5.39 Originally we planned to treat this cost item as part of the collective smaller items. On reflection we then considered using a two year average instead of three year (i.e. exclude 2007) since in

2007 actual costs in this area were significantly higher due to the sale of PNGL's transmission business, and the development of PC03.

5.40 By way of example, the three year average (2007 to 2009) is c£300k per annum and the two year (2008 and 2009) is c£168k. This compares to an average annual allowance granted in PC03 of c£334k. As per expenditure on IT, PNGL's performance demonstrates successful achievement of efficiencies on professional and legal fees, particularly when allowances are compared to actual spend in 2008 and 2009.

5.41 PNGL is now seeking £605k in 2012 and £569k in 2013, which is a significant increase compared to both actual historic spend and annual allowances granted in PC03. Some detail was provided by PNGL on the build-up of these forecast costings, which we have reviewed and considered. In our review we categorised costs into two groups: (1) business-as-usual costs; and (2) new costs.

5.42 We note that business-as-usual costs are forecast to increase, but with no explanation as to why. We will therefore set such costs based on a historic two year average.

5.43 For new costs, there are three cost lines that were either not included at all prior to 2009 or were included but at a lower introductory value, and so are due to increase. These are:

- Rating agency costs i.e. fees payable for providing a credit rating;
- Costs for PAS55 development; and
- Non-executive director fees.

5.44 The requested sum for the above cost lines amounts to c£315k per annum. We have considered these items and have set an allowance of c£212k per annum[18]. In total our overall allowance works out around £380k in each year.

Rates

5.45 As mentioned in paragraph 5.15, we have in the past set Rates using a formula which links the allowance to PNGL revenues. We will retain the formula approach.

5.46 Note that PNGL's allowance request for Rates was also calculated using the formula. However, our allowance is lower than PNGL's request since we have based our calculation on a lower revenue requirement (assessed as part of this price control exercise) than that proposed by PNGL.

5.47 As per the treatment in PC03, the allowance for Rates will continue to form part of the retrospective mechanism.

Summary of smaller items

5.48 The allowances that we have assessed using the methodologies described above are presented in the table overleaf. However, there is one final adjustment however to be made to *some* of these smaller cost lines, resulting in some of the numbers presented overleaf in Table 7 differing a small amount from those presented in the final overall opex allowances summarised in Table 13 at the end of this section.

5.49 A full explanation for this adjustment will follow in paragraph 5.50 onwards, where we describe the Advertising, Marketing and PR mechanism.

[18] Note that this figure does not include an allowance for the development of PAS55; see section on Network Maintenance for more details.

Table 7 – Small Items Allowances, £k

Cost Item	*PNGL Submission*			*UR Allowance*			*Difference*		
	2012	*2013*	*Total*	*2012*	*2013*	*Total*	*2012*	*2013*	*Total*
Billing	217	221	**438**	145	148	**293**	-72	-73	**-145**
Entertainment	60	60	**120**	20	20	**40**	-40	-40	**-80**
Fleet costs	268	269	**536**	249	249	**499**	-18	-19	**-37**
Human resources	121	107	**227**	73	73	**146**	-48	-33	**-81**
Information Technology	305	285	**590**	185	185	**371**	-120	-99	**-219**
Licence fees	293	293	**585**	241	241	**483**	-51	-51	**-103**
Office costs	492	486	**978**	444	444	**887**	-48	-42	**-91**
Own use gas	17	17	**34**	14	14	**28**	-3	-4	**-7**
Professional and legal fees	605	569	**1,174**	380	380	**760**	-225	-189	**-414**
Rates	1,261	1,479	**2,740**	1,257	1,357	**2,614**	-5	-122	**-126**
Stationery	46	47	**93**	35	35	**70**	-11	-12	**-23**
Telephone and postage	103	104	**207**	82	82	**163**	-21	-23	**-44**
Travel and subsistence	78	78	**157**	49	49	**98**	-29	-29	**-58**
Total	**3,866**	**4,014**	**7,880**	**3,174**	**3,277**	**6,451**	**-692**	**-737**	**-1,429**

As mentioned in paragraph 5.48, the following cost lines in the table above are higher than those presented in the final overall opex allowances summary at the end of this section: Fleet costs, Human resources, Information Technology, Office costs, Rates, Stationery, Telephone and postage, Travel and subsistence. A full explanation for this adjustment will follow in the description of the Advertising, Marketing and PR mechanism.

Source: PNGL and the Utility Regulator

Advertising, Marketing and PR

5.50 In previous price controls we have granted fixed allowances to PNGL for costs associated with sales activities. Whilst we believed, and still continue to believe, that such costs are necessary to continue growing the market, we are also mindful that allowances of this nature may no longer be appropriate as the company matures. Consider for example, that in its original business case PNGL had forecast that the market was going to grow much more quickly, thereby negating the need for sales-related allowances of the current magnitude.

5.51 For this reason we are now placing even greater emphasis on the need for all future connections made by PNGL to its network to be economic. By this we mean that on average, making a new connection to the network will deliver positive NPV revenues over a suitable time period. That is, the present value of direct revenues from the connection should be equal to or exceed the present value of direct costs of making that connection.

5.52 We are therefore moving away from past practice of granting fixed allowances for sales-related costs and instead plan to remunerate PNGL with a per connection allowance. We have therefore designed a mechanism to assess what an economic allowance should be.

The mechanism

5.53 As part of its submission, PNGL are looking for allowances for:

- Advertising and Marketing and PR;
- Incentives i.e. monies offered to customers to connect to gas;
- The Retail Operations Department in its Manpower submission (i.e. the sales team), including the Director of Retail Operations; and
- A range of other shared corporate overhead costs, which are apportionable to sales activities.

5.54 We consider the above opex costs directly relevant for sales i.e. attracting new customers to connect to gas. In addition to opex costs, a new connection will also incur direct capex costs, those being the Service and the Meter. (Direct capex costs are considered in the next section.)

5.55 For the opex costs above, we have developed a mechanism that will assess a per connection allowance to cover all or some of these costs.

Mechanism principles

5.56 The main principles used in the development of the mechanism are as follows:

- The opex allowance per connection has been calculated using the formula:

Allowance per connection = (Revenue per connection) – (Direct capex cost per connection)

Where:

Revenue per connection = Average consumption X Conveyance tariff X Recovery period

AND

Direct capex cost per connection = Determined service cost + Determined meter cost

- We have developed a model around the above formulae using estimates, where necessary, for some key assumptions within the formulae.
- The mechanism will apply only to domestic Owner Occupier (OO) housing. We have therefore granted a certain level of fixed allowance for sales-related costs that are NOT associated with OO connections.

Revenue per connection

5.57 A reminder of the formula:

Revenue per connection = Average consumption X Conveyance tariff X Recovery period

5.58 The assumptions we have used are as follows:

Variable	Assumption
Average consumption (A)	**390 therms per annum (tpa)** This is the approximate average consumption figure expected in 2012 and 2013, as advised by PNGL.
Conveyance tariff (B)	**37 pence per therm (ppt)** This is an estimate of the approximate tariff applicable to domestics in 2012 and 2013.
Recovery period (C)	**15 years** This is considered a suitable payback period for recovery of direct connection costs. Thereafter all future revenues would contribute to the costs of the wider network.
Average revenue per annum	**£144** Calculated as: (A) x (B)
Net present value (NPV) of average revenue over recovery period	**£1,428** NPV of: (A) x (B) x (C)

Direct capex cost per connection

5.59 A reminder of the formula:

Direct capex cost per connection = Determined service cost + Determined meter cost

5.60 We look at capex allowances in detail in the next section, but to summarise:

Variable	OO – Credit customers	OO – Pay As You Go customers
Service cost	£512	£512
Meter cost	£85	£262
Proportion to be installed	15%	85%
Service cost (weighted)	**£512**	
Meter cost (weighted)	**£235**	

Allowance per connection

5.61 Using the above figures we have determined an allowance per connection:

Allowance (£)	***=***	***(Revenue per connection) – (Direct capex cost per connection)***
	=	***1,428 – (512 + 235)***
	=	***681 (which we will round up to £690)***

Allowance application

5.62 Using our model we have calculated an appropriate allowance of £690 per connection, to cover those opex costs we consider directly apportionable to sales-related activities for domestic OO properties. However, the full allowance will not be applicable to *all* new OO connections.

5.63 There will be a certain number of OO connections that would have happened anyway without any direct marketing or selling to these customers. We would describe these connections as "non-additional". Since PNGL could in theory avoid any sales-related costs to connect such customers, no allowance will be applicable for these customers. We have assumed that 25 per cent of all new connections will fall into this category[19].

5.64 There is also the issue of how long this allowance should be available to PNGL. In our considerations, we note on one hand that the GDNs in GB do not receive an explicit allowance of this nature. We also note that PNGL's original business plan was for the company to achieve its target connections by 2016. On the other hand, we also acknowledge that at least some potential customers require a certain amount of direct marketing to switch over to gas. We will therefore reduce the allowance to 50 per cent (i.e. £345 per connection) from 2017 onwards. This will be reviewed at the next price control.

What costs are being replaced by the mechanism?

5.65 As stated in paragraph 5.53, the relevant opex costs are: (1) Advertising, Marketing and PR; (2) Incentives; (3) the Retail Operations Department in the Manpower submission, including the Director of Retail Operations; and (4) shared corporate overheads.

5.66 The full allowance request for these cost items are as follows:

[19] For clarity, it is our intention that the amount of "non-additionals" will be fixed at 25 per cent of the target OO connections i.e. 25 per cent of 4,200, or 1,050.

Table 8 – Costs to be Replaced, £k

Cost Item	*2012*	*2013*
Advertising, Marketing and PR		
Market Development	610	610
Corporate Affairs	148	151
Additional Corporate Affairs	27	27
TOTAL	**785**	**788**
Incentives		
Domestic	813	813
I&C	34	34
TOTAL	**847**	**847**
Retail Operations Department (inc Director)	**1,070**	**1,083**
Corporate Overheads (apportioned)	**649**	**646**
Total	**3,350**	**3,363**

Source: PNGL and the Utility Regulator

5.67 The *Corporate Overheads (apportioned)* cost line above refers to a share of overhead costs which are appropriate to apportion to the Retail Operations Department. The costs are:

- Fleet Costs;
- Human Resources;
- Rates (excluding network rates);
- Office Costs;
- Telephone and postage;
- Stationery;
- IT;
- Travel and subsistence;
- Insurance (Buildings and Car Insurance); and
- Corporate support personnel AND their apportioned share of the above costs (by this we are referring to staff in the Finance and Business Development departments including the Finance Director, and the Chief Executive Officer).

Our intention is that these costs are to be recovered via the mechanism. Therefore we have reduced the fixed allowances for these costs items by an appropriate amount. (This explains why for example our "smaller items" allowances set out in Table 7 are slightly higher than those presented in the final overall opex allowances summarised in Table 13 at the end of this section.)

5.68 The costs PNGL seeks, as set out in the above table, should be recovered through the mechanism but we do acknowledge that some element of these costs may not be directly linked to domestic OO sales. We have therefore set a fixed sum against some or all of the above cost lines, in addition to the allowance recoverable via the mechanism.

5.69 The fixed sums we have allowed, along with a rationale, are set out in the table below. Note that total costs in our fixed allowances have been rounded down to the nearest £10k.

Table 9 – Fixed Allowances, £k

Cost Item	*2012*	*2013*	*Rationale*
Advertising, Marketing and PR			
Market Development	29	29	We accept that some of these costs will relate to connections other than domestic OOs, so have pro rated the total cost based on forecast I&C connections.
Corporate Affairs	148	151	Corporate Affairs costs are incurred to support the existing customer base and are not linked to achieving new connections. We will therefore grant PNGL in the region of its full allowance request as fixed.
Additional Corporate Affairs	27	27	
TOTAL	**200**	**200**	
Incentives			
Domestic	0	0	Incentives offered to domestics are to be fully recovered via the mechanism.
I&C	30	30	We have allowed a sum in the region of what PNGL has requested for I&C incentives. And note that this will be the last time that we grant an explicit allowance for I&C incentives.
TOTAL	**30**	**30**	
Retail Operations Department (inc Director)	**500**	**500**	A detailed review of the Retail Operations Department indicates that there are some members of this team whose activities are not focused on OO domestics. We further accept that the Director of Retail Operations will spend some of his time on activities not related to OO domestics.
Corporate Overheads (apportioned)	**0**	**0**	Corporate overheads have already been apportioned using a ratio of those staff in the Retail Operations Department (whose focus is on OO domestics) to the total staffing complement at PNGL. Therefore no fixed sum is allowed.
Total	**730**	**730**	

Note that total costs have been rounded down to the nearest £10k.

Source: The Utility Regulator

Related businesses recharge

5.70 We have deducted a sum of £75k from PNGL's overall allowance to in part reflect the value bestowed on its sister companies, Phoenix Supply Limited (PSL) and Phoenix Energy Services (PES), of marketing the "Phoenix" brand.

5.71 In its allowance request for its forthcoming price control PSL was granted a sum of £50k per annum as an allowance for a recharge from PNGL in respect of advertising and marketing. PES is not price controlled but we consider that a sum of £25k is an appropriate equivalent. We therefore consider that PNGL should recover directly from PSL and PES £75k for the advertising and marketing services it provides, and have reduced the overall allowance by this amount.

Summary

5.72 The A+M+PR mechanism is summarised as follows:

- The full allowance is £690 per OO connection, applicable to all new OO connections *after* consideration of non-additional connections.
- The total aggregate allowance has been calculated by multiplying the appropriate allowance (i.e. full or none in the case of non-additionals) by the forecast number of OO connections,

less a sum for recharges to PSL and PES. The aggregate allowance will be retrospectively adjusted at the time of the next price control using the actual number of connections.

- The allowances to be recovered via the mechanism will replace those costs set out in Table 8. Where an element of fixed allowance is considered appropriate, this has been included in our overall allowances.
- The full per connection allowance will reduce by 50 per cent from 2017 onwards.
- The mechanism and all its components will be reviewed at the next price control.

Emergency Costs

5.73 PNGL has requested an allowance of c£2.1 million per annum in its submission. For comparison, historic actual costs from 2007 to 2009 have averaged around £1.6 million per annum. We commissioned our engineering consultants, PB Rune, to advise on the appropriateness of PNGL's allowance request.

5.74 In undertaking this review, PB Rune examined the company's emergency programme, and questioned PNGL staff on the detailed build-up of the cost estimates. Where comparable, costs have also been suitably benchmarked against other GDNs in GB.

5.75 In Appendix 2 we include an extract from PB Rune's report with the full narrative on Emergency Costs. We have accepted the recommendations from PB Rune and are granting an allowance of c£1.8 and c£1.9 million in 2012 and 2013 respectively. This represents an increase on the historic average of 15 per cent in real terms.

Incentives

5.76 For the avoidance of doubt, the cost item "Incentives" refers to a sum of money that PNGL makes available to new connecting customers to encourage the connection.

5.77 Incentives are covered as part of the A+M+PR mechanism.

Insurance

5.78 PNGL has requested an allowance of £909k and £933k in 2012 and 2013 respectively in its submission.

5.79 Historic actual costs in 2007, 2008 and 2009 are: £749k, £734k, and £662k respectively. This would indicate a clear downward trend even as the network has been expanding, which suggests PNGL has some ability to manage this cost downwards.

5.80 The approaches considered for smaller opex items have been considered for Insurance. Using the three year average approach would give an allowance of £715k per annum.

5.81 However our preferred approach is to use the Ofgem benchmark in the existing Gas Distribution Price Control Review (GDPCR). Ofgem's benchmark is 1.04 per cent of turnover, which was used

to set allowances for network insurance (the equivalent of the Business Insurance element of PNGL's total Insurance cost build-up).

5.82 For the remaining elements of PNGL's total Insurance costs, namely Fleet Insurance and Building Insurance, we have used the three year average approach. This gives a total Insurance allowance of c£533k and c£548k in 2012 and 2013 respectively[20].

Manpower

5.83 PNGL has requested an allowance of £5 million and £5.1 million in 2012 and 2013 respectively in its submission. For comparison, historic actual costs in 2007, 2008 and 2009 are: £4.6 million, £4 million, and £4 million respectively.

5.84 In its submission, PNGL included a detailed build-up of its Manpower costings, which has allowed us to undertake a thorough review. An initial inspection revealed the main reason for the increase in costs in 2012 and 2013 is an increase in the number of staff working in the Commercial Operations department. We have considered the appropriateness of this as part of our review.

5.85 In our review we answer two main questions:

- Is the level of staffing resource requested by PNGL appropriate for operating and maintaining its network?
- Is the level of remuneration appropriate across the various job grades?

We consider each of these questions in turn.

PNGL staffing resource

5.86 PNGL is organised into four main departments as follows:

- **Commercial Operations –** this department can be thought of as PNGL's engineering department, and is responsible for the safe, reliable and efficient operation of its network.
- **Retail Operations –** this department is responsible for sales and customer service.
- **Finance –** this department provides corporate support functions such as finance, human resources and IT support.
- **Business Development –** this department deals with business planning, regulation and corporate affairs.

5.87 There is also a senior management team comprising four executive directors, namely: Chief Executive Officer (CEO), Director of Commercial Operations, Director of Retail Operations, and Director of Finance and Business Development.

5.88 The full staff complement presented as full time equivalents (FTEs) in post, as advised by PNGL, is set out in the table below.

[20] Note that our allowance proposal for Business Insurance has been calculated using annual turnover figures *as proposed by PNGL in its submission (£46-48 million)*. Also, note that the final allowance proposed for Insurance at the end of this section is less than the figures cited here, since we have apportioned an element of the Insurance allowance to be recovered via the A+M+PR mechanism.

Table 10 – PNGL Staffing Complement

Department	2007	2008	2009	2010	2011	2012	2013
		Actual			Forecast		
Senior Management	5.0	4.2	4.0	4.0	4.0	4.0	4.0
Commercial Operations	48.5	46.4	44.8	52.0	54.5	60.0	59.0
Retail Operations	43.9	37.6	34.8	37.0	38.0	39.0	39.0
Finance	25.1	28.4	27.4	29.8	30.8	30.8	30.8
Business Development	7.5	8.0	7.0	7.0	7.0	7.0	7.0
Total	130.0	124.6	118.0	129.8	134.3	140.8	139.8

Source: PNGL

5.89 Below we set out the main conclusions from this aspect of our review.

- **Commercial Operations**
  It is clear from inspecting the above table that PNGL is seeking an increase in the resources available to this department. PNGL did provide further detail to justify this, namely that additional staff are required: (1) to support its growing operation and maintenance programs; (2) to ensure the requirements of the Dangerous Substances and Explosive Atmosphere Regulations (DSEAR) are met; and (3) to meet the extra demands anticipated by its transportation services team, following the opening of the domestic market in 2010.

  We asked our engineering consultants, PB Rune, to consider the appropriateness of PNGL's proposed resourcing in this department. PB Rune advised that PNGL's resourcing levels did not seem unreasonable; therefore we have accepted PNGL's proposals.

- **Retail Operations**
  We set out earlier in this section (see paragraph 5.50 onwards, the A+M+PR mechanism) our intention to implement a per connection opex allowance for new OO connections. We described how this mechanism would replace all sales-related costs directly attributable to new OO connections.

  A significant element of the Retail Operations department costs has therefore been replaced by the A+M+PR mechanism.

- **Finance**
  We benchmarked the resources PNGL require for corporate support functions (such as finance, human resources and IT support) using a range of metrics and publicly available comparative data. Our analysis indicates that PNGL's resourcing levels are not unreasonable; therefore we have accepted PNGL's proposals.

- **Business Development**
  We have accepted PNGL's proposals.

Remuneration levels

5.90 As part of its submission, PNGL provided a detailed build-up of the remuneration packages offered to its staff. We have benchmarked these remuneration packages at all levels using publicly available comparative data and advice from remuneration consultants, and have used these to inform our allowances.

Summary

5.91 We have accepted the additional FTEs requested by PNGL[21]. However we have included a significant element of the Retail Operations Department in the A+M+PR mechanism, thereby reducing the fixed allowance element in our decision.

5.92 We have benchmarked the remuneration packages offered at all levels to PNGL staff using publicly available comparative data and advice from remuneration consultants, and have used these to inform our allowances[22].

5.93 In summary, we have set a fixed allowance for Manpower of c£3.6 million in 2012 and 2013[23].

Network Maintenance

5.94 PNGL has requested an allowance of c£2.4 million and c£2.5 million in 2012 and 2013 respectively in its submission. For comparison, historic actual costs from 2007 to 2009 have averaged around £1 million per annum. We commissioned our engineering consultants, PB Rune, to advise on the appropriateness of PNGL's allowance request.

5.95 In undertaking this review, PB Rune examined the company's forward maintenance programme, and questioned PNGL staff on the detailed build-up of the cost estimates. In its report on the matter, PB Rune provided analysis under three headings: (1) network maintenance; (2) meter maintenance; and (3) supplier work requests.

[21] These additional resources are considered sufficient for PNGL to successfully carry out its activities, including all resources needed to facilitate customer switching.

[22] Note that our allowance is for the overall pot of money allocated to Manpower. We are not therefore approving or granting allowances for individual employee remuneration.

[23] It is worth noting that our remuneration consultants advised that pay increases in the Northern Ireland private sector for 2010 and 2011 have been around two per cent (significantly below the increase in the RPI). There may be merit therefore in offering a lower increase to the Manpower allowance than RPI. However on balance, we do not propose isolating the Manpower allowance and applying a separate (lower) uplift than that applied to all other costs.

5.96 The allowance request under each heading in 2012 an 2013 are as follows:

Table 11 – Network Maintenance Submission, £k

Maintenance Area	*2012*	*2013*	*Total*
Network maintenance, including costs associated with DSEAR[24]	462	471	**933**
Meter maintenance	1,282	1,308	**2,591**
Supplier work requests	664	677	**1,341**
Total	**2,408**	**2,456**	**4,864**

Source: PNGL and PB Rune

5.97 The advice we received, and our decision regarding allowances, is summarised as follows:

- **Network maintenance**
  Network maintenance comprises all activities associated with operation and maintenance of network pressure control equipment, including pressure regulators incorporated in supply connections to industrial and commercial, and domestic premises. Associated costs are driven by policies, procedures and operational activities appropriate to the various types of asset incorporated in the distribution network.

  In its submission, PNGL provided what PB Rune described as "a detailed and credible analysis" of the build-up of the network maintenance cost. PB Rune further advised that:

  - PNGL's policy regarding the frequency and scope of routine maintenance activity is aligned with manufacturers' recommendations, which may be overly conservative (and thus result in higher costs).
  - PNGL's tendency to follow manufacturers' recommendations stems from the fact the company does not operate an asset risk management system, which would contain information that might otherwise inform a maintenance schedule based on need and reliability.
  - PB Rune therefore suggested that we advise PNGL to develop and implement a suitable asset risk management system, such as that required under PAS55[25].
  - PB Rune further suggested that if/when PNGL implements PAS55 and incorporates its principles into its maintenance operations, PNGL will have access to better information that will facilitate optimisation of activity, based on need and reliability. This should in turn improve overall cost effectiveness.
  - Finally, setting aside the above considerations, PB Rune found no significant issues in the cost build-up as presented by PNGL.

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[24] The Dangerous Substances and Explosive Atmospheres Regulations 2002 (DSEAR) requires employers to assess the risks of fires and explosions that may be caused by dangerous substances in the workplace. These risks must then be eliminated or reduced as far as is reasonably practicable. The aim is to protect employees and other people who may be put at risk, such as visitors to the workplace and members of the public.

[25] PAS55:2008 is the BSI Specification for the optimized management of physical assets and is regarded as the industry standard of best practice. PAS55 is an internationally recognized specification that details the requirements for establishing a whole-life management system for all types of physical assets. Compliance with the specification demonstrates effective management of assets, and the associated risks, to external authorities, e.g. regulators, HSE. Also, it provides evidence that asset maintenance processes are appropriate, cost is optimized and safety performance is managed.

We have granted PNGL its full allowance request for network related maintenance but with an efficiency reduction applied to reflect our previous expectations that PNGL would have developed an asset risk management system by now (see paragraph 5.98 below).

We also will advise PNGL to develop and implement a suitable asset risk management system, but have not granted an explicit allowance to do so since: (1) it has already been suggested in the last two price controls but the company has not yet acted on this; and (2) it is considered best industry practice to operate such a system, and would in fact be beneficial to PNGL. We note also, in terms of considering best regulatory practice, that Ofgem has never granted an allowance to the GDNs for similar system development.

Finally, when developing the next price control, if information on asset condition is not available, we may commission our consultants to carry out actual site visits and physically inspect a sample of PNGL assets. The intention being that our consultants can advise on a maintenance schedule – and associated costs – based on need and reliability, rather than manufacturers' recommendations.

- **Meter maintenance**
  As with the network maintenance cost item, PNGL has developed a maintenance schedule for meters in line with manufacturers' recommendations. This is likely to be overly conservative, leading to a heavier workload than might otherwise be needed if the maintenance schedule was based on need. However as stated above, such a schedule cannot be developed without a suitable asset risk management system.

  This issue of overall workloads notwithstanding, PB Rune also compared PNGL's meter maintenance unit costs with that of National Grid Metering, who undertake similar work in Great Britain. PB advised that PNGL's unit costs were reasonable in comparison.

  We have granted PNGL its full allowance request for meter maintenance less an efficiency reduction (see paragraph 5.98 below), and reiterate the importance to PNGL of developing an asset risk management system as soon as possible.

- **Supplier related maintenance**
  The components of this cost area are customer telemetry, meter switching and supplier work requests (to both domestic and I&C properties).

  - We have granted PNGL its full allowance for customer telemetry.
  - Meter switching costs relate to customers requesting a replacement meter, and PNGL has assumed the volume of such requests will increase as a result of the opening of the domestic market to competition. PNGL's estimated cost is in the region of £300k per annum in 2012 and 2013.

    We have considered the assumptions used by PNGL and adjusted them downwards based on our own views of the level of switching activity the market is likely to experience. We have granted PNGL c£38k per annum for meter switching costs.
  - PNGL is seeking around £330k per annum for supplier work requests (about £310k for domestic works and £20k for I&C). We have granted PNGL its full allowance for domestic works. However, we consider it appropriate at this stage of the market's development for any supplier requested works in respect of I&C customers to be paid

for directly by the end customer. We have therefore offered no allowance for I&C work requests.

Asset risk management systems and associated efficiencies

5.98 It has been our opinion for sometime now that PNGL should develop and implement an asset risk management system. For example in our price control decisions for the period 2002 to 2006, we suggested that PNGL should develop such a system. PNGL did not act on our suggestion during this control period, so we restated the opinion in PC03.

5.99 Note that we did not explicitly direct PNGL to develop such a system – we merely suggested it would be good practice as we do not believe it is our place to micromanage PNGL on such issues. We did however reduce PNGL's allowance request in PC03, to reflect the fact that the company was unlikely to be operating to the most efficient maintenance schedule.

5.100 PNGL has still not made sufficient progress in developing a suitable system, although we acknowledge and welcome the initial scoping work the company has undertaken. Given that full implementation is still some way off however – and the fact that it would be in the best interest of everyone involved, including PNGL, that the company operates such a system – we will again suggest that the company develop and implement a suitable system during the forthcoming control period.

5.101 Furthermore, in recognition that the company is in all likelihood still not operating to the most efficient maintenance schedule (as advised by PB Rune), we have again reduced the allowances in respect of network and meter maintenance[26].

5.102 The table below presents a summary of our allowances for Network Maintenance and represents a near doubling over the average actual spend in 2007 to 2009.

Table 12 – Network Maintenance Allowances, £k

Maintenance Area	*2012*	*2013*	*Total*
Network maintenance, including costs associated with DSEAR	416	424	**839**
Meter maintenance	1,154	1,177	**2,332**
Supplier work requests	381	389	**770**
Total	**1,951**	**1,990**	**3,941**

Source: The Utility Regulator

[26] We are suggesting a reduction of ten per cent in this price control review, but are prepared to increase this in the 2014 review if PNGL continues to resist the development of an asset risk management system such as PAS55. PNGL has already indicated that it will not develop such a system if our office does not grant it an explicit allowance. However, and to repeat, we do not consider it appropriate to grant PNGL an allowance given that: (1) we suggested in the last two price controls to develop such a system but the company has not yet acted; and (2) it is considered best industry practice to operate such a system, and would in fact be beneficial to PNGL. We note also that Ofgem has never made an allowance to a GDN for this activity. Nevertheless we still expect the company to develop and implement a suitable system during this control period.

Opex Summary

5.103 The table below presents a summary of the total opex allowances, representing an increase on historic spend of around 9 per cent.

Table 13 – Opex Summary, £k

Cost Item	*PNGL Submission*			*UR Allowance*			*Difference*			
	2012	*2013*	*Total*			*Total*	*2012*	*2013*	*Total*	*Total, %*
Advertising, marketing and PR	785	788	**1,572**	200	200	**400**	-585	-588	**-1,172**	**-75%**
Billing	217	221	**438**	145	148	**293**	-72	-73	**-145**	**-33%**
Emergency costs	2,069	2,139	**4,208**	1,835	1,890	**3,725**	-234	-249	**-483**	**-11%**
Entertainment	60	60	**120**	20	20	**40**	-40	-40	**-80**	**-67%**
Fleet costs	268	269	**536**	203	203	**407**	-64	-65	**-130**	**-24%**
Human resources	121	107	**227**	60	60	**119**	-61	-47	**-108**	**-48%**
Incentives	847	847	**1,693**	30	30	**60**	-817	-817	**-1,633**	**-96%**
Information Technology	305	285	**590**	129	133	**262**	-176	-152	**-328**	**-56%**
Insurance	909	933	**1,842**	524	539	**1,063**	-385	-394	**-779**	**-42%**
Licence fees	293	293	**585**	241	241	**483**	-51	-51	**-103**	**-18%**
Manpower	5,016	5,058	**10,074**	3,593	3,608	**7,200**	-1,424	-1,450	**-2,873**	**-29%**
Network maintenance	2,408	2,456	**4,864**	1,951	1,990	**3,941**	-457	-466	**-923**	**-19%**
Office costs	492	486	**978**	361	361	**723**	-130	-125	**-255**	**-26%**
Own use gas	17	17	**34**	14	14	**28**	-3	-4	**-7**	**-19%**
Professional and legal fees	605	569	**1,174**	380	380	**760**	-225	-189	**-414**	**-35%**
Rates	1,261	1,479	**2,740**	1,236	1,337	**2,573**	-25	-142	**-168**	**-6%**
Stationery	46	47	**93**	28	28	**57**	-18	-18	**-36**	**-39%**
Telephone and postage	103	104	**207**	66	66	**133**	-37	-38	**-74**	**-36%**
Travel and subsistence	78	78	**157**	40	40	**80**	-38	-38	**-76**	**-49%**
Total	**15,899**	**16,234**	**32,133**	**11,057**	**11,288**	**22,345**	**-4,842**	**-4,946**	**-9,788**	**-30%**
Potential £ from A+M+PR mechanism				2,099	2,099	**4,197**	2,099	2,099	**4,197**	**n/a**
Total	**15,899**	**16,234**	**32,133**	**13,155**	**13,387**	**26,542**	**-2,744**	**-2,848**	**-5,591**	**-17%**

As per the comment under the summary table for smaller cost items, a number of cost lines in the table above may be lower than the allowance stated in the main body of this chapter. This is due to the apportionment of some of the allowed costs to the A+M+PR mechanism.

Source: PNGL and the Utility Regulator

6 CAPITAL EXPENDITURE

Update from Draft Proposals

6.1 We have corrected a minor transposition error which has marginally increased the allowances under “Other Capex Items”. Otherwise our final decisions have not changed from our draft proposals.

Introduction

6.2 PNGL has requested an allowance of c£12.3 million and c£11.7 million in 2012 and 2013 respectively in its submission, to deliver a forecast workload as set out in the table below. For comparison historic actual costs from 2007 to 2009 have averaged around £12.4 million per annum, delivering an average workload which is also shown in the table.

Table 14 – Workloads: PNGL12 Forecast and 2007 to 2009 Actuals

Workload	*2012*	*2013*	*Average 2007-09*
Pipe laid, km	58.3	51.3	73.1
Properties passed	5,250	5,250	8,211
Connections (domestic)	7,200	7,200	8,549
Connections (I&Cs)	378	378	498

Source: PNGL and the Utility Regulator

6.3 We commissioned our engineering consultants, PB Rune, to advise on the appropriateness of PNGL’s allowance request.

6.4 In undertaking this review, PB Rune examined the company’s forward capital programme, some areas of which were considered in great detail, and questioned PNGL staff on the build-up of the cost estimates. We have taken on board PB Rune’s findings in setting our allowances for capex.

Overview

General overview

6.5 In its submission PNGL provided a build-up of its estimated capex costs, which typically consisted of a forecast workload multiplied by an estimated unit rate. As an example, in 2012 PNGL forecast it will lay just over 5.4 kilometres of 4 bar pipe at an average unit cost of c£87 per meter. Multiplying the two together gives an overall cost of c£470k, which is what PNGL has requested for 4 bar pipe laying in 2012.

6.6 This method has been applied by PNGL for most of the individual capex cost items.

6.7 In its review, PB Rune examined at a summary level the overall cost effectiveness of PNGL at delivering capital projects. The analysis looked at both historic performance (2007 to 2009) and future forecasts (2012 and 2013). PB Rune compared PNGL with the GDNs in GB, and concluded that PNGL is generally efficient at undertaking and delivering capital projects. Implicit in this is that the unit rates for the various capex activities, as proposed by PNGL, do not seem unreasonable.

Street works legislation

6.8 In GB there are two main pieces of legislation which set out the rules and regulations that apply whenever utilities or any other such organisations undertake capital works on public roads. They are the Traffic Management Act (TMA) and the New Roads and Street Works Act (NRSWA). There is currently no equivalent legislation in Northern Ireland, but it is anticipated that the Department for Regional Development (DRD) will introduce legislation in due course.

6.9 PNGL has included an uplift of ten per cent to those capex cost items that will be impacted if and when legislation equivalent to the TMA and NRSWA in GB is introduced in Northern Ireland[27]. At this stage no one is sure when this legislation will be brought in, and indeed what the likely impact on costs will be. For this reason we have agreed with PNGL that all costs associated with the legislation will be adjusted retrospectively at the time of the next price control, to reflect the actual level of expenditure incurred as a result. This approach protects both PNGL (in the event actual costs turn out higher) and consumers (in the more likely event that the legislation is delayed, or that the impact is less than our assumption).

6.10 PNGL has embedded the ten per cent uplift into the unit rates for the following cost items (since these activities involve capital works on public roads):

- 4 bar mains;
- Feeder mains;
- Infill mains;
- Domestic services; and
- I&C services.

6.11 In our review of capex costs and in setting allowances, we have removed the uplift from the unit rates and instead include TMA as a separate cost item. This will better facilitate the retrospective adjustment at the time of the next price control.

6.12 We have also retained the ten per cent uplift and applied this to the cost items listed above.

Management fee

6.13 PNGL outsource much of its capital works to a third party contractor, currently McNicholas Construction Limited. Costs forecast under the generic heading of “management fee” covers all costs incurred by McNicholas associated with managing PNGL construction activity i.e. manpower and associated costs, supply chain costs, depot costs, security, training, safety equipment, general office and support costs etc.

[27] We commissioned engineering consultants to advise on the typical cost increase arising as a result of TMA and NRSWA in GB. Following this advice, we consider ten per cent to be a reasonable assumption at this stage. This will be reviewed if/when the legislation is introduced.

6.14 In addition, the management fee also covers operating costs relating to staff directly employed by PNGL, plus their associated overheads, that are recharged from opex to capex.

6.15 In keeping with what it has always done historically, PNGL has submitted the management fee as a separate and explicit cost item. This treatment of management costs differs from most other capital works contracts operated by GDNs in GB (and indeed in Northern Ireland), since costs associated with managing contracts are usually embedded in the quoted unit rates.

6.16 Whilst there is nothing inherently wrong with the way that PNGL builds up its costs, it does make comparison more difficult. To get around this problem, in our allowances we have apportioned the management fee across the various capex activities undertaken by PNGL. This allows more direct comparison of unit costs with other GDNs.

Overview summary

6.17 As PB Rune in general found PNGL to be efficient at undertaking and delivering capital projects, we have broadly accepted the implied unit rates of the various capex activities forecast over the control period.

6.18 Our allowances however differ from PNGL's in two ways:

- The unit rates submitted by PNGL include a ten per cent uplift for TMA. In our allowances we have stripped out this uplift, and instead include TMA as a separate and explicit cost item; and
- PNGL has submitted a forecast of its management fee as a separate and explicit cost item. In setting our allowances we have determined what we consider to be an efficient allowance for the management fee, and apportioned this across capex activities on a pro rata basis. Our unit rates therefore include an appropriate uplift to account for management costs.

7 Bar Mains

6.19 PNGL does not plan to lay any 7 bar pipe during the control period. Accordingly we have not needed to assess or grant an allowance for this cost item.

4 Bar Mains

6.20 PNGL plans to lay 5,413 meters of 4 bar mains, all in 2012. In its submission the cost per meter was around £87, which includes an uplift for TMA.

6.21 We have removed the TMA uplift and embedded a proportion of the management fee cost item into the 4 bar unit rate. Our allowance is £100 per meter.

Table 15 – 4 Bar Mains Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	*2013*	*2012*	*2013*
Pipe laid, km	5.4	0	5.4	0
Cost per meter, £	87	87	100	100
Total, £k	**471**	**0**	**541**	**0**

Source: PNGL and the Utility Regulator

Pressure Reduction Stations

6.22 PNGL does not plan to construct any pressure reduction stations during the control period. Accordingly we have not needed to assess or grant an allowance for this cost item.

Feeder Mains

6.23 PNGL plans to lay 4,983 meters of feeder mains in 2012, and 3,395 meters in 2013. In its submission the cost per meter was around £50, which includes an uplift for TMA.

6.24 We have removed the TMA uplift and embedded a proportion of the management fee cost item into the feeder unit rate. Our allowance is £58 per meter.

Table 16 – Feeder Mains Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	*2013*	*2012*	*2013*
Pipe laid, km	5.0	3.4	5.0	3.4
Cost per meter, £	50	50	58	58
Total, £k	**254**	**168**	**289**	**197**

Source: PNGL and the Utility Regulator

Infill Mains

6.25 In previous price controls we have granted an allowance per property passed for infill mains, with the allowance varying depending on the type of property. For example an allowance of say, £500 (a purely illustrative number) may have been granted in the past for each domestic owner occupier household that PNGL passed as it built out its network.

6.26 We have chosen to retain this approach for PNGL12.

6.27 In preparing its submission, PNGL carried out a detailed analysis of all the areas that remain in its licence area that are not currently readily connectable to the gas network. PNGL developed

estimates of the cost of building out the network into these areas, which it shared with us and PB Rune.

6.28 The PNGL submission indicated an assumed allowance per property passed for each type of property. This is summarised as follows:

- For owner occupier, PNGL's analysis indicates an appropriate allowance of £705. This figure has been calculated as a weighted average cost of passing all remaining owner occupier properties in PNGL's licence area. PNGL did acknowledge however that the actual average cost could vary widely from this, depending on the actual properties that were passed during the control period;
- For new build properties, PNGL's analysis indicates an appropriate allowance of £287;
- For NIHE properties, PNGL's analysis indicates an appropriate allowance of £414; and
- For I&C properties, PNGL's analysis indicates an appropriate allowance of £875.

6.29 Note the above allowances include the uplift for TMA.

6.30 We undertook a review of PNGL's allowance requests, supported by PB Rune, and found the requests to be reasonable.

6.31 However for owner occupier properties, our review indicated that PNGL will pass around 700 properties of this nature *as a consequence of passing NIHE properties*. For example, consider that a typical NIHE estate might contain houses that are both NIHE properties and owner occupier properties. Further consider that the uniform nature of the estate would suggest an equal cost to PNGL to lay infill mains passed either type of house. For this reason, it is appropriate for these 700 properties to grant PNGL the same allowance as we grant for NIHE properties.

6.32 For the remaining 550 owner occupier properties to be passed each year, a higher allowance request would apply. We have therefore calculated an allowance for passing *all* owner occupier properties as a weighted average of 700 consequentially passed properties, and 550 "normal" passed properties.

6.33 We have also removed the TMA uplift and embedded a proportion of the management fee cost item into the infill unit rate. Our allowances are as follows:

Table 17 – Infill Mains Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	***2013***	***2012***	***2013***
Number of properties passed				
Owner occupier	1,250	1,250	1,250	1,250
New build	3,000	3,000	3,000	3,000
NIHE	600	600	600	600
I&C	400	400	400	400
Allowance per property passed, £				
Owner occupier	705	705	600	600
New build	287	287	382	382
NIHE	414	414	488	488
I&C	875	875	917	917
Aggregate allowance, £k				
Owner occupier	881	881	750	750
New build	860	860	1,146	1,146
NIHE	249	249	293	293
I&C	350	350	367	367
plus allowance for Millisle extension	161	161	147	147
Total, £k	**2,501**	**2,501**	**2,702**	**2,702**

Source: PNGL and the Utility Regulator

Domestic Services

6.34 PNGL plans to connect 7,200 domestic customers in 2012 and 2013. We have applied an upwards adjustment to the forecast for domestic owner occupiers by 500 per annum (see the discussion in Section 5 under Our Connection Assumptions).

6.35 In its submission the cost per service was around £446, which includes an uplift for TMA.

6.36 We have removed the TMA uplift and embedded a proportion of the management fee cost item into the service allowance. Our allowance is £512 per service.

Table 18 – Domestic Services Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	***2013***	***2012***	***2013***
Number of connections	7,200	7,200	7,700	7,700
Cost per service, £	446	446	512	512
Total, £k	**3,211**	**3,211**	**3,942**	**3,942**

Source: PNGL and the Utility Regulator

Domestic Meters

6.37 A meter will be required for all new connections, and PNGL estimate that around 2,000 existing meters will need replacing each year. PNGL's allowance request for new meters is higher than for replacement meters (£196 versus £166) since the mix of new meters is expected to include more pay-as-you-go meters, which are more expensive than the alternative of credit meters.

6.38 We have set a single allowance for all domestic meters, calculated as a weighted average of the two types of meters. We have also embedded a proportion of the management fee cost item into the meter allowance. Our allowance is £235 per meter.

6.39 This allowance has been applied to the higher assumed level of connections, as for domestic services.

Table 19 – Domestic Meters Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	*2013*	*2012*	*2013*
Number of new meters	7,200	7,200	7,700	7,700
Cost per new meter, £	196	196	235	235
Number of replacement meters	1,962	2,051	1,962	2,051
Cost per replacement meter, £	166	166	235	235
Total, £k	**1,747**	**1,742**	**2,271**	**2,292**

Source: PNGL and the Utility Regulator

I&C Services

6.40 PNGL plans to connect 378 I&C customers in 2012 and 2013. In its submission the cost per service was around £1,699, which includes an uplift for TMA.

6.41 We have removed the TMA uplift and embedded a proportion of the management fee cost item into the service allowance. Our allowance is £1,979 per service.

Table 20 – I&C Services Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	*2013*	*2012*	*2013*
Number of connections	378	378	378	378
Cost per service, £	1,699	1,699	1,979	1,979
Total, £k	**642**	**642**	**748**	**748**

Source: PNGL and the Utility Regulator

I&C Meters

6.42 A meter will be required for all new connections, and PNGL estimate that around 140 existing meters will need replacing each year. PNGL's allowance request for replacement meters is substantially higher than for new meters. This is due to the consumption patterns, and hence the required meter size and cost, of those customers whose meters will need replacing i.e. the larger customers with high consumption volumes.

6.43 We have set a single allowance for all I&C meters, calculated as a weighted average of the allowance for new and replacement meters. We have also embedded a proportion of the management fee cost item into the meter allowance. Our allowance is £1,281 per meter.

Table 21 – I&C Meters Allowance

Variable	*PNGL Submission*		*UR Allowance*	
	2012	*2013*	*2012*	*2013*
Number of new meters	378	378	378	378
Cost per new meter, £	469	469	1,281	1,281
Number of replacement meters	137	141	137	141
Cost per replacement meter, £	2,793	2,793	1,281	1,281
Total, £k	**566**	**566**	**660**	**665**

Source: PNGL and the Utility Regulator

Other Capex Items

6.44 The individual cost items under "other capex" are: network code, fixtures and fittings, capex-related IT, costs related to the Titanic Quarter project, and management fee. With the exception of the management fee, the other three costs items are relatively small and the requested allowances reasonable. We have therefore granted PNGL what it has asked for.

6.45 With respect to the management fee, we have already discussed what this cost line constitutes (see paragraph 6.13 above). Given that PB Rune's review found PNGL to be generally efficient at undertaking and delivering capital projects, we have concluded that PNGL's actual spend on the management fee in the period 2007 to 2009 could be considered efficient.

6.46 Similar to the approach taken with the smaller opex cost items, we have taken an average of the management fee from 2007 to 2009. We have then pro rated this average based on the forecast workload in 2012 and 2013 compared to the 2007 to 2009 period, using a composite scale variable based on kilometres of pipe laid and connections made (both domestic and I&C).

6.47 This gives an allowance of c£2.4 million per annum, which we have then apportioned across all capex activities including the individual cost items under "other capex".

Traffic Management Act

6.48 As mentioned from paragraph 6.8 onwards, PNGL embedded an uplift of ten per cent into the unit rates of those cost items that involve capital works on public roads. We however have removed this uplift from the unit rates and instead include TMA as an explicit separate cost line. This is to better facilitate the retrospective adjustment that will be made at the time of the next price control.

6.49 We have retained the ten per cent uplift and applied this to the relevant cost items that will be impacted by TMA.

6.50 We have therefore allowed PNGL an allowance of c£822k and 2012 and c£759k in 2013 for TMA. This allowance will be retrospectively adjusted at the time of the next price control, to reflect actual expenditure incurred as a result of TMA.

Capex Summary

6.51 In the table below we set out a summary of the total capex allowances for 2012 and 2013. Note that our allowances are based on PNGL achieving an additional 500 domestic owner occupier connections per annum.

Table 22 – Capex Summary, £k

Cost Item	*PNGL Submission*			*UR Allowance*			*Difference*			
	2012	*2013*	*Total*	*2012*	*2013*	*Total*	*2012*	*2013*	*Total*	*Total, %*
7 bar mains	0	0	**0**	0	0	**0**	0	0	**0**	**n/a**
4 bar mains	471	0	**471**	541	0	**541**	71	0	**71**	**15%**
Pressure reduction stations	0	0	**0**	0	0	**0**	0	0	**0**	**n/a**
Feeder mains	254	168	**422**	289	197	**486**	35	29	**64**	**15%**
Infill mains	2,501	2,501	**5,002**	2,702	2,702	**5,405**	201	201	**403**	**8%**
Domestic services	3,210	3,210	**6,421**	3,942	3,942	**7,885**	732	732	**1,464**	**23%**
Domestic meters	1,747	1,742	**3,489**	2,271	2,292	**4,562**	524	550	**1,073**	**31%**
I&C services	642	642	**1,284**	748	748	**1,496**	106	106	**212**	**17%**
I&C meters	566	566	**1,132**	660	665	**1,325**	94	99	**193**	**17%**
Network code	100	100	**200**	125	126	**251**	25	26	**51**	**26%**
Fixtures and fittings	40	40	**80**	50	50	**101**	10	10	**21**	**26%**
Titanic Quarter project	164	0	**164**	164	0	**164**	0	0	**0**	**0%**
IT	150	150	**300**	188	189	**377**	38	39	**77**	**26%**
Management fee	2,631	2,574	**5,205**	0	0	**0**	-2,631	-2,574	**-5,205**	**-100%**
Total excluding TMA	**12,475**	**11,694**	**24,170**	**11,680**	**10,912**	**22,592**	**-795**	**-782**	**-1,577**	**-7%**
*** Traffic Management Act**				822	759	**1,581**	822	759	**1,581**	**n/a**
Total including TMA	**12,503**	**11,694**	**24,170**	**12,503**	**11,671**	**24,174**	**27**	**-23**	**4**	**0%**

* No explicit costs for TMA were set out in the PNGL submission; instead they were embedded into the mains laying estimates. However in our allowances we have extracted the cost of TMA from our allowed unit rates for mains laying, and therefore include an explicit allowance for TMA.

Source: PNGL and the Utility Regulator

7 REGULATORY MODEL

Update from Draft Proposals

7.1 In its response to our draft proposals consultation, PNGL questioned our proposed adjustment to its regulatory asset base in respect of deferred capex and historical outperformance. Its argument centred on what was or was not agreed in the 2006 discussions and subsequent 2007 licence modifications.

7.2 PNGL has suggested that the 2007 licence modifications allowed it to retain all the benefits of deferred capex and outperformance. We are accused of going back on the agreement and, leaving the issue of the agreement aside, that our proposals are in any case inconsistent with regulatory best practice. Our detailed consideration of PNGL's response can be found in a separate document which is also posted on our website. In view of the importance of the issues raised, however, we feel it appropriate to deal with them in summary below.

7.3 We shall address the issue of regulatory best practice first. Our proposed treatment of deferred capex is consistent with best practice. This is consistent with how some regulators in GB treat deferred capex, and is also symmetrical with how we treat unpredictable and/or unforeseeable additional capex costs (see paragraph 8.10 for details).

7.4 With regards to outperformance, our treatment is also consistent with best practice although we would highlight that it is not possible to treat PNGL identically with regulatory best practice given the unique nature of the PNGL regime. Outperformance from the historical period of 1996 to 2006 was rolled up and capitalised at the end of 2006, and the price control over the period 2007 to 2011 provided investors with a reward for outperformance (explained in detail in the shaded box below). An adjustment to the asset base at the end of the period delivers a sharing of outperformance with consumers, and is consistent with how regulators typically treat capex outperformance.

The Profile Adjustment

In order that conveyance charges are not unduly high in the early phases of the gas market's development, PNGL currently defers an element of its revenue entitlement into the future. The recovery of this deferred revenue is secured for PNGL by way of an addition to the regulatory asset base, via a mechanism enshrined in its licence known as the Profile Adjustment. The Profile Adjustment builds up over the course of each respective price control period, and then forms part of the asset base at the beginning of successive reviews.

Because of the Profile Adjustment, the benefit that PNGL has accrued between 2007 and 2011 as a result of historical outperformance has taken two forms: (1) a direct and immediate increase in revenues over the period 2007 to 2011 of c£15 million; and (2) an addition of c£20 million to the TRV over the same period, to account for entitled revenues that have been deferred. The c£20 million addition remains in the asset base under our final decisions. The value it represents will be awarded to PNGL over the course of the remaining licence recovery period (i.e. to 2046), by way of depreciation and the full rate of return. If the licence followed a standard approach with no Profile Adjustment PNGL would have received c£35 million in revenues over the period 2007 to 2011.

7.5 We recognise that not all outperformance was capex in nature. However, our analysis of how other regulatory regimes would have treated savings made, both capex and opex, over the 1996 to 2006 period indicates that the approach we have taken broadly delivers a similar overall sharing of benefits. Furthermore, it is right to treat all the historical outperformance as capex since the PNGL licence sees all expenditure capitalised, regardless of its nature.

7.6 With specific reference to the 2007 licence modifications, we have not been presented with any evidence to support the view that either these or the correspondence that was published at the time of the modifications can be taken to imply that the above benefits should not be shared and this sharing implemented as part of the current process using licence modification powers.

7.7 Furthermore, having reviewed our files from the 2006/7 period, there are a number of things that are clear. Namely that:

- A sum in respect of deferred capex and historical outperformance entered the asset base in 2006;
- In deriving this sum, no assessment was made as to whether this represented genuine efficiencies; and
- This sum did not include sharing with customers based on regulatory practice elsewhere.

7.8 None of the documents make any commitment to this sum remaining in the PNGL asset base until 2046 (as PNGL asserts). As explained in our draft proposals, we are compelled by our statutory duties to see that historical outperformance is shared with customers, and plan to implement this by way of an asset base adjustment at the end of 2011. Such an approach can be considered to be consistent with how regulators typically treat capex outperformance.

7.9 If we were to make no adjustment to the TRV, this would effectively result in PNGL retaining all of the benefit of deferral and underspend, creating a transfer of value of around £74.4 million[28] from customers to shareholders that will earn the full rate of return going forward. It is clearly inappropriate that customers should pay PNGL such an outsize reward, remembering of course that this relates to investments that were never made and did not need to be financed.

Alternative options

7.10 As part of the considerations for these final decisions, we did consider a range of alternative options.

Option A

7.11 One such option we fully explored was to allow historical outperformance to remain in the asset base until the time of next price control review in 2014. This option was considered in light of some of the representations made to the draft proposals consultation.

7.12 The rationale for pursuing such an option is in response to the view from some respondents that the decision to remove historical outperformance in 2012 was unexpected. We could instead signal our intention to remove outperformance *after* the forthcoming price control ends. Naturally this increases the share of the benefits accruing to PNGL and reduces the share accruing to customers.

[28] Since our draft proposals we have taken on board responses to the draft proposals consultation and altered the calculation of the TRV adjustment, hence this lower figure than the £80.8 million in the draft proposals. More details are provided later in this section.

7.13 We calculate that *in present value terms* this option would result in a reduction to our proposed adjustment to the TRV of around £10 million. That is, the total reduction under this option would amount to c£64 million, versus the reduction of c£74.4 million under the original approach. This reduces the average saving on current prices to a typical domestic consumer from around £10 per annum to £7 per annum (present value) between now and 2046. In practice this would actually involve prices going up in 2012 and 2013 and then down again from 2014 onwards.

Option B

7.14 Option A is clearly more favourable to PNGL than our draft proposals. We also considered some other approaches that might be less favourable, bearing in mind that the original approach could be argued to be more generous than the Ofgem treatment of outperformance because of the Profile Adjustment.

7.15 As described in the shaded box below paragraph 7.4, the Profile Adjustment secures the recovery of deferred revenues for PNGL by way of an addition to the asset base, and the company earns its full rate of return on these deferred revenues. This is appropriate for deferred revenues resulting from actual expenditure, since this has to be financed immediately but an element of the resulting entitled revenues is deferred into the future. Therefore there is a carrying cost of finance to PNGL, which is remunerated by way of earning the full rate of return. However, for historical outperformance there has been no actual expenditure and we considered whether it is appropriate for PNGL to earn the full rate of return on the deferred element of the associated revenue entitlement earned between 2007 and 2011 (which amounts to c£20 million).

7.16 Whilst we do recognise that the c£20 million sum represents monies that are fully due to the company as its reward for historical outperformance, we would also highlight that these monies represent investments that were never made and hence did not need to be financed. Therefore there is no actual carry cost of finance, and the company's cost of capital may be too high a rate to apply. Instead something closer to the risk-free rate might be more appropriate. If a utility without a revenue deferral model wished to earn a return of 7.5 per cent on some of its outperformance revenue – as PNGL will – it would have to reinvest it and put the money at commensurate risk. This is not the case for PNGL.

7.17 If we felt it appropriate to roll forward the c£20 million sum at a lesser rate than PNGL's cost of capital, there are numerous ways we could implement this. We considered a range of methods and the resulting impact. As an example, if we applied an escalation rate of say, two per cent instead of PNGL's full cost of capital, and returned the c£20 million to PNGL over a ten year period, this would effectively increase the transfer of value to customers *over and above* that of our original proposals by around £5 million.

Conclusions

7.18 With regards to Option A, it is not clear to us why, even if we were to accept that inadequate notice had been given, customers should have to pay additional monies to PNGL to compensate for this. We do not accept that PNGL had any legitimate expectation that it could retain the value of historical outperformance for longer than normal regulatory practice allows. We remain satisfied that the GB precedent of five years is appropriate.

7.19 With regards to Option B, we have decided not to consider this further and are content that our original proposals strike the right balance of value sharing between customers and the company.

7.20 On balance, and with reference to our statutory duties, it is right for us to carry forward our draft proposals to our final decisions with comparatively few adjustments.

Introduction

7.21 The opex and capex allowances, as set out in the previous sections, feed into a regulatory model which calculates the allowed revenues over the control period. This is a vital final step in our price control setting process.

7.22 This section of the paper focuses on a number of the other key components of the regulatory model, namely:

- Cost of capital;
- Depreciation; and
- The value of the regulated asset base at the beginning of 2012.

Cost of Capital

7.23 PNGL has a fixed cost of capital[29] embedded in its licence, set at 7.5 per cent (in real terms and pre tax) until the end of 2016. (To better understand the reason for awarding PNGL a cost of capital in this manner, readers should refer to the narrative in Appendix 1 which describes a brief history of the company and its governing regulatory regime.)

7.24 For this price control, we considered reviewing the appropriateness of PNGL's existing cost of capital, as there are arguments as to why 7.5 per cent may not reflect the risks facing the company (see Appendix 1 for more details). By way of comparison, in the table below we have calculated a range of weighted average cost of capital (WACC) allowances – or their pre-tax equivalents – in recent price control determinations.

Table 23 – Recent WACC Determinations (restated in pre-tax terms where necessary)

Regulator	*Price Control*	** WACC, %*	*Year*
Ofgem	Transmission (TPCR4)	**6.0**	2006
Ofgem	GDPCR 2008-2013	**5.8**	2007
ORR	Network Rail	**5.6**	2008
Ofgem	Electricity Distribution (DPCR5)	**5.5**	2009
Ofwat	Water and Sewerage (PR09)	**6.1**	2009
Competition Commission	Bristol Water	**5.9**	2010

* The WACC figures set out above are calculated based on: the stated cost of equity, the stated cost of debt, and a corporation tax assumption of 25 per cent (the applicable rate effective from 1 April 2012).

Source: The various organisations cited above and the Utility Regulator

[29] Note that we use the terms "cost of capital" and "rate of return" interchangeably.

7.25 PNGL's original rate of return was set at 8.5 per cent in 1996. As part of the 2007 licence modifications the rate of return was reduced to 7.5 per cent, with the one per cent reduction determined as part of the overall licence package. In the absence of a detailed build-up of the typical components that constitute the cost of capital, it is difficult to set out precisely the balance between risks and returns compared to other companies.

7.26 We would further highlight that since the 2007 licence modifications, certain actions we have taken have further reduced risk to PNGL without a corresponding reduction in the rate of return e.g. removal of volume risk.

7.27 As was noted in one of the responses to the draft proposals consultation, the rate of return allowed to PNGL is quite high relative to comparators. It is also not clear that the high rate of 7.5 per cent reflects the level of risk facing the company. If we were to reduce PNGL's cost of capital to 6.5 per cent from 2012 to 2017, we estimate the benefit to customers would be in the region of £17 million.

7.28 On reflection however, and when viewed against the overall price control package we have put together for PNGL12, we have decided to retain PNGL's cost of capital at 7.5 per cent over the control period.

7.29 In the next price control review (to take effect from 2014) we will be setting a revised cost of capital from 2017 onwards, most likely using a standard methodology such as the capital asset price model (CAPM). We envisage that this will entail a full assessment of all the building blocks comprising the WACC, including consideration of PNGL's risk profile versus that of the GDNs in GB.

Depreciation

7.30 Future assets still to be constructed are depreciated in our regulatory model using a straight-line methodology over a range of periods, as follows:

- Mains – depreciated over 40 years;
- Services – depreciated over 35 years; and
- Meters – depreciated over 15 years.

7.31 For the existing asset base, in its submission PNGL propose a straight-line methodology over 34 years i.e. the number of years left of its licence recovery period from 2012. We have adopted this methodology in our own modelling.

Total Regulatory Value

7.32 A regulated company's asset base changes year-on-year through the depreciation of existing assets and/or additions of new assets. It is therefore standard regulatory practice to review the value of the asset base at each price control. In our review we have considered the value of the PNGL asset base (defined in the licence as the company's Total Regulatory Value, or TRV) at the end of the previous price control and the adjustments that need to be made to reach an opening TRV position in this price control.

Opening TRV

7.33 As part of the 2006 discussions and the resulting 2007 licence modifications, we assessed the value of the PNGL asset base. A figure of £312.8 million (2006 prices) was determined and granted to PNGL, taking effect at the end of 2006. This figure included an element for deferred capex and historical outperformance.

7.34 The figure of £312.8 million fed directly into the opening TRV in 2007, the year that PC03 commenced.

7.35 Over the course of PC03, PNGL has continued to develop and build out its network, and in so doing has been increasing the net value of its asset base. In addition PNGL continues to defer recovery of some of its entitled revenues, which is secured for PNGL by way of an addition to its asset base via the Profile Adjustment. We are in agreement with PNGL that the net addition in respect of approved capitalised expenditure over the course of PC03 is c£98.5 million.

7.36 As well as approving the addition of allowed capitalised expenditure to the asset base, our assessment of the opening value of the asset base for PNGL12 has sought to address two further issues, namely:

- Deferred capex; and
- Treatment of historical outperformance.

7.37 Below we consider each of these in more detail.

Deferred capex

7.38 PNGL has in the past been granted allowances for projects it has yet to complete, or which were completed much later than originally anticipated. As a result PNGL's asset base has increased by more than it would otherwise have if capex was (or is) included only at the time of actual spend. Gas customers should not have to pay for assets before they are built and we have made an adjustment to the asset base to account for this. In principle this is designed to reflect the position of competitive markets. That is, companies would not be able to recover money for investments that were never made since if they tried to do so, competitors would undercut them and they would lose market share.

7.39 This issue was identified and highlighted at the time developing PC03. In our final determination we stated:

"*The Utility Regulator wishes to consider the appropriateness of deferred capex (**4/7 bar and Governors**) that is planned for future construction, and will review the planned activity to ascertain when/if it will be carried out and if it would be in the customer interest to use the "deferred" cash within the asset base for other construction activities. This analysis will form one of the reviews to be conducted during PC03*." (Emphasis added.)

7.40 As part of this price control exercise, PNGL submitted updated information on the status of the relevant deferred projects identified in PC03 (details can be seen in Appendix 3). Our analysis of this information indicates the following:

- PNGL was originally remunerated for these projects in 1999 or 2000, by way of an addition to its asset base.
- All the projects were deferred from their original date and are now either:
    - No longer required;
    - Completed;

- Still to be completed; or
- No longer required but have been substituted for other projects.

7.41 Our analysis further indicates that PNGL has benefited from the early receipt of allowances into its asset base versus when the work actually took place. The make-up of the gain varies depending on the status of the project, namely:

- For projects no longer required, PNGL has received an allowance and has been earning a return on that allowance for investment that it has never made;
- For projects deferred but subsequently completed, PNGL received a return on the allowance for a number of years before the projects were actually completed; or
- For projects still to be completed, PNGL already has the allowance in its asset base and has been earning a return on this allowance before the projects are completed.

  [Note for projects no longer required but that have been substituted for other projects, there has been no obvious benefit to PNGL. We have therefore excluded such projects from our decisions to remedy the matter.]

7.42 Taking the above together, we have concluded that the PNGL asset base has been inflated to a level beyond that which it should have and have made an adjustment to account for this.

Deferred capex – our decision

7.43 We have removed all of the gain to PNGL, as identified in the narrative above. We have calculated an appropriate downward adjustment to the opening TRV in 2012 of c£17.3 million. (In its consultation response PNGL informed us of two issues with the data used to calculate this adjustment, hence the change since the draft proposals where the figure was c£21.2 million.)

7.44 This figure represents the removal of:

- Any return earned prior to a project being completed; plus
- The original allowance that entered the asset base *if the project is not yet completed*.

7.45 Note that for projects still to be completed, PNGL can request the monies again and, if granted, these would re-enter the asset base in future price controls. Allowances for such projects have been included as part of our decisions in PNGL12.

7.46 A detailed build-up of our adjustment is set out in Appendix 4 and includes updated figures after taking on board responses to our draft proposals consultation.

Deferred capex – a direct response to PNGL's counterarguments

7.47 In its response to the draft proposals consultation, PNGL stated that deferred capex featured as part of the TRV assessment in the 2006 discussions and subsequent 2007 licence modifications, and that it should remain a fixed and binding element of the TRV. PNGL also argued that the methodology we have employed to calculate an appropriate TRV adjustment is inconsistent with how deferred capex was valued in the 2006 discussions and subsequent 2007 licence modifications.

7.48 We always said that deferred capex would be subject to a review during the control period that followed the 2006 discussions and subsequent 2007 licence modifications (i.e. during PC03). In fact, PNGL's own response acknowledged this to be the case. Where PNGL disagrees with us is

in the way we have calculated the adjustment, stating that we had somehow committed ourselves to a different approach than that in our draft proposals.

7.49 Namely, PNGL has implied that: (1) the value of deferred capex had already been settled in the 2006 discussions and subsequent 2007 licence modifications and was fixed; and (2) this agreed sum would effectively be deducted from PNGL's capex allowances but the associated outputs (or suitable substitutes) would still be expected to be delivered.

7.50 First, it should be noted that PNGL's submission for the current price control contradicts its own understanding. That is, PNGL requested further allowances for deferred projects even though the monies for these were already in its asset base. Second, we do not agree that any statements we made committed us to any particular approach to deal with deferred capex.

7.51 We acknowledge that the substitution method was suggested as a possibility. However, after more detailed consideration we do not believe there are enough sizeable projects left in the PNGL licence area for substitution to provide a realistic solution. And we find it highly unlikely that PNGL would agree to develop its network outside its licence area with no additional allowances granted for such extensions. Therefore our approach to deferred capex is much more practical – and realistic – to implement.

7.52 In any case our approach is equivalent in principle to PNGL's expectations since we could now substitute the deferred cash amount in the asset base against total future capex which would produce the same revenues for PNGL.

Treatment of historical outperformance

7.53 Between 1996 and 2006 PNGL overall spent less than the allowances set in our price controls. The aggregate absolute figure determined to have been underspent amounted to around £37.2 million (2006 prices).

7.54 As part of the 2006 discussions and subsequent 2007 licence modifications, the value of this outperformance (the expenditure that PNGL would otherwise have made) was retained and rolled up into the asset base at the prevailing allowed rate for the cost of capital. This led to an addition of c£74.1 million (2006 prices) to the asset base at the end of 2006. This was money that was never invested.

7.55 This and other related matters pertaining to the 2006 discussions and resulting 2007 licence modifications were consulted on in April 2007[30].

7.56 The April 2007 consultation paper explains in more detail the main aspects of the 2007 licence modifications. It shows the importance we put on sharing of outperformance based on regulatory practice elsewhere.

7.57 The following extracts are of direct relevance:

"*11. The agreed OAV* [Opening Asset Value] *is a function of actual investment (opex and capex), under-recovered revenue and a sharing of cost out performance for the period 1996-2006.*"

"*13. Out performance for the period 1996-2006 is shared between customers and Phoenix based on regulatory practice elsewhere while the net cash flow over the period established the base for the OAV.*"

[30] "*Phoenix Natural Gas Licence Restructuring: Proposed Price Control Licence Modifications*", the Utility Regulator, 6 April 2007. http://www.uregni.gov.uk/uploads/publications/Phoenix_Gas_price_control_conditions_consultation_April_07.pdf

In relation to the Depreciated Asset Value (DAV), a component of the TRV:

"*21. The DAV at the beginning of each control period is calculated as the DAV at the start of the previous control period (OAV in 2007) net of depreciation plus capex over the previous control period net of depreciation.*

22. The discounted cash flow methodology in the original licence is based on forecast costs at the previous review and as such makes no allowance for passing on out performance in capex to customers.

23. The modified conditions allow the Licensee to retain the benefit (financing and depreciation) of capex out performance against agreed capex forecasts (for a given output) for the period from the year of out performance to the start of the following control period.

24. This continues to provide the Licensee with an incentive to make efficiency savings over a control period which are passed to customers at the beginning of the subsequent control period."

7.58 Whilst the above quotes may not make completely clear how we would treat historical outperformance in future, there is nothing which commits us to allowing the outperformance to be retained until 2046. Our preferred treatment, as set out in the draft proposals, is to adopt an approach that is consistent with regulatory practice elsewhere.

Historical outperformance – our decision

7.59 In order that the benefits from PNGL's outperformance are shared between the company and customers, it is necessary to remove the outperformance addition from the asset base at the end of the five year period 2007 to 2011 to reflect regulatory practice elsewhere.

7.60 Such action is consistent with best regulatory practice elsewhere, and with the intentions of the 2007 licence modifications. To illustrate the point, in the shaded box below we briefly consider how some GB regulators have treated outperformance.

Capex outperformance: some regulatory precedents

Ofgem

Ofgem's five year rolling mechanism for gas distribution networks allows capex outperformance to remain in the asset base for a period of five years, during which time the company receives depreciation and return as normal. After five years however, the outperformance is removed from the asset base. The net gain to the company will depend on the rate of return and depreciation period applied, but is typically in the region of 40 per cent of the outperformance.

Ofwat

Under Ofwat's most recent price control, capex outperformance is shared between the company and customers on a 30/70 basis (on average).

7.61 Our decision to remove the outperformance from the asset base in 2012 is consistent with the approach taken by Ofgem. As an alternative we considered retaining the figure in the asset base until a future year e.g. 2014 or 2016. This would have allowed an increased reward to PNGL for the outperformance. However on balance we consider the five year period to be consistent with best regulatory practice and with our statutory duties.

7.62 The sum we will remove is calculated as follows:

- The c£74.1 million (2006 prices) cited above; less

- An amount to correct for the fact that this sum *includes* an element for deferred capex, which we are already making an adjustment for as part of PC03 and this price control. Specifically, as part of PC03 we have already adjusted for deferred infill and feeder mains; and as part of PNGL12 we are adjusting for 7 bar and 4 bar mains, and governors; less
- A further amount in respect of prepayment meters, since the assessment of the PNGL opening asset value in 2007 included a write-down of c£2.3 million (2006 prices) which reflected the excess value of installed prepayment meters over and above the allowed number of such meters; and
- The resulting sum is then suitably depreciated for five years.

7.63 This calculation leaves a residual value of c£50.6 million (2006 prices), or c£57.1 million in 2010 prices. This is the sum we will remove from the asset base in 2012.

7.64 Allowing PNGL to retain the outperformance for the five year period 2007 to 2011 has delivered a cumulative cashflow benefit to the company of around £15 million. In addition, PNGL has accrued a further revenue entitlement of c£20 million (the recovery of which has been deferred to the future through the Profile Adjustment). This is an appropriate amount to reward PNGL for outperformance achieved in the period 1996 to 2006, bearing in mind that none of this money relates to any actual physical investments.

Historical outperformance – a direct response to PNGL's counterarguments

7.65 In its response to the draft proposals consultation, PNGL stated its belief that the 2006 discussions and subsequent 2007 licence modifications allowed it to retain outperformance in its asset base until 2046. PNGL also stated that, notwithstanding its first point, that our draft proposals are in any case inconsistent with regulatory best practice.

7.66 We have addressed PNGL's objection in paragraphs 7.3 to 7.20 above.

Opening TRV in 2012

7.67 Taking all of the above together, the removal of deferred capex and outperformance from the asset base results in an adjustment to the opening TRV in 2012 of c£74.4 million. The opening TRV in 2012 would therefore be c£376.3 million.

7.68 We have carefully considered how this adjustment impacts on PNGL's ability to finance the activities which are the subject of obligations placed on it (the financing duty at Article 14(2)(b) of the Energy Order), and how more generally it affects the company's ability to raise finance and its cost of capital (which together we call 'financeability' – see Section 9 for a full discussion). We further recognise that the need to ensure a high degree of protection for the interests of consumers also requires us to have due regard to the investor's position, as consumers are to a greater or lesser extent exposed to the resulting cost of capital. We have decided to adjust the TRV only because the reasons for doing so are strong.

7.69 This adjustment in effect represents the closing off of a range of historic issues relating to PNGL. We have reviewed the build-up of the TRV and recognise that it still includes significant elements of historical underrecoveries and some historical outperformance. These will continue to be part of the TRV and do not require any future adjustment. Once implemented by way of a licence modification, we consider these historic issues to be finalised and closed. This should provide a significant element of certainty to investors.

Allowed Revenues and Impact

7.70 We have used the regulatory model to assess the revenues that we have granted over this control period. In the table below we set out a summary of the key input components to the model, and the resulting allowed revenues it has calculated[31].

Table 24 – Regulatory Model Inputs and Resulting Allowed Revenues, £m

Component	*PNGL Submission*			*UR Decision*			*Difference*	*Difference, %*
	2012	*2013*	*Total*	*2012*	*2013*	*Total*	*Total*	*Total*
Opex allowance	15.9	16.2	**32.1**	13.2	13.4	**26.5**	**-5.6**	**-17%**
Capex allowance	12.5	11.7	**24.2**	12.5	11.7	**24.2**	**0.0**	**0%**
Total	**28.4**	**27.9**	**56.3**	**25.7**	**25.1**	**50.7**	**-5.6**	**-10%**
Cost of capital	**7.5%**			**7.5%**			**No difference.**	
Depreciation	**See discussion above.**			**As per PNGL submission.**			**No difference.**	
The above allowances are fed into our regulatory model, which calculates a revenue requirement to ensure the company recovers the value of future as well as past investments, plus a return on this investment.								
Allowed revenues	46.8	48.3	**95.1**	39.9	41.2	**81.1**	**-14.0**	**-15%**

Source: PNGL and the Utility Regulator

7.71 The resulting tariffs from our decisions will see prices fall from their 2011 levels, mainly driven by the end of the reward to PNGL for historical outperformance. For the average domestic customer, the saving is approximately £10 per annum[32], which is projected to continue to 2046 under the current price control formulae.

7.72 Compared to the PNGL submission, our decisions will result in the average domestic customer paying around £25 less per annum.

7.73 For industrial and commercial (I&C) customers, particularly large ones, the difference will be greater given their higher consumption levels. We estimate savings for the larger I&C customers may amount to tens of thousands of pounds, and for the very largest it may even exceed £100k per annum.

[31] This table sets out allowances for the control period only i.e. 2012 and 2013. However, it should be noted that as part of every price control we do determine costs and revenues etc right through to 2046 (the end of the PNGL's licence recovery period). This is necessary since the PNGL business model requires the deferral of some of its entitled revenues, to be recovered in future. This helps keep conveyance charges lower now which in turn encourages the continued growth of the gas market.

[32] Customer savings are intended to be indicative only, as the exact quantum of savings is very sensitive to the assumptions used in the calculation e.g. assumed inflation, assumed consumption levels.

8 Retrospective Adjustments

Update from Draft Proposals

8.1 We have added some details on the scale of the retrospective adjustments made in respect of calendar years 2007 to 2009. We have also flagged our intention to review the scope of the retrospective mechanism over the control period.

Retrospective Adjustment Mechanism

8.2 As part of PC03, we agreed with PNGL that a number of cost items would be retrospectively adjusted at the time of the next price control, to correct for deviations between forecast and outturn events. The purpose of these adjustments is to ensure that PNGL is remunerated only for the activities and outputs that it actually undertakes and delivers.

8.3 An agreement was reached on the specifics of how the mechanism would function, formalised in a supplemental note and spreadsheet model to the PC03 determination in July 2010. The supplemental note to the agreement is included in Appendix 5, and contains full details of what is included in the retrospective mechanism and how it operates.

8.4 The mechanism works on a rolling basis. For example, at the time of developing our draft proposals PNGL had provided details of actual expenditure and outputs delivered in calendar years 2007 to 2009, during which time the outturns were less than forecast. PNGL also managed to achieve some efficiencies on its capex of around £300k. This sum has entered the asset base and will earn depreciation and return for a five year rolling period, after which time it will be removed from the asset base.

8.5 We have retrospectively adjusted the allowances in respect of calendar years 2007 to 2009, to account for the variations mentioned above. This is crystallised and applied by way of an adjustment to the opening value of the asset base in 2012 – in this case, a c£5.2 million reduction.

8.6 Adjustments in respective of 2010 and 2011 will be carried forward and crystallised by way of an asset base adjustment at the time of the next price review in 2014.

8.7 We will retain the mechanism for this price control, although some further development will be necessary to fully reflect our final decisions (namely the addition of the A+M+PR mechanism).

8.8 We also intend to review its scope with a view to introduce a rolling mechanism for opex outperformance, similar to the existing rolling mechanism for capex.

8.9 Finally, we may also carry out audits of actual outputs over the control period, to ensure PNGL has actually delivered the outputs that it claims to.

Treatment of Unforeseeable/ Unpredictable Costs

8.10 The retrospective mechanism has to date also been used as the vehicle through which we have granted additional allowances to PNGL for genuinely unforeseeable and/ or unpredictable costs that have arisen after the PC03 determination was finalised. The process for granting such additional costs can be summarised thus:

- Where an unforeseeable or unpredictable cost has arisen, PNGL has approached us requesting additional monies. Each submission has been accompanied with information to substantiate the request.
- We have then considered and reviewed the request and, where appropriate, granted an additional allowance.
- The additional allowance has then been captured (or "logged up" as commonly termed by regulators) in the retrospective adjustment mechanism, ensuring that PNGL is appropriately remunerated for these allowed costs at the time of the next price control.

8.11 We intend to continue using the mechanism as the vehicle for dealing with genuinely unforeseeable and/ or unpredictable costs over the control period[33]. It should also be noted that we will only consider granting additional allowances of this nature for spend in excess of a de minimis of £100k.

[33] Note that any additional (efficient) allowance we consider appropriate to grant may include a net reduction of any outperformance achieved on say, the general IT budget (for IT projects) or the general professional and legal fees budget (for additional consultancy).

9 FINANCEABILITY

Update from Draft Proposals

9.1 In our draft proposals we stated we were comfortable that the company would remain on a financially sustainable trajectory. We also indicated our intention to continue developing our assessment of financeability, and would carefully consider feedback from respondents to the consultation.

9.2 Over the course of the consultation period, we also met with Fitch Ratings Limited – an agency used by PNGL to assess its credit rating – to discuss our draft proposals and financial modelling. In our final decisions we have adjusted our assumptions to be more in line with those used by Fitch, and we have expanded our analysis to include some downside scenarios.

9.3 This section has therefore been substantially updated since the draft proposals.

Introduction

9.4 In carrying out our gas functions, we are required to act in the manner that we consider is best calculated to further the principal objective in relation to gas (see paragraph 3.2) whilst also having regard (among other things) to the need to secure that companies can finance the activities which are the subject of obligations imposed on them. At the same time, the efficiency element of the principal objective means, in the case of a capital intensive business such as PNGL, that we should have regard to the cost of capital to be achieved by the company.

9.5 We recognise that maintaining financeability is also in the consumer interest, since consumers are ultimately exposed in the future to the effects of any higher cost of capital.

9.6 As part of this price control review therefore, we have carefully considered how our decisions impact on the financeability of PNGL. In considering financeability we have taken into account a number of criteria. These include:

- The licence condition to have an investment grade credit rating. Using Fitch's rating system, investment grade requires a 'BBB-' rating, which we infer would imply (under normal circumstances) gearing of 80 per cent or less, and a Post-maintenance Interest Cover Ratio (PMICR) of around 1.4x or better[34];
- The specific bond covenants in PNGL's existing debt[35] which state gearing of 77.5 per cent or less, and a PMICR of 1.4x or better for dividend lock-up; and
- The current rating of PNGL by Fitch which is 'BBB' and implies a gearing of 70 per cent or less, and a PMICR of 1.5x or better.

[34] Gearing and debt interest cover (i.e. the PMICR) are the two key financial indicators referred to in Fitch's credit rating methodology, although we note that there are other factors that also feed into assessing credit quality.
[35] Specifically this refers to a £275 million bond at 5.5 per cent coupon rate, which matures in 2017.

9.7 For the purposes of modelling we consider it sensible to apply the most conservative criteria (i.e. the toughest) and so we have done this based on the 'BBB' credit rating.

9.8 Whilst we have carefully considered the impact in 2012 and 2013 we have also considered the longer term ability of PNGL to finance its activities. And whilst we will be repeating this exercise with updated data for the next price control in 2014, we feel it is important to examine a longer time period now, and so have carried out relevant calculations to 2046.

Financial Modelling

9.9 To help analyse the financial impact of our decisions, we have expanded our regulatory price control model. Our expanded model provides the following functionality:

- It provides a framework for specifying assumptions for alternative outturn scenarios that differ from those that underlie the price control calculations;
- It models the results of future price control reviews that take into account such alternative scenarios;
- It models the accounts of PNGL (balance sheet, profit and loss account and cashflows) that would result from these scenarios; and
- It computes the consequent key financial indicators relevant to the company's credit rating.

9.10 The model is founded on the accounts of PNGL for 2010 and, following discussions with Fitch, we have adopted assumptions for working capital movements to calibrate to a net debt forecast for 2011 of c£280.3 million. We would point out however that Fitch has included working capital of a separate company (PSL) within this debt forecast[36]. In order to ensure accurate comparisons we have included this in our modelling, but would point out that this makes the results of our modelling more conservative than they might otherwise be.

9.11 We have also assumed that the deferred tax provision made in the 2010 accounts will reverse by 2022 (increasing tax payments over that period).

9.12 The enhanced model allows us to consider the financial prospects for the company under a range of downside scenarios, taking into account the risk-sharing characteristics of the regulatory regime.

9.13 To compute dividend profiles, we have adopted the principle that PNGL would not reasonably declare dividends that would trigger a default of its licence obligation to maintain an investment grade credit rating, and/or breach any covenants of existing debts. As mentioned above, an investment grade credit rating using Fitch's rating system, would imply a rating of 'BBB-'. In our modelling however, we have taken a more conservative approach and used the ratio guidelines adopted by Fitch in its 'BBB' Long-term Issuer default Rating of PNGL as a reference point for computing such a dividend profile.

9.14 Our modelling assumption is that dividends will only be paid in any year to the extent that there is headroom over the ratio guidelines in the previous year.

[36] PSL is a regulated gas supply company which is the largest supplier in the Greater Belfast market. Its accounts show a positive cash position of c£6 million in 2010 and its regulated business allows pass-through of gas prices and a 'k factor' to ensure recovery of any underrecoveries in the following year.

9.15 Before examining our findings, it may be useful to consider the underlying regulatory economics that underpin the PNGL business model. This is important since it demonstrates its long term nature, and explains why PNGL has so far not paid – and is unlikely in the near future to pay – any dividends.

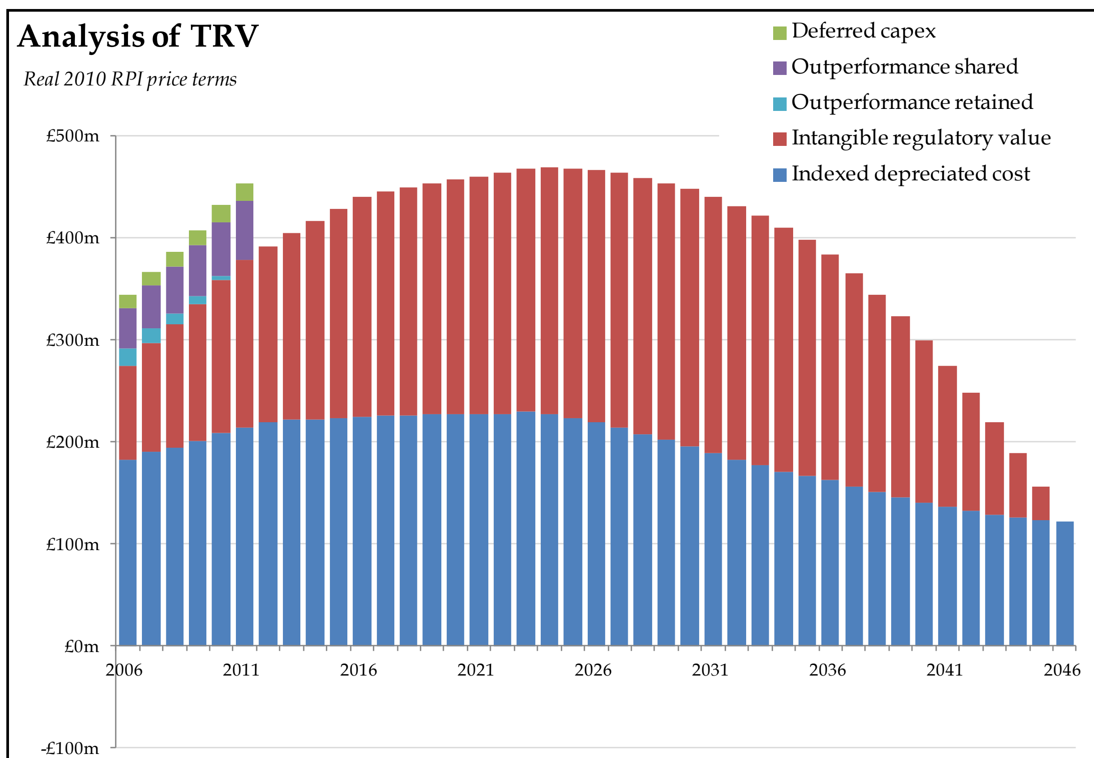
Underlying Regulatory Economics

9.16 The financial requirements of a business are driven by two factors: its profitability and its investment cycle. A company will generate cash from profits or when it invests less than its depreciation charges. It will use up cash when it makes losses or when it invests more than its depreciation.

9.17 For the first 15 years of PNGL's existence, it was in investment mode. But it was not just investing in a brand new physical network; it was also building up its revenue profile from a zero base, suffering low volumes and low prices while developing the market. The regulatory regime necessarily interprets the financial impact of low revenues during the market development phase as investment rather than outright losses.

9.18 Consequently, only part of the total net investment value to date represents physical fixed assets. The following chart shows the TRV profile from 2006 analysed in to its tangible and intangible components.

Diagram 1 – Tangible and Intangible Components of TRV



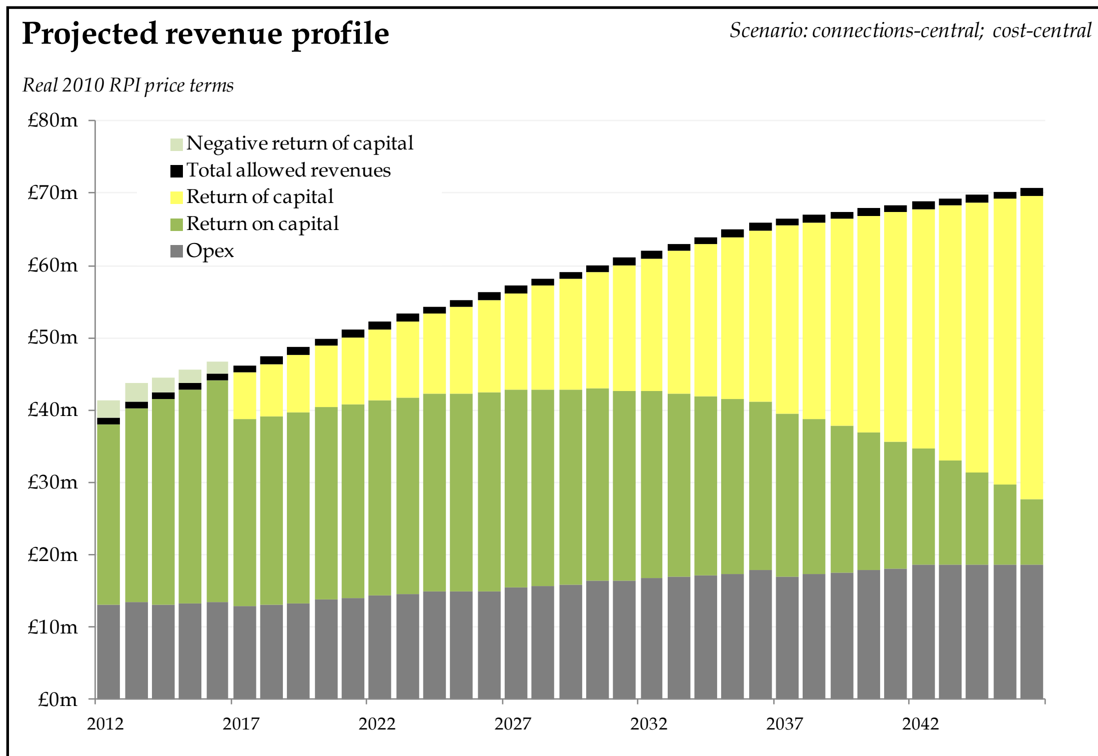
Source: The Utility Regulator

9.19 The steep upward slope on the left of the chart shows that the business continued in investment mode from 2006 but that the rate of investment is starting to stabilise, will be relatively modest after 2016 and will start to reverse, strongly, over the last 20 years of the licence period.

9.20 That sharp fall-off in the TRV represents the return of value to investors. The return of the intangible component (red columns) is built-in to the regulatory regime through allowances for regulatory depreciation of the opening asset value as at the start of 2007 (which included substantial intangible value) and the calculation of the Profile Adjustment in the licence. Some return of tangible value in addition (blue columns) reflects the fact that PNGL has a relatively new network asset and will in future benefit from a period of relatively low spend on renewal.

9.21 Though the return of the intangible component is built-in to the regime, the mechanism for its return is the calculation of a price profile that generates its return by the end of 2046. The resulting revenue profile is described in the following chart.

Diagram 2 – Revenue Profile



Source: The Utility Regulator

9.22 In broad terms, the price level is calculated to ensure the correct overall yellow area. Anticipating some continued growth in volumes means that the pattern of return can be weighted towards the end of the period – lower growth would have implied a flatter revenue profile and higher prices would be required to return the correct amount. Price and revenue profiles are liable to be modified in subsequent reviews, but the underlying amount to be returned to investors remains underpinned by the TRV-basis of regulation. In addition, the regime provides protection to PNGL in the event that conveyance volumes turn out to be different between reviews since the licence permits the company compensating price rises in respect of any shortfall in conveyance revenues.

9.23 The sharp return of value over the last 20 years or so of the licence period provides a natural starting point for shareholder dividends.

Central Case Projections

9.24 Reflecting the underlying regulatory economics of the business discussed earlier, dividend flows would naturally be weighted towards the back-end of the licence period. This was always the intention and was fully understood by all parties at the outset of PNGL's operations in 1996. For 2012 and 2013 it is clear that it would not be appropriate to assume dividends. This is consistent with PNGL's comment in its consultation response that it would not pay dividends for a few years.

9.25 In the longer term, our modelling suggests that it would be prudent for PNGL to begin paying dividends around 2018 to 2020, depending on the assumptions used, and there would be very substantial scope for dividend payments.

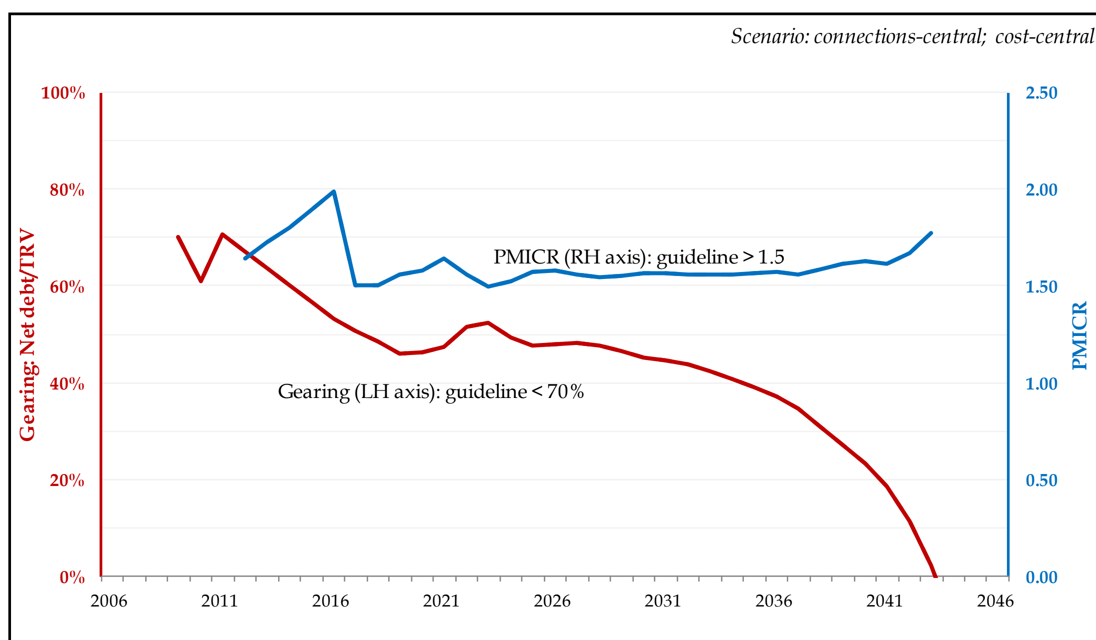
9.26 The key assumption driving this assessment is the cost of capital allowance from 2017. We have decided to retain the allowance at 7.5 per cent until 2016 and, for the purpose of computing a price profile for PNGL12, use a working assumption that the allowance will reduce to 5.866 per cent in 2017 in line with Ofgem's initial cost of capital assessment for the GDNs in its last price control review. Given this assumption, the constraining financial indicator is the PMICR, Fitch's guideline level for which is 1.5x or better (for a 'BBB' credit rating).

9.27 The PMICR is calculated as EBITDA[37] less regulatory depreciation adjusted by movements in the Profile Adjustment and less tax payments, divided by interest. It indicates by how much interest payments are covered by pre-financing profits, calculated on a regulatory basis.

9.28 Under our central case estimates (i.e. assuming no outturn variances) and adopting our modelling assumption that dividends will only be paid in any year to the extent that there is headroom over the ratio guidelines in the previous year, the financial model projects the following profile for gearing and the PMICR.

[37] EBITDA is 'earnings before interest, tax, depreciation and amortisation'.

Diagram 3 – Key Financial Indicators: Central Case



Source: The Utility Regulator

9.29 We project the gearing ratio at the start of 2012 to be marginally above the guideline level of 70 per cent, as set out in the table below. We calculate the PMICR in 2012 to be 1.6x which is above the 'BBB' guideline.

Table 25 – Projected Gearing at 1 Jan 2012

	2010 prices	*Nominal prices*
RPI	225.3	237.9*
Projected level of debt[38], £m		280.3
Opening value of TRV, £m	376.3	397.4
Resulting gearing ratio, %		**70.5**

* This is the RPI figure for September 2011. As the corresponding figure for December is liable to be higher, the gearing ratio in this table may be overstated.

Source: The Utility Regulator

9.30 The gearing level should, however, fall progressively until it is prudent for the company to start paying dividends. In 2013 gearing is projected to be 69.5 per cent, and the PMICR is projected to be 1.7x.

[38] Note that our assumption for PNGL's net debt, at c£280.3 million, has been based on estimates as indicated by Fitch. This figure includes a provision of c£12 million described by Fitch as an "*expectation of PSL working capital requirement*". We queried this with Fitch as we consider its inclusion to be inappropriate. Fitch's response was that its assumptions were provided by PNGL. We maintain that a provision for PSL working capital should not in any way be considered a liability for PNGL for the purpose of this regulatory calculation. However for prudence, we have retained this provision in our modelling but would highlight that if it were excluded it would result in gearing in 2012 of around 67.5 per cent.

9.31 Looking over a longer time horizon gearing falls significantly over time and the PNGL business model can accommodate payment of significant dividends. The PMICR is sensitive to dividend payments, but with a prudent dividend policy we project it to be relatively stable at a level above threshold guidelines, over the long term.

9.32 There is adequate headroom in the ratios for PNGL to begin paying dividends averaging £12.4 million in 2019.

Conclusions under the central case

9.33 We have updated our financial model to include the payment of dividends, constrained by an assumption that these will only be paid in any year to the extent that there is headroom over the ratio guidelines in the previous year.

9.34 It is worth noting that PNGL was never likely to pay a dividend in 2012 and 2013 – the company itself stated this in its response to our draft proposals consultation. With no dividend payments planned in these years, PNGL's gearing and PMICR during this price control will comfortably be within the guideline levels needed for an investment grade credit rating.

9.35 Our analysis shows that PNGL is substantially cashflow positive in the medium to long term, allowing the company to pay substantial dividends to its investors. We are therefore content that the business remains inherently financeable under our final decisions.

Modelling Downside Scenarios

9.36 The financial model provides a basis for modelling alternative outturn scenarios.

9.37 The regulatory regime provides for some risk sharing – at periodic reviews, the price control is reset to take into account new information. This means that the company's exposure to unanticipated levels of costs or demand is limited and that, in due course, customers share in the financial benefit or pain.

9.38 In general, the company will be exposed for a period of up to five years, being the default period of price controls specified in the licence. The current review, however, is for a rather shorter period of two years to the end of 2013. To understand the potential scale of impact on the company if outturns are worse than expected, we have assumed allowances are not reset in future price controls.

9.39 We have modelled two types of outturn variance, with downside assumptions we consider to represent reasonably extreme outturn scenarios:

- Reductions in the level of new connections – a 50 per cent reduction in the rate of new connections from 2012 onwards; and
- Increases in costs – a 15 per cent increase in both operating and capital expenditure from 2012 onwards.

9.40 We consider that the risk of these outturn variances may be small. PNGL has a very good record of performance against regulatory allowances and we are allowing them an increase in opex of more than ten per cent from the last audited figures in 2009, and capex is based on contract rates with efficiencies set at one per cent. Connections have performed well in a difficult

climate recently and it is not obvious what would lead to a 50 per cent reduction. However it is important and prudent to plan for the unexpected.

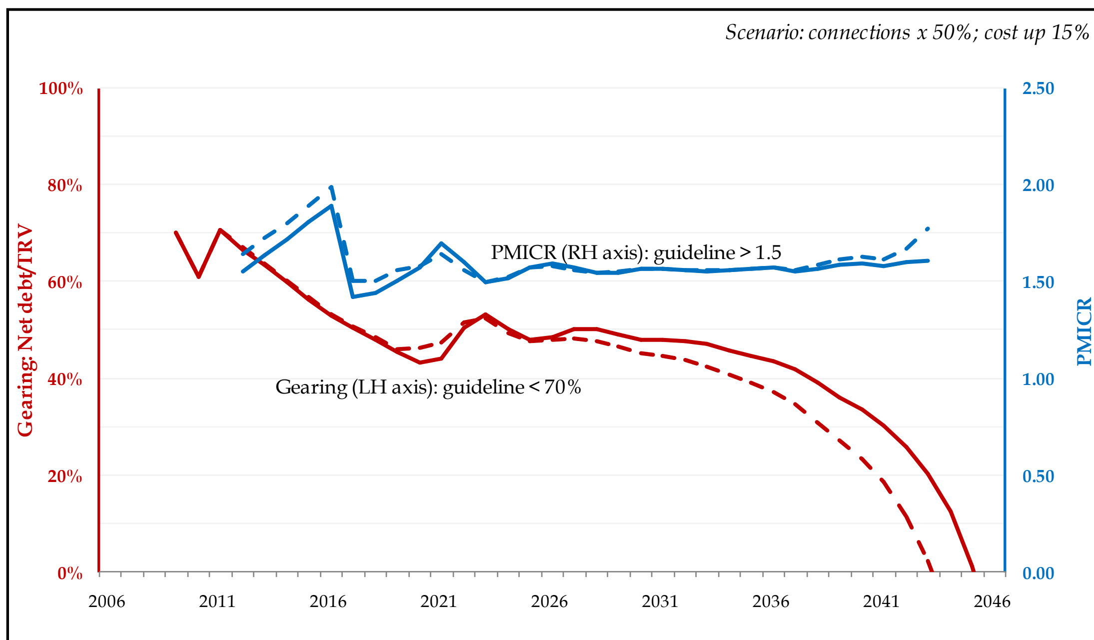
9.41 To further stress test the robustness of the PNGL business we have ignored the fact that the price control sets a fixed revenue stream for PNGL. That is, our downside modelling disregards that the licence formulae allow for prices to increase in the subsequent year to compensate for any shortfall in revenues that occurs because of say, outturn connections and volumes falling short of forecasts. We then consider the impact of downside scenarios on financial indicators and the dividend profile.

Variances from 2012

9.42 The following chart summarises the results of downside modelling for the control period 2012-13 and beyond, assuming an unanticipated change in the rate of connections and costs from the start of 2012.

9.43 The agreed cost of capital allowance of 7.5 per cent applies throughout the control period, which helps the PMICR to stay above the guideline level. The gearing levels are also in line with the central case scenario.

Diagram 4 – Key Financial Indicators: 2012 Downside Case



Note that the dashed lines above represent the gearing and PMICR outturn under the central case scenario.

Source: The Utility Regulator

9.44 If we analyse the impact over a longer period and assume that allowances are not reset at subsequent price control reviews, we do project some pressure on the PMICR in the following period, driven by the consequent change in the cost structure, which means it is projected to dip below the 'BBB' guidelines when the cost of capital allowance falls to its new level in 2017. However the ratios never breach the 'BBB-' guidelines nor the bond covenants in any of our modelling. And the PMICR is restored to Fitch's 'BBB' guideline through a delay in dividend

payments. This scenario would still allow PNGL to pay significant dividends in later years and ensure a healthy return on equity.

Overall Assessment of Financeability

9.45 Since our draft proposals, we have updated our financial model to include the payment of dividends and downside scenarios, and we have clarified the calculation of net debt.

9.46 Under the central case scenario the PMICR is 1.6x and 1.7x in 2012 and 2013 respectively. This is comfortably above the guidelines for all three of our criteria; bond covenants, investment grade credit rating and current credit rating. Gearing in 2012 and 2013 is calculated to be 70.5 per cent and 69.5 per cent respectively, which is comfortably below two of the criteria and on the threshold for Fitch's guideline for a 'BBB' credit rating. This is based on an assessment of nominal debt that includes a c£12 million provision that may be more appropriate to exclude. Excluding this provision would see gearing below the required 70 per cent threshold in 2012 and 2013.

9.47 We have also modelled the financial position over the long run and our analysis shows that PNGL is substantially cashflow positive in the medium to long term, allowing the company to pay substantial dividends to its investors. Our modelling indicates that gearing falls progressively from 2012 and is comfortably below the guideline level for all years up to 2046. For the PMICR we have assumed that PNGL will retain a prudent dividend policy, which will allow the PMICR to remain above 1.5x in all years.

9.48 Once the company reaches its "return of investment" phase, early in the 2020s, the financial position of the company becomes significantly more flexible. The projection of substantial dividends means that the company should have considerable financial resilience. These features mean that the longer term financial position of the company is strongly underpinned by the regulatory economics. PNGL will have substantial headroom in its cashflows during the final two decades or so of the licence period.

9.49 The results of our downside scenario modelling demonstrate that there is no significant pressure on the ratios for any of our three criteria in 2012 or 2013. Looking over the longer term and even assuming allowances are not reset at future price controls, gearing remains well below guidelines for all three criteria. Analysis shows that the PMICR remains above guidelines for two of the three criteria. There could be some pressure on the PMICR under the downside scenario against 'BBB' guidelines but our results show that a prudent delay in dividends would bring it back within guidelines. We will of course carry out further financial analysis of this period at the next price control.

9.50 Fundamentally the underlying financial resilience in the short, medium and longer term means that the business is inherently robust. We remain satisfied that our final decisions leave the company on a financially sustainable trajectory.

9.51 Finally, and with reference to our statutory duties, the allowed revenues we propose are sufficient to ensure that PNGL can finance the activities which are the subject of obligations placed on it under the legislation. We are therefore content that the business remains inherently financeable under our final decisions.

10 NEXT STEPS

Implementation of the Price Control

10.1 In order to implement our final decisions, it will be necessary to modify the PNGL licence under Article 14 of the Gas Order. We have therefore published the required statutory consultation on the licence modification alongside this document.

10.2 Pending the outcome of this consultation, and assuming that PNGL consents to the licence modification and/or does not disapply our final decisions herein, the price control for 2012 and 2013 can then be implemented.

10.3 In the event that PNGL rejects the licence modification and/or disapplies our final decisions, the licence allows us 56 days from the date of rejection to refer the matter to the Competition Commission.

APPENDIX 1
A Brief History of PNGL

Update from Draft Proposals

In its response to our draft proposals consultation, PNGL sought to clarify what it felt was a selective representation of the company's history.

The brief history of PNGL that we presented in our draft proposals was intended to illustrate how the risk-reward profile of PNGL has altered over the years. We do not consider it to be a complete history.

A full response to PNGL's comments can be found in the consultation responses document which has been posted alongside this document on our website.

A Brief History of PNGL

In this appendix we briefly document PNGL's history, with a focus on the changing nature of the risk-reward balance facing the company. We took account of this history when considering an appropriate rate of return over the control period.

1996 to 2006

In 1996 PNGL was awarded a licence that gave it a recovery period of 20 years, during which time the company would construct the network, develop and grow the market, and ultimately recover its investment.

The original licence differed from a typical regulated entity's licence in that all of PNGL's expenditure was capitalised, regardless of its nature. In addition PNGL was granted a rate of return enshrined in the licence at 8.5 per cent, in real terms and pre tax, and stated as fixed until the end of the licence recovery period.

- Capitalising all of PNGL's expenditure was considered necessary because it was private sector funding developing the network from the outset, with no meaningful income generation expected to follow for several years (since it would take time to grow the market). Therefore it was considered reasonable that all expenditure be capitalised.
- The high rate of return was granted to reflect the high level of risks associated with developing an entirely new market from a zero base.

PNGL began constructing the network in the Greater Belfast and Larne areas, but by the early Noughties it was becoming clear that the original business case was flawed and that demand for PNGL's product was not growing as rapidly as envisaged. It was therefore looking more and more likely that PNGL would struggle to recoup its investment within the 20 year time frame. PNGL considered the possibility of raising its prices substantially, which we felt would be harmful to the still infant gas industry. This paved the way for a renegotiation of the PNGL licence.

2006 to 2011
PNGL and our office developed a solution in 2006, which lead to significant licence modifications in 2007. The changes benefited PNGL is many ways, but to summarise:

- Between 1996 and 2006, PNGL opted to price below the maximum level set in our price controls, and thus accumulated significant underrecoveries over the period (some of which the company would have never recovered under the previous licence arrangements). As part of the negotiations, we agreed to capitalise the underrecoveries into the opening asset value (OAV) in 2006. This increased the OAV by c£76 million (2006 prices).
- Between 1996 and 2006, PNGL overall spent less than the allowances set in our price controls. The aggregate absolute figure determined to have been underspent amounted to around £37.2 million (2006 prices). As part of the 2006 discussions and subsequent 2007 licence modifications, the value of this outperformance (the expenditure that it would otherwise have made) was retained and rolled up into the asset base at the prevailing allowed rate for the cost of capital. This led to an addition of c£74.1 million (2006 prices) to the asset base at the end of 2006.
- A recovery period of 40 years beginning in 2006 was granted. Given the 1996 licence had been in effect for ten years at this stage, the total recovery period granted to PNGL from start to finish now sits at 50 years.

In return PNGL did see its rate of return reduced from 8.5 per cent to 7.5 per cent, fixed at this level until 2016. PNGL also agreed to sell its transmission business.

The third price control of PNGL (PC03) followed after the 2006 deal was concluded. Some further changes were made in that price control that also benefited PNGL, the key ones being:

- PNGL was moved from a price control to a revenue control, removing volume risk from PNGL.
- PC03 saw the introduction of an extensive retrospective adjustment mechanism, which sees much of PNGL's allowances (for both opex and capex) adjusted up or down depending on outturn events, significantly reducing activity-based risks for PNGL.

A further point worth mentioning is that PNGL is likely to still be off-setting past losses against current profits, meaning its post tax rate of return is likely to be much higher than comparable utilities in Great Britain.

2012 onwards
The company today faces very different risks than those it once faced.

- It has laid pipe in almost all of its existing licence area, so no longer faces the same level of construction risk as it once did.
- There are no planned major expansions to its network, which in effect means PNGL is now a stable "steady as she goes" business rather than a rapidly growing business. Inherent in this is that the risks it faces are much lower.
- The 2007 licence modifications have given PNGL a recovery period that will total 50 years by 2046. And at this stage the market has grown sufficiently to the point where even if there was little or no further growth, PNGL could still realistically recover its investment by 2046.
- Customer connections have not suffered during the recession and there seems to be a good constant flow of new customers (perhaps reflecting a steady stream of connections as oil boilers age and need replacing, or people renovate their homes).

To summarise
PNGL faces very different risks today and going forward than it did in the past. And whilst the company has been significantly de-risked, its corresponding rate of return has not yet been reduced to rebalance the risk-reward profile it enjoys.

APPENDIX 2
Emergency Costs

Emergency Costs

As stated in the main body of this report, we commissioned PB Rune to examine PNGL's emergency programme and provide advice on an efficient allowance that we should grant over this price control period. The text below is an extract from the PB Rune report.

Extract from PB Rune Report

EMERGENCIES

The Emergency cost element within the PNGL submission cannot be directly compared with the Emergency elements as reported by GB network to Ofgem. *Table 26* below shows the mapping between GB Networks (& Metering Companies) and PNGL

PNGL Cost Elements		GB Network (& Metering)
First Call (PES)	ETM (PES)[39]	Metering
	Emergency (PES)	Emergency
Emergency (Sub Contractor)		Repair
Call Centre		Part of Work Management

Table 26

Emergency Volumes

PNGL has explained both at the meeting and in their note on emergency numbers that NI does not have a 24 hour emergency gas number other than the emergency number (0800 002 001) which is answered by National Grid on their behalf. This statement is used to explain why they are receiving calls which should not normally be expected to be handled by the gas emergency service operated by PNGL. In discussion at the meeting assurances were given by PNGL that there is no benefit in consumers calling PNGL to attend to non-emergency situations (such as a boiler breakdown), as the person attending the report will advise that it is not within the scope of the service. The difference between PNGL and GB first call operatives is that in those attending for PNGL are PES staff who are trained to undertake appliance work, and on rota will move between the emergency role and appliance servicing. In GB the first call operatives are not trained in appliance repair and not accredited to carry out the work.

[39] Phoenix Energy Services

It is noted from the Phoenix web site that PES offer a boiler servicing contract which offers 7 days/week 365 days/year boiler breakdown cover. The web site does not offer a telephone number which operates out of hours and weekends.

Recommendation 7 **NIAUR confirms with PES if a contact telephone number is provided to their customers taking out a boiler servicing contract and if not how a breakdown callout is invoked.**

Public reported escapes:

Taking into account the alignment of activity described in Section 6.1.2 regarding benchmarking, the number of public reported escapes (PRE) received by PNGL in 2009 has been compared with the networks in GB. The results are shown in Table 27 and are represented in *Figure 1*. PNGL received 547 PREs/10,000 customers which is at the higher end of the number for the GB networks, which range from to 330 to 606 PREs/10,000 customers.

	GDN1	GDN2	GDN3	GDN4	GDN5	GDN6	GDN7	GDN8	PNGL
Financial Year				2010					2009
Numbers of Customers (m)	2.67	2.27	2.44	1.76	1.94	2.62	3.96	4.03	0.13
Number of PREs ('000s)	126	118	104	106	85	87	150	190	7
Number of PREs /10,000 Customers	469	517	427	606	436	330	379	473	547

Table 27

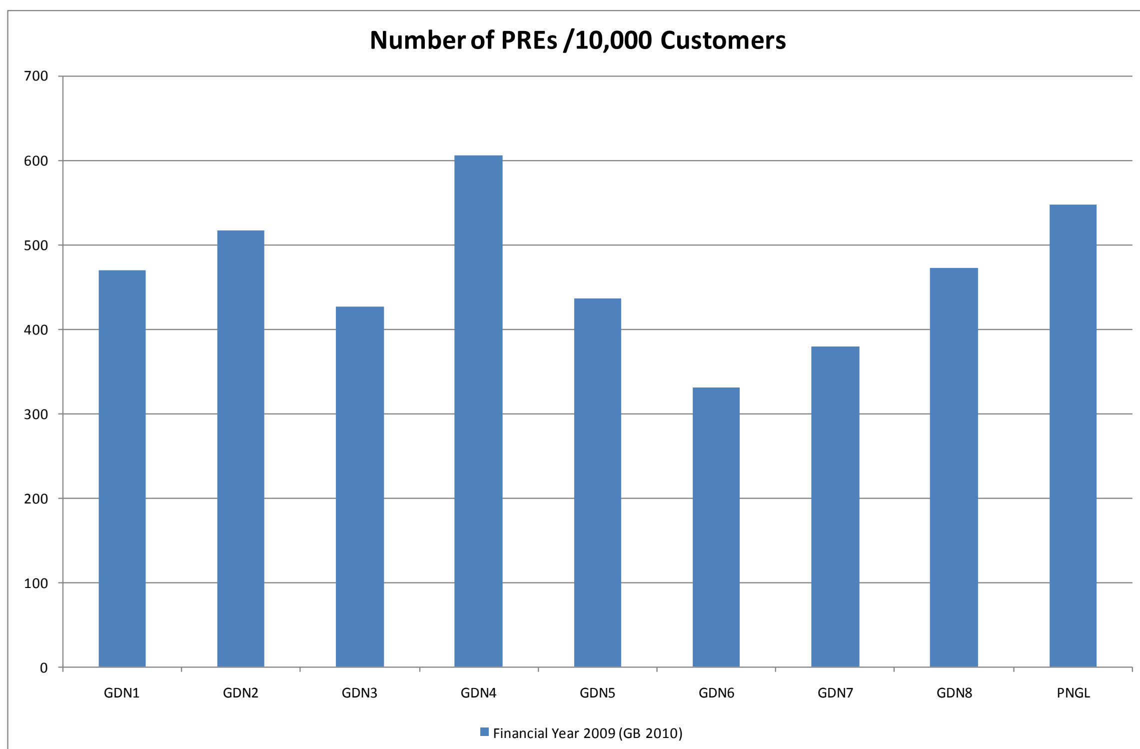


Figure 1

The trend for PNGL's actual PRE activity over the period 2007 to 2009 is downward, as shown in *Figure 2*, whereas the forecast for 2010/12/13 shows an increase. PNGL attributes 16%, a significant proportion, of PREs to 'brand protection' issues and also claims no control over the number or type of calls received in this respect. However, as the market matures it is to be expected that customer awareness of the limitations of services provided by PNGL will increase and the number of such calls will decline therefore. Positive action by PNGL, and PES, to address this issue is necessary and would also contribute to the reduction.

An alternative forecast PRE level has been suggested by PB Rune. It is suggested that a reduction of 3% per year from 2009 to 2013 would be more appropriate given the reductions seen between 2007 and 2009. This forecast trend reduction would leave the 2013 PREs at 481/10,000 customers. This level is still higher than all but two GB Networks reported in for the year 2010. This reduced level of forecast PRE numbers leads to a corresponding reduction in operating cost.

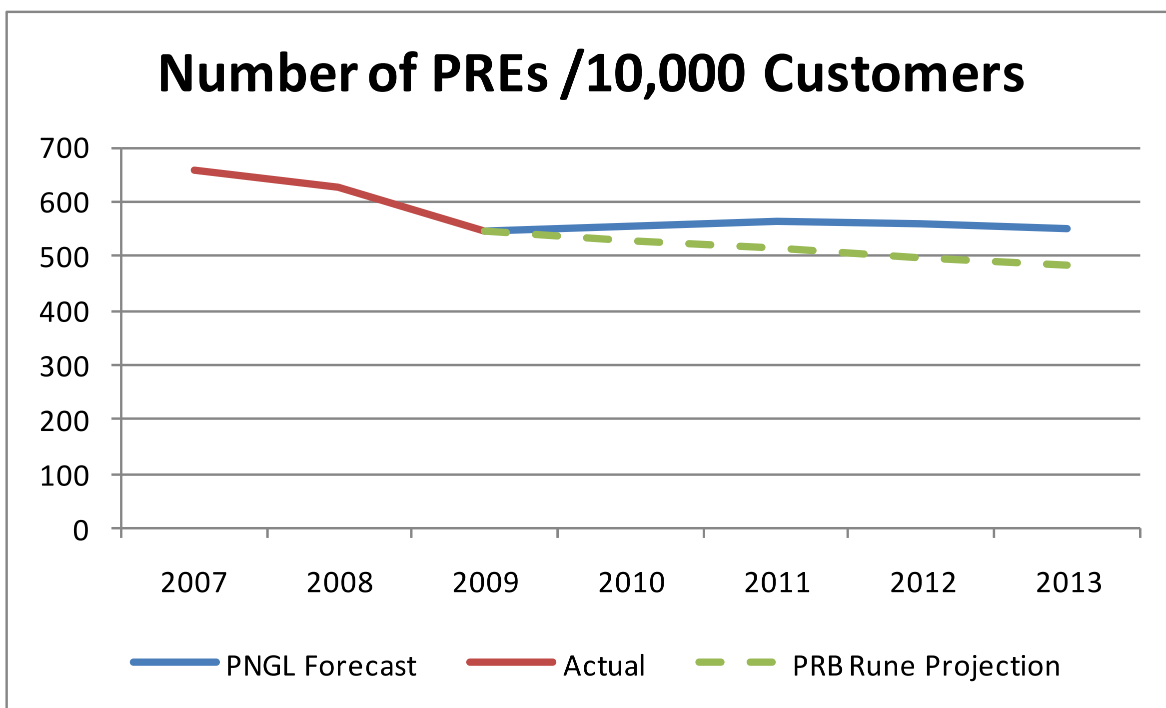


Figure 2

Misdirected Calls

PNGL reports that it receives a large number of misdirected calls and claim that this is largely due to NI not having any other 24 hour emergency number (see comments earlier in this section about Boiler Servicing). PNGL also claims that the number of misdirected calls is likely to increase with the introduction of supply competition in November of 2010. Unfortunately the breakdown for 2010 call numbers is not available and it is likely that if this is the case the increase may not be seen until later in 2011. *Figure 3* below shows the number of misdirected calls per 10,000 consumers both actual 2007-2009 and PNGL's forecast 2010-2013. Whilst PB Rune is sceptical about the increase in the volume of these calls predicted by PNGL, it has no way of knowing what the impact of supply competition will be and therefore has not adjusted these forecast numbers in its' considerations.

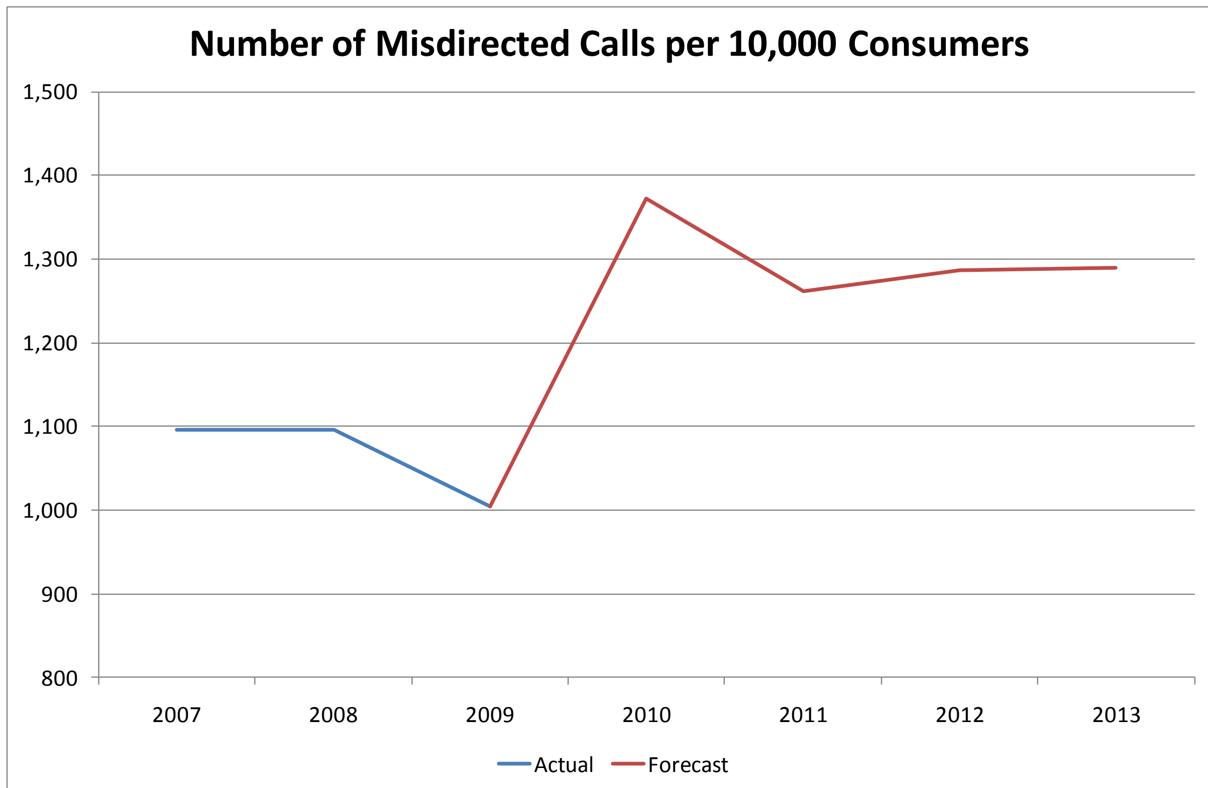


Figure 3

Benchmarking Emergency (PES)

The Emergency elements of the total Emergency costs have been benchmarked. The costs relate to ensuring an operative attends a premise or location within a 1 or 2 hour period of an emergency report being received at the call centre. This operational activity is almost entirely undertaken by PES.

Benchmarking PNGL costs to deal with public reported escapes with the costs incurred by the networks in GB has been considered in the past and it was concluded that it is feasible subject to the provision of relevant information similar to that reported by the GB networks (Report - Advice on Information Submission for PNGL 2012 Price Control – August 2010). The information required to facilitate alignment of activity and costs, as specified at that time, has been provided by PNGL; comprising:

- Number of external escapes
- Number of internal escapes
- Number of mains PREs
- Number of service PREs
- Number of interference damage events
- Number of ‘no gas escape found’ reports

To ensure alignment, the following PNGL activity categories/costs are excluded from this element of the benchmarking:

- Metering reports
- Call centre costs
- Pager costs
- Sub Contractor costs
- Cost recoveries

The output from the benchmarking regression analysis of actual performance for the period 2009 is shown in *Figure 4* below, and indicates that PNGL ranks third in terms of overall cost effectiveness when compared with the eight GB networks. However, the result is influenced by the substantial difference in the level of activity due to the relative sizes of the networks/businesses.

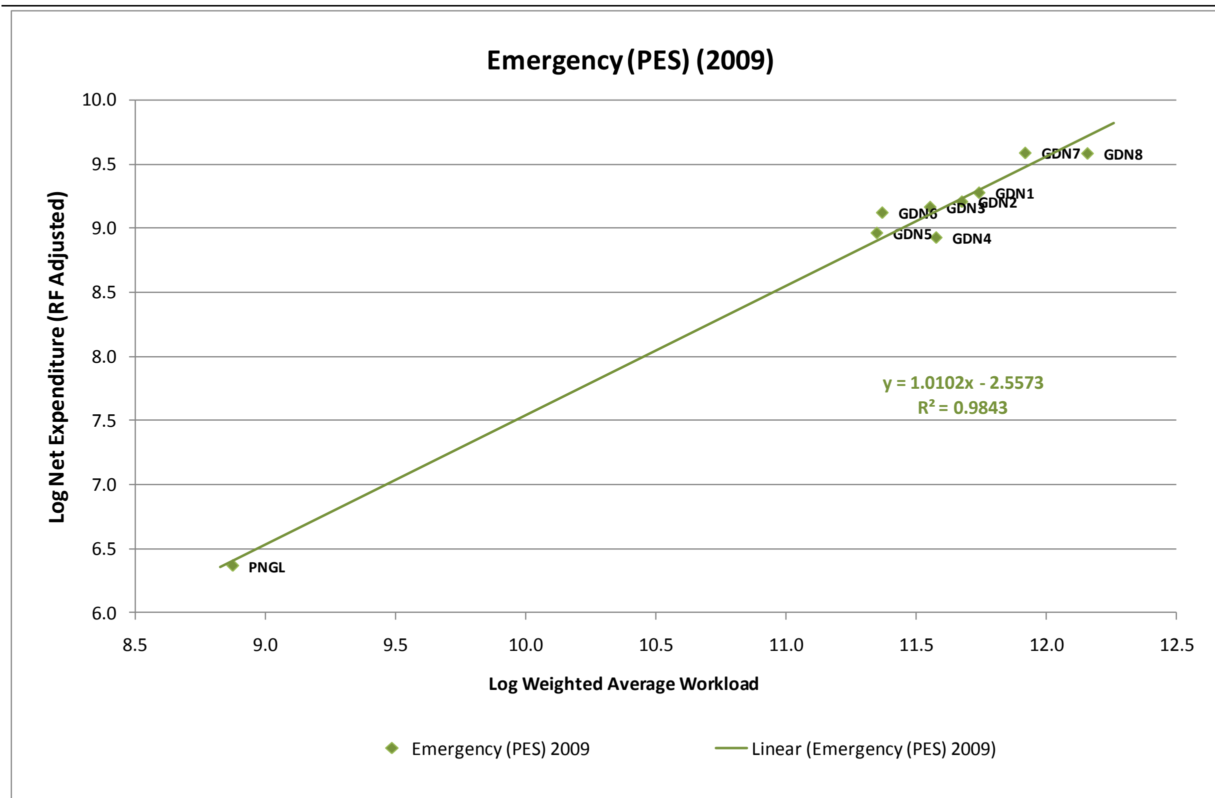


Figure 4

Further analysis has been undertaken to compare PNGL's unit cost performance with the eight GB networks, taking into account regional differences by the application of a 'Regional Factor' (RF) (See Section [XX]) The comparative workloads and costs used for the regression analysis are shown in Table 28.

Company	Cost (£m)	RF Cost (£m)	Workload	Unit Cost (£)	RF Unit Cost (£)
GDN1	10.32	10,732.06	125,541	82.17	85,486.46
GDN2	11.55	10,006.65	117,525	98.28	85,144.89
GDN3	9.23	9,595.39	104,044	88.68	92,224.36
GDN4	7.32	7,562.46	106,474	68.79	71,026.33
GDN5	7.54	7,839.33	84,784	88.88	92,462.40
GDN6	8.88	9,186.69	86,559	102.57	106,132.14
GDN7	14.07	14,642.57	149,878	93.91	97,696.62
GDN8	15.62	14,583.86	190,372	82.02	76,607.15
PNGL	0.56	583.49	7,146	78.39	81,656.18

Table 28

As indicated by the regression analysis and shown in *Table 29*, PNGL's ranking is third in terms of cost effectiveness.

Company	Regression Ranking
GDN1	5
GDN2	4
GDN3	6
GDN4	1
GDN5	7
GDN6	9
GDN7	8
GDN8	2
PNGL	3

Table 29

The unit cost of emergencies has been tracked in *Table 30* below. PNGL has forecast a step increase on the 2009 unit cost of 4.9% for 2010 and later years. They have not forecast any productivity improvements over the period 2010-2013.

Emergency (PES) Unit Cost Tracking	2007	2008	2009	2010	2011	2012	2013
Cost / Emergency (Excluding ETM)	85.77	76.21	78.39	82.19	82.39	82.34	82.31

Table 30

The estimated workloads for future years have been used to project the appropriate allowed costs for 2010-2013 based on the performance level in 2009.

	2009	2010	2011	2012	2013
Workload for Regression	7,146	7,357	7,560	7,711	7,847
Allowance @ Maintain Efficiency (£m)	0.560	0.577	0.593	0.605	0.616
Allowance @ 1.0% Efficiency (£m)	0.560	0.571	0.581	0.587	0.591
Allowance @ 2.0% Efficiency (£m)	0.560	0.565	0.569	0.569	0.568

Table 31

The workloads for each of the years 2009-2013 are shown in *Table 31*. These workloads have been used to calculate the appropriate allowance for each subsequent year at the level of performance seen in 2009. Additionally, the recommended allowances have been calculated assuming an annual productivity efficiency saving of 1% & 2% per year.

Benchmarking Emergency (Sub Contractor)

The costs associated with permanent repairs following the initial 'make safe' of public reported escapes are very dependent on the range of asset types incorporated in the distribution network. The distribution networks in GB are generally mature and significantly different in composition to those in Northern Ireland which are relatively new, small in scale and unique in terms of the asset characteristics. The range and scope of permanent repairs to the networks are significantly different therefore, and this activity is excluded from the benchmarking regression analysis.

The size and characteristics of PNGL's network are comparable to those of an iGT business operating in GB. If the necessary cost and activity information could be obtained, benchmarking comparison with an iGT would provide a more reliable indication of performance, for both emergency response and permanent repair activities, to support review of the PNGL 12 submission.

Summary

In summary, the emergency costs for the period 2010-2013 as presented by PNGL have been set out below in *Table 32*.

PNGL Submission (£m)	2010	2011	2012	2013
Emergency (PES)	0.632	0.681	0.714	0.736
Emergency (Sub Contractor)	0.253	0.273	0.278	0.285
Call Centre	0.423	0.451	0.472	0.487
ETM Meters (PES)	0.521	0.567	0.605	0.631
	1.830	1.971	2.069	2.139

Table 32

The way in which the Emergency (PES) costs have been assessed using regression analysis has been set out above. Benchmarking of the repair activities is not possible, for the reasons outlined earlier in the section, and the PNGL estimates of these costs have been carried forward. The call centre costs have been reduced on the assumption that the number of emergency calls should be expected to fall in line with the reduction seen in the period 2007-2009 (3%/year). The ETM costs have been revised assuming the same unit

cost as seen in 2009 is maintained for the rest of the period until 2013. *Table 33* below therefore shows the overall recommendation for the total allowed costs in the emergency area.

Recommendation 8 The allowances shown in Table 33 are considered for adoption by NIAUR

PB Rune Recommendation (£m)	2010	2011	2012	2013
Emergency (PES)	0.577	0.593	0.605	0.616
Repair	0.253	0.273	0.278	0.285
Call Centre	0.346	0.363	0.380	0.392
ETM Meters (PES)	0.494	0.536	0.572	0.597
	1.669	1.765	1.835	1.890

Table 33

APPENDIX 3
Deferred Capex – Information Set

Update from Draft Proposals

In its response to our draft proposals consultation, PNGL highlighted two errors in our information set as follows:

- The Upper Road Carrick project was completed in 2009, not 2010; and
- Only part of the Bangor Reinforcement project was deferred.

We have amended this appendix, and the one that follows, in line with PNGL's corrected information.

Deferred Capex – Information Set

As part of its submissions for both this and the previous price control, PNGL submitted information on the status of those projects that sit within the scope of our deferred capex review. An extract of the pertinent information is set out in the table overleaf.

Deferred capex – information set on which analysis has been conducted

Project name	Category	Original deferral year	Estimated cost		Project status	Revised date of completion
			in £2000	in £2010		
O'Neill Road	4 bar	2000	210,000	275,556	No longer required	n/a
Legoneil MPRS	PRS	2000	30,000	39,365	Done	2010
Botanic Gardens MPRS	PRS	1999	25,000	32,804	Done	2007
Carrick MPRS	PRS	1999	25,000	32,804	To be done	2010
Donegall Road	4 bar	2000	140,000	183,704	Done	2008
Dee Street extension	7 bar	2000	75,000	98,413	Done	2008
Duncrue backup	7 bar	2000	150,000	196,826	Done	2010
Duncrue IPRS	PRS	1999	30,000	39,365	To be done	2014
Upper Road Carrick	4 bar	1999	150,000	196,826	Done	2009
Upper Road G'Island	4 bar	1999	100,000	131,217	To be done	2012
Bangor & N'ards MPRS	PRS	1999	210,000	275,556	To be done	2015
Albetbridge MPRS	PRS	1999	25,000	32,804	To be done	2015
Inverary Avenue IPRS	PRS	1999	30,000	39,365	No longer required	n/a
Lisburn Road MPRS	PRS	1999	25,000	32,804	No longer required	n/a
Shankhill Road MPRS	PRS	1999	25,000	32,804	To be done	2014
Stream 3 Lambeg	PRS	1999	20,000	26,243	To be done	2011
Stream 3 F'William	PRS	1999	20,000	26,243	To be done	2015
N'ards - Bangor IP	7 bar	2000	975,000	1,279,368	To be done	2020
Newtownards 7bar	7 bar	2000	300,000	393,652	To be done	2020
Bangor 250mm duplicate	7 bar	2000	600,000	787,303	To be done	2021
East Reinforcement	7 bar	2000	900,000	1,180,955	To be done	2022
*** Bangor Reinforcement**	7 bar	2000	912,600	1,197,489	To be done	2023
Cutts IPRS	PRS	1999	30,000	39,365	To be done	2016
Total			**5,007,600**	**6,570,834**		

***** Note that of the 13 km of pipeline required for the Bangor Reinforcement project, only 6.084 km have been deferred. The associated costs set out in this table relate only to the deferred element.

Source: *PC03 and PNGL12 submissions*

APPENDIX 4
Deferred Capex – Decision

Deferred Capex – Decision

We have calculated an appropriate downward adjustment to the opening TRV in 2012. This figure has been calculated based on the removal of:

- Any return earned prior to a project being completed; plus
- The original allowance that entered the asset base *if the project if not yet completed*.

The table on the page overleaf presents a summary of these calculations.

Deferred capex – information set on which analysis has been conducted

A	B	C	D	E			
Project name	**Project status**	**Revised date of completion**	**Treatment**	**All monies in £2010**			
				Original allowance	**Management fee @ 20%**	**Return to end 2011**	**Total**
O'Neill Road	No longer required	n/a	Remove capex + return	275,556	55,111	443,816	774,484
Legoneil MPRS	Done	2010	Remove surplus return	39,365	7,873	59,859	59,859
Botanic Gardens MPRS	Done	2007	Remove surplus return	32,804	6,561	47,466	47,466
Carrick MPRS	To be done	2010	Assume will be done, remove surplus return	32,804	6,561	57,720	57,720
Donegall Road	Done	2008	Remove surplus return	183,704	36,741	242,464	242,464
Dee Street extension	Done	2008	Remove surplus return	98,413	19,683	129,892	129,892
Duncrue backup	Done	2010	Remove surplus return	196,826	39,365	299,297	299,297
Duncrue IPRS	To be done	2014	*Remove capex + return*	39,365	7,873	72,807	120,045
Upper Road Carrick	Done	2009	Remove surplus return	196,826	39,365	327,276	327,276
Upper Road G'Island	To be done	2012	*Remove capex + return*	131,217	26,243	242,689	400,150
Bangor & N'ards MPRS	To be done	2015	*Remove capex + return*	275,556	55,111	509,647	840,315
Albetbridge MPRS	To be done	2015	*Remove capex + return*	32,804	6,561	60,672	100,037
Inverary Avenue IPRS	No longer required	n/a	No action required since allowances have been used for Harbour reinforcement works	n/a	n/a	n/a	n/a
Lisburn Road MPRS	No longer required	n/a		n/a	n/a	n/a	n/a
Shankhill Road MPRS	To be done	2014	*Remove capex + return*	32,804	6,561	60,672	100,037
Stream 3 Lambeg	To be done	2011	Assume will be done, remove surplus return	26,243	5,249	48,538	48,538
Stream 3 F'William	To be done	2015	*Remove capex + return*	26,243	5,249	48,538	80,030
N'ards - Bangor IP	To be done	2020	*Remove capex + return*	1,279,368	255,874	2,060,575	3,595,816
Newtownards 7bar	To be done	2020	*Remove capex + return*	393,652	78,730	634,023	1,106,405
Bangor 250mm duplicate	To be done	2021	*Remove capex + return*	787,303	157,461	1,268,046	2,212,810
East Reinforcement	To be done	2022	*Remove capex + return*	1,180,955	236,191	1,902,069	3,319,215
Bangor Reinforcement	To be done	2023	*Remove capex + return*	1,197,489	239,498	1,928,697	3,365,684
Cutts IPRS	To be done	2016	*Remove capex + return*	39,365	7,873	72,807	120,045
Total				**6,498,662**	**1,299,734**	**10,517,572**	**17,347,587**

Column code	Commentary
A, B and C	These columns are as per those in the previous appendix.
D	Our decision is to do the following: 1. For projects no longer required, to remove the original sum that went into the asset base and the return earned to 2012. 2. For projects deferred from the original date but completed before 2012, to remove the surplus return earned between the original and actual dates of completion. 3. For projects deferred and still to be completed (text in italics in Column D above), to remove the original sum and the return earned to 2012. However PNGL can request the monies again and, if granted, this would then re-enter the asset base in future price controls (such as PNGL12). 4. For projects no longer required but substituted for other projects, no action to be taken.
E	• We have used the original allowances for these calculations. • We have added on an uplift of 20 per cent for the Management Fee. This uplift is necessary in order to value the true total cost of each individual project. • The total return calculated is on the original allowance plus management fee, from the original date of deferral, at the appropriate rate of return. • This analysis indicates the value of PNGL's asset base is greater than it should be given the level of capital projects PNGL has delivered.

APPENDIX 5
Retrospective Adjustment Mechanism

Retrospective Adjustment Mechanism

This appendix sets out in full on the pages overleaf the agreement on the retrospective adjustment mechanism agreed as part of PC03. We are retaining this mechanism as part of this price control, see Section 8 of the main report.

Utility Regulator
ELECTRICITY GAS WATER

PNG Distribution Third Price Control (PC03)
2007 to 2011

Supplemental

Retrospective Adjustments and Rolling Capex Incentive

July 2010

Introduction

1. On the 30th November 2007 the Utility Regulator ("UR") issued Phoenix Natural Gas Limited ("PNG") with its Price Control Determination ("the determination") for the period 2007 – 2011.

2. Since issue of the determination and associated determined distribution charges, the TRV in 2006 has been revised[1], corporate affairs and market development allowances have been reviewed and revised[40] which in turn recalculates the determined distribution charges (P_is) and the profile adjustment (PA). For clarity we include the revised determined distribution charges, determined revenues and profile adjustment below.

Determined Distribution Charges

Sector	Designation	$P_{,E.i}$, 2006£/therm
Tariff Domestic, Tariff I&C <2,500	$P_{E,1}$	0.3294
Tariff I&C 2,500-25,000	$P_{E,2}$	0.2965
Firm I&C 25,000-75,000, Firm I&C >75,000	$P_{E,3}$	0.2793
Int I&C >75,000	$P_{E,4}$	0.1405

Determination Revenue

£k, 2006 prices	2007	2008	2009	2010	2011
$R_{E,t}$	28,822	30,394	31,804	33,447	35,082

Profile Adjustment

£k, 2006 prices	$PA_{E,n=2011}$
$PA_{E,n=2011}$	75,702

3. As part of the determination it was agreed that PNG's licence would be modified to replace the volume revenue driver with a fixed revenue control from 2007. These modifications were implemented in 2009 along with a connections incentive mechanism, the objective of which is to provide PNG with a monetary incentive to maximise new connections to the distribution network each year and over the control period. For clarity the connections incentive revenue is defined separately from the determined conveyance revenue and passes directly to customers in reduced/increased distribution charges. PNG publishes its conveyance charges statement for each forthcoming year by 1 October of the preceding year e.g. PNG must publish its conveyance charges statement for 2011 by 1 October 2010. The 2009 connections incentive revenue will pass directly to customers in reduced/increased distribution charges in 2011. The connections

[40] UReg consulted with PNG on the corporate affairs and market development allowances as part of its review of the licence modifications to implement the move to a fixed revenue control and to implement the connections incentive mechanism. These licence modifications also confirmed UReg's acceptance of the value of $TRV_{F\,t}$, £312.8m (£2006), in respect of formula year *t=2006*. PNG consented to the licence modifications in its letter of 18th March 2009. UReg issued PNG with its determination for Market Development and Connection Incentives for the period 2007-2011 on 2nd April 2009. The licence modifications became effective on 5th June 2009.

incentive revenue therefore does not impact on the determination revenue, determined distribution charges and profile adjustment detailed above.[1]

4. In subsequent reviews some minor errors in transposing capex unit rates into the determination paper were identified due to misallocation of costs. For clarity, we include the revised unit rates below and this note and *. xls supersedes the PC03 determination for these.

(£1996)	2007	2008	2009	2010	2011
Infill	£22.85	£21.56	£21.42	£20.65	£20.17
Feeder	£34.56	£34.34	£34.13	£33.91	£33.70
Domestic Prepayment Meters	£106.71	£106.86	£106.60	£106.60	£105.93
Domestic Standard Credit Meters	£48.96	£48.82	£48.61	£48.43	£48.13
I&C Meters	£234.05	£232.58	£211.17	£196.49	£195.26
Domestic Services	£351.88	£355.00	£351.20	£348.99	£346.80
I&C Services	£791.57	£786.80	£774.92	£765.99	£761.36

5. Following the determination (section 6.11.5[1] of the determination), PNG obtained advance approval from UR for the costs of undertaking a number of large load projects which were not included within the determination. These additional projects are detailed below:

Additional Projects (£1996)	2008	2009	2010	2011
Bombardier[41]	27,569			
Larsen[2]	46,884			
McQuillan Quarry[42]	298,939			
Precision Liquids[43]	92,802			
Contour Global[44]	310,030			
Bombardier AAB Building[45]		32,072	33,260	12,128
Large IC Connections cost[2]	16,301	16,198	16,097	15,995

6. Similarly, any projects which are included in the determination but do not go ahead will be removed from the asset base. [Note that by "projects" we mean defined 7 bar or 4 bar mains laying (to include governors) and/or large load connections.] We anticipate that this will be considered as part of the fourth price control review.

[41] Letter from Brian McHugh to Ivan Bell on 17th April 2008
[42] Letter from Brian McHugh to Ivan Bell on 22nd July 2008
[43] Letter from Brian McHugh to Ivan Bell on 29th September 2008
[44] Letter from Brian McHugh to Ivan Bell on 29th October 2008
[45] Letter from Brian McHugh to Ivan Bell on 17th August 2009

Background

7. As part of the determination it was decided that certain items within PNG's cost base for PC03 would be retrospectively adjusted at the start of subsequent control periods based on actual performance. The purpose of this paper is to set out UR's determination of how such adjustments will be made.

8. These adjustments will be accounted for at the time of PNG's fourth price control review "PNGL12" for each formula year where actual data is available. Where actual data is not available for a formula year, the adjustment will be accounted for at the time of PNG's fifth price control from 2014.

9. The determination also contained a commitment to implement a "rolling incentive" to account for over and under expenditure of capex. This paper also sets out UR's determination of how such adjustments will be made.

10. During the PC03 price control review PNG advised that all deferred capex contained within its asset base will eventually be constructed. The Utility Regulator removed such deferred activity from PNG's future forecasts in setting its determination for PC03. The determination also stated that the Utility Regulator wished to consider the appropriateness of deferred capex (4/7bar and governors) planned for future construction, and would review the planned activity to ascertain when/if it will be carried out and if it would be in the customers interests to use the "deferred" cash within the asset base for other construction activities. It is anticipated that this analysis will be considered as part of PNGL12.

Retrospective adjustments

11. The determination included cost allowances for certain capex and opex items which would be adjusted at the start of subsequent price control periods depending on actual performance within PC03.

Capex

12. The adjustments fall into one of three categories set out in the determination:

Outturn – UR determined a unit price for some capex items. The amount included within the PC03 cost base was the determined unit price times the forecast driver for that item e.g. connections, properties passed etc. Any difference between the allowance in the determination (i.e. the determined unit price times the forecast driver) and the calculation based on actual outturn (i.e. the determined unit price times the actual driver) will result in a retrospective adjustment at the next review.

Pass through costs – any difference between the allowance in the determination and the actual costs incurred will result in a retrospective adjustment at the next review.

Ring fenced sums – any difference between the allowance in the determination and the costs which PNG requested within PC03 and UR approved will result in a retrospective adjustment at the next review.

13. The retrospective capex items are limited to those listed below together with the basis on which they were set and the paragraph from the determination to which they refer. The order is the same as that used in the *.xls spreadsheet.

Para	Capex	Basis
6.11.1	Traffic Management Act	Ringfenced
6.9.1	Domestic Meter Failures	Retrospective based on outturn cumulative domestic connections and determined unit rates
6.11.2	Infill mains	Retrospective based on outturn properties passed and determined unit rates
6.11.2	Feeder mains	Retrospective based on outturn properties passed and determined unit rates
6.11.4	Meters	Retrospective based on outturn connections and determined unit rates. In addition, the weighted cost of a meter in the determination was calculated based on 50% prepayment and 50% standard credit meters being installed. This limit has been removed following the modification to Condition 2.6 of PNG's licence on 25th February 2010 and applies from the start of PC03.
6.11.4	Services	Retrospective based on outturn connections and determined unit rates
6.11.4	Management fee on retrospective capex	Retrospective based on connections services and meters costs above and determined %
6.11.3	Comber & Temple Quarry Costs	Any difference between what UR considers reasonable following its review and the allowed costs in the determination will be subtracted from the cost base at the start of the next review.
6.11.5	Capex over and under spend	Additional projects which UR has approved within PC03 will retrospectively be allowed into the cost base at the time of the next review. These are listed in paragraph 5 above. Similarly any projects within the price control which do not go ahead will be removed from the cost base (see paragraph 6 above).

14. For infill and feeder the determination states that "*the number of properties passed will form part of a retrospective mechanism for infill and feeder mains. At the time of the next review, if the number of properties passed is less than forecast (outlined below) the cost associated with infill and feeder mains in relation to these properties will be subtracted from RAV".* We have subsequently agreed[46] that retrospective adjustments will be based on cumulative properties passed rather than annual properties passed. This is reflected in the *.xls.

[46] E-mail from Brian McHugh to Ivan Bell dated 5th February 2010.

Opex

15. The adjustments fall into one of three categories set out in the determination:

Outturn – UR determined a unit allowance for some opex items. The amount included within the PC03 cost base was the determined unit allowance times the forecast driver for that item e.g. connections. Any difference between the allowance in the determination (i.e. the determined unit allowance times the forecast driver) and the calculation based on actual outturn (i.e. the determined unit allowance times the actual driver) will result in a retrospective adjustment at the next review.

Pass through costs – any difference between the allowance in the determination and the actual costs incurred will result in a retrospective adjustment at the next review.

Ring fenced sums – any difference between the allowance in the determination and the costs which PNG requested within PC03 and UR approved will result in a retrospective adjustment at the next review.

16. The retrospective opex items are limited to those listed below together with the basis on which they were set and the paragraph from the determination to which they refer. The order is the same as that used in the *.xls spreadsheet.

	Opex	Basis
5.18.1	Rates	Pass through except for change in formula Rates are currently calculated using a formula based on PNG's turnover. UR's decision on Rates is to set the allowance based on the current formula and any variation in turnover will be accounted for retrospectively.
5.18.2	Licence fees	Pass through
5.18.3	Corporate Affairs	2007 pass through up to limit
5.18.3	Market development	Retrospectively adjusted based on Owner occupier connections and determined unit rates
5.18.3	Customer Incentives	Retrospectively adjusted based on Owner occupier connections and determined unit rates
5.18.4	Supply Competition Costs	Ring-fenced
PNGL License condition 1.18 - 1.22	Financial Ring-fencing and Corporate Governance	Following implementation of the financial ring-fencing and corporate governance licence conditions on 26th June 2009, PNG has been allowed the costs of obtaining credit rating, £57k (£1996) in 2009, annual review of credit rating, £25k (£1996) in 2010 and 2011, and £70,241 (£1996) in 2010 and 2011 for non-executive directors (NEDs). Note that the retrospective allowance in 2010 and 2011 for NED remuneration will account for any monies already allowed within PC03.
5.18.5	Own Use Gas	The PNG forecast for own use gas was accepted in the determination, but with the proviso that these costs may be reviewed to consider the potential for an incentive mechanism. Given that work is now progressing on PNGL12, this cost item will not be reviewed as part of PC03.
5.18.6	Unregulated Revenue	In PC03 the Utility Regulator stated that unregulated revenue may be reviewed and may result in a re-opener going forward. However, as per own use gas, this cost item will now not be reviewed as part of PC03.
5.18.7	Domestic Regulator Replacement	Ring-fenced amount

5.18.8	PAYG Switchers	Ring-fenced amount
5.18.9	Recharges	In PC03 the Utility Regulator stated that the recharging methodology used to apportion costs from PNG distribution to other Phoenix businesses may be reviewed and a re-opener considered to take account of any changes. However, as per own use gas and unregulated income, recharges will now not be reviewed as part of PC03.
5.0.0	Transmission Recharges	As part of the PNGL12 review, UR is minded to remove charges on the basis of the E-Mail to PNG on the 4th October 2007, subject to any other correspondence that clearly details the matter, relating to the now sold off Transmission business and PNG's asset base.
2.3.18	Working Capital and Capital Creditors	Pass through based on current licence conditions

17. The accompanying spreadsheet (*.xls) illustrates the methodology and calculations for each item to be retrospectively adjusted. The spreadsheet includes references to the determination for guidance. *.xls has been set up so that when outturn connections and properties passed are entered the adjustments to allowances based on these are automatically calculated.

Implementing the retrospective adjustment

18. The following calculations are illustrated in the accompanying spreadsheet and for the avoidance of doubt this paper sets out PNG's and UR's agreement on how the retrospective adjustments are to be implemented.

19. At the time of the next price control review and only for the years for which capex and opex are actualised, PNG will calculate the allowed capex and the allowed opex for each year i.e. the capex and opex within the 30th November 2007 determination adjusted for the various retrospective adjustments identified above.

20. It has been agreed that this adjustment up to formula year *t=a* will be made at the start of the next control period by including the capex and opex variances in opening 2012 TRV.

21. For capex, the adjustment equals the return (at the PC03 rate of return) and depreciation on the variance between allowed capex and capex within the 30th November 2007 determination.

22. For opex, the adjustment equals the variance in allowed opex from opex within the 30th November 2007 determination together with the return (at the PC03 rate of return) on this variance.

23. The variance in allowed capex from capex within the 30th November 2007 determination will be accounted for when capex is actualised as set out in Condition 2.3.14 of PNG's licence.

Capex Rolling Incentive

24. The determination contained a commitment to implement a “rolling incentive” for over and under expenditure of capex. For clarity, this is the difference between actual capex and allowed capex (i.e. capex within the 30th November 2007 determination adjusted for the various retrospective items listed above) and therefore cannot be calculated until the retrospective capex adjustments identified in the section above have been made and the allowed capex for each year established.

25. The capex rolling mechanism calculations are included at 6.11.5 of *.xls. For the avoidance of doubt this paper sets out PNG’s and UR’s agreed methodology for implementing the capex rolling incentive. The calculations are illustrated in the accompanying spreadsheet.

26. Annex 2 of the determination set out how capex under and over-spend would be treated as follows;

[1] For efficiently incurred Capex projects not included in the Price Control which are clearly in the interests of customers we will allow the inclusion of these costs into the RAV at the time of spend. Examples of such projects could include Utility Regulator approved network extensions. We would expect PNG to approach us in advance to get approval for such projects. Likewise any projects within the price control which do not go ahead will be removed from the RAV.

[2] As requested by PNG, all other Capex under spend will be removed from the RAV on a five year rolling basis. We recognise that this is inconsistent with the current licence and we plan to implement a licence modification to reflect this. Capex over spend will be treated symmetrically with under spend where PNG demonstrate to the Utility Regulator that the over spend has been incurred efficiently. In reaching a determination on this, the Utility Regulator will take into account material changes to the utility cost environment since the last Price Control determination

27. Under the scheme PNG retain five years of financing costs (equivalent to 4 years return and 5 years depreciation) on under spend and will forego five years of financing costs on approved overspend[47]. Overspend and under spend are thus treated symmetrically under the scheme providing PNG demonstrate to UR that any overspend has been incurred efficiently.

28. We have agreed the licence modification referred to for capex roller is unnecessary at this stage.

[47] For the avoidance of doubt, the term “approved overspend” in the context of the capex rolling incentive refers only to situations where total actual capex proves to be higher than total allowed capex for each year i.e. the capex within the 30 November 2007 determination adjusted for the various retrospective adjustments identified above. If PNG can justify this outcome by demonstrating the overspend to be efficient, and we approve this, then and only then will the overspend qualify for the capex rolling incentive.

29. For underspends, where the full five years of financing benefit roll into the next price control period the present value of the benefit within the next control period (i.e. return and depreciation) will be included in TRV in 2012.

30. For (approved) over spend the depreciated value will be included in the opening DAV on the 5th anniversary of the over spend.

31. Depreciation will be calculated based on weighted average asset life as set out in *.xls where there is a mixture of assets with different lives.

32. For clarity under and over spend here means the difference between audited actual costs and allowed costs.

33. TMA and management fee and other ring fenced costs are not included in the scheme.

34. The retrospective sheet has been integrated with the Regulatory model used to calculate P_is and other regulatory values.

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