

Gas Network Extension in Northern Ireland

Utility Regulator Workshop
Friday 8 June 2012

Overview of workshop

- Introductions
- Utility Regulator (UR) opening remarks
- DETI presentation
- UR presentation:
 - The role of the UR in this process
 - The award of licence process and the regulatory model
 - Transmission straw man
 - Distribution straw man
 - Generic policy on distribution network extensions
- Participant discussion

Disclaimer

- The role of this workshop and associated presentations is to generate debate in order to ensure that future consultations are robust and cover all material issues. Nothing in this workshop or presentations should be construed as indicating a decision as to what process the Utility Regulator will follow or view it may take on any aspect connected with a network extension. The Utility Regulator is at a very early stage in developing our thinking and so has not formed a final view on how the process will proceed.

The Role of the Utility Regulator

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- The Utility Regulator will be responsible for the design and application of the award of licence process / processes by which the necessary licence (s) will be awarded.
- The award of licence process will be a competitive process unless there is only one applicant in which case it is most likely that the existing processes will apply.
- The Utility Regulator will be responsible for the various conditions contained within the awarded licence(s) which will set out the regulatory regime within which the successful licensee will operate.
- The Department (DETI) will be responsible for a number of other policy decisions including the level of any subvention that might be available and the decisions on the postalisation of tariffs

Guiding Principals

These should be grounded in our statutory duties and we have suggested the following in line with our duties

- Efficient – the regulatory regime should facilitate efficient and cost effective network operation and development
- Economic – network extension should be delivered in a way that takes account of all relevant costs and benefits
- Co-ordination – there should be no unnecessary fragmentation of the NI gas network
- Promotion of gas industry – maximise connections within the area of the extension and across Northern Ireland subject to the constraints of efficiency and economy

Guiding Principals contd

- Protects gas consumers – overlaps with other principals to some degree, in particular an appropriate balance of risks and rewards between consumers and licensees
- Compliant with National and European legislative requirements.
- Consistent with the Utility Regulator's overall policy on network price controls
- When judging any licence bid more particular criteria may be needed to assess the bids

Issues in the design of the Regulatory Model and the Award of Licence Process

Award of Licence Process Design

- This presentation assumes that more than one party is interested in securing a licence to operate in a new area.
- A competitive process should be designed so as to sharpen competitive pressure and address issues such as risk sharing

Q1. How prescriptive should the Utility Regulator be in the design of the regulatory model against which interested parties compete?

- a) A design that is left entirely open to competition participants?
 - b) A limited number of options designed by the Utility Regulator from which participants could choose?
 - c) A single option designed by the Utility Regulator with participants competing on a limited number of parameters such as rate of return
- Other possible suggestions are welcome.
 - Straw men to illustrate the implications

Award of Licence Process Design contd

Q2. What are companies competing for?

- A single licence (T and D) in the new area or separate transmission and distribution licences?
- A related question is should we hold the transmission and distribution award process in parallel or sequentially?

Q3. What should interested parties be asked to compete on?

- Obvious parameters may be levels of Opex and Capex, the sharing of risks between consumers and the licensee and expected rate of return
- But, first need to consider issues in the design of the regulatory model
- Straw men are an attempt to provide some illustration of what a competition could look like.

Issues in the design of the regulatory model

Q4. Which of these do you consider to be the most important?

- Potential network distribution models
 - Distribution Business Model BM1 (skinny- design network connect I&C with domestics being an add on) BM2 (fat – design network to connect domestics with I&C connection being the anchor)
- Risk sharing between consumers and licensees
- The parameters of various incentive mechanisms – development plan – volume incentive – connections incentive
- How to capture innovative ideas and future proofing the network
- The role of supply exclusivity in helping to promote network development
- The role of user commitment to promote network development and to reduce the risk of stranded assets

Now attempt to translate these into straw men.

Transmission Licence – Straw Man

Transmission Straw Man

- Aim is to engender discussion – as such purely illustrative and do not indicate any preference by the Utility Regulator

Assumes for purposes of straw man illustration only:

- There will be a single transmission licence for all transmission assets in the area of the network extension.
- The allowed revenue of the licensee will be recovered through a Northern Ireland wide postalised transmission tariff
- The level of any subvention to assist the funding of network construction will be known
- There will be a pre-qualification stage where the licensee must demonstrate that they have access to sufficient financial resources to fund the construction of a transmission network and to fund the on-going operating costs of that network and the necessary technical skills to own operate and construct a transmission network in a safe and responsible way.

Assessment of Competing Licence Applicants

- We currently have two very different models for transmission licences – one with opex pass through (PTL and BGTL) and the other a more traditional rate of return model without opex pass through (BGE(UK))
- Underlying each licence is a different balance of risk between the company and customers

Q5. For transmission should we choose one of these licence models and ask companies to bid against it or leave the spectrum of potential licences open?

Assessment of Competing Licence Applicants

Q6. If left open how should we evaluate the benefits to customers of bids containing different parameters?

- For a BGE(UK) type model the balance of risk would ultimately be expressed by the rate of return required. In terms of CAPEX risk materials and construction costs are allowed based on tendered rates and archaeology and planning risks are passed through to the customer.
- Companies could bid on:
 - Rate of return
 - Ongoing opex costs
- In a mutual type model opex is a pass through and companies compete on rate of return.
- However, previous licences of this type have been granted in the case of assets already constructed so we have not had to assess CAPEX risk. It may be that the level of pass through in the BGE(UK) model above would facilitate a mutual model.

Distribution Licence – Straw Man

The Regulatory Model – Straw Man

Aim is to engender discussion – as such purely illustrative and do not indicate any preference by the Utility Regulator

Assumes for purposes of straw man illustration only:

- There will be a single distribution licence for all distribution assets in the area of the network extension.
- The Business model will be based on maximising domestic connections (BM2 fat)
- The allowed revenue of the licensee will be recovered through a common distribution tariff within the area of the network extension
- No subvention will be available to assist the funding of network construction
- A price control review will be carried out every five years with a price cap being set as the main form of control to begin with.

The Regulatory Model – Straw Man

- Capex unit rates and opex information submitted as part of any bid will be used in setting the price control
- For the first price control period the price cap will be subject to adherence to an agreed development plan and a volume incentive.
- For subsequent price control periods assume an allowed revenue subject to a connections incentive.
- There would be no supply exclusivity
- Opex and Capex subject to standard five year rolling risk sharing mechanisms
- As with transmission there will be a pre-qualification stage where the licensee must demonstrate that they have access to sufficient financial resources to fund the construction of a distribution network and to fund the on-going operating costs of that network and the necessary technical skills to own operate and construct a distribution network in a safe and responsible way.

Q7. What are your views on the assumptions above?

Assessment of Competing Licence Applicants – Straw Man

- The Utility Regulator would assess the competing bids on the basis of the combined impact of the following factors on the total cost to consumers
 - Rate of Return Required linked to the level of risk accepted
 - Annual Operating Expenditure
 - Capital Expenditure
 - Strategy to achieve volumes/connections

We could calculate the impact of these combined factors on prices and use this to judge the bids.

Capital Expenditure (Capex) – Straw Man

Q8. Should we prescribe a particular business model against which to provide cost information?

Q9. Alternatively, should we ask companies to provide cost information for both business models?

- Based on an estimated length of pipeline required in each town, by pressure gauge, the applicant would submit a unit cost for laying each gauge of pipe.
- Applicants would compete on the basis of these unit rates
- These unit rates would be used to calculate allowed capex once the licence had been awarded

Operating Expenditure (Opex) – Straw Man

- Each applicant will also be expected to compete on operating costs on the understanding that they will be used in their price control if successful in the competition .
- Each applicant would submit operating cost information and for each activity:
 - The baseline cost of carrying on this activity
 - The driver that would cause this cost to vary
 - The impact of the driver on baseline costs
- These data would then be used to calculate allowed opex once the licence had been awarded and at subsequent price controls
- There would need to be a review mechanism after two PCR periods

Volume Incentive – Straw Man

- The Business model will be based on maximising volumes and domestic connections. Consequently, the applicant would also be expected to compete on their business development plan, in particular factors such as:
 - Volume growth
 - Connection rates
 - Marketing and advertising spend (linked to opex)
 - Other?
- Figures for volume growth and connection rates would be submitted on the understanding that these will form the basis for incentive mechanisms.

Q10. How will we assess who will best deliver on volumes/connections?

Distribution network Extension – Generic Policy?

Current UR policy

- The Utility Regulator will only amend a licence in circumstances where a financial analysis of the proposed extension produces a positive NPV.
- In certain cases this financial analysis approach might be regarded by some as overly restrictive and while described as an economic test potentially ignores some of the costs and benefits associated with network extension.
- DETI are examining the development of a policy to govern extensions of the network to uneconomic areas. This issue is linked to the question of distribution tariff postalisation.

Future policy options

- The Utility Regulator has identified a number of potential policy options in the event that an uneconomic extension is proposed
 - Do nothing and continue with the existing policy
 - Allow extensions that have a marginally negative NPV
 - Require consumers in areas with a negative NPV to make an additional contribution to fund network development
 - Government subvention
 - Other?

Distribution Tariff Postalisation

- Existing tariffs postalised within the PNG and Firmus areas but not on a Northern Ireland basis
- Current arrangements in gas lead to adjacent towns paying different tariffs with no obvious justification
- Contrasts with electricity distribution where tariffs are postalised on a Northern Ireland basis
- Potential advantages of NI wide distribution tariff postalisation
 - Facilitates negative NPV network extension as spreads cost over a larger common pool
 - Reduce the level of risk for new distribution licensees
 - Reduce complexity and lead to a more co-ordinated gas supply industry

BUT

- Requirement for legislation and licence changes needs consideration
- Thinking at very tentative stage

Next steps and Indicative Timetable

- Utility Regulator will publish further consultation on award of licence process once DETI processes are further advanced
- DETI currently preparing an Outline Business Case
- DETI to present paper to Northern Ireland Executive in autumn 2012
- Utility Regulator will initiate award of licence process by end of 2012
- Utility Regulator anticipates that licence(s) will be awarded during 2013

- A more detailed timetable is dependant on clarity on the award of licence process to be applied level and will be communicated to stakeholders in due course

Reminder of questions posed

- Q1. How prescriptive should the Utility Regulator be in the design of the regulatory model against which interested parties compete?
- Q2. What are companies competing for?
- Q3. What should interested parties be asked to compete on?
- Q4. Which if these do you consider to be the most important?
- Q5. For transmission should we choose one of these licences and ask companies to bid against it or leave the spectrum of potential licences open?
- Q6. If left open how should we evaluate the benefits to customers of bids containing different parameters?
- Q7. What are your views on the assumptions above?
- Q8. Should we prescribe a particular business model against which to provide cost information?
- Q9. Alternatively, should we ask companies to provide cost information for both business models?
- Q10. How will we assess who will best deliver on volumes/connections?