

**Output from the Utility
Regulator Discussion Paper
and Workshop 8 June 2012**

**‘Extending the Northern
Ireland Gas Network’**

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1. Introduction

On 16 May 2012 the Utility Regulator published a 'Discussion Paper on Gas Network Extensions in Northern Ireland' and subsequently hosted a workshop on 8 June 2012 to discuss the issues raised in the paper. This provided an opportunity for potential investors as well as other stakeholders to provide structured input into the policy making process of both the Utility Regulator and the Department of Enterprise Trade & Investment.

The period for formal responses to the Discussion Paper closed on 27 June 2012. This document summarises the comments received in the formal consultation process as well as output from the workshop.

This document should be read alongside the Utility Regulator 'Discussion Paper on Gas Network Extensions in Northern Ireland' and the presentations given by the Department of Enterprise Trade & Investment and the Utility Regulator at the Workshop, all of which are available on the Utility Regulator website www.uregni.gov.uk.

2. Summary

There are a number of areas in Northern Ireland which do not have access to gas as they are not commercially viable at the moment. This has been set out in the June 2011 DETI consultation on 'The Potential for Extending the Natural Gas Network in Northern Ireland' which highlighted the need for a subvention of up to £50m to facilitate the Gas to the West project. DETI have outlined its timetable for the NI Executive to deliver a decision by the end of 2012 and are currently working on the business case. Once this decision is made there will be greater clarity on the potential for gas extensions.

The Utility Regulator has decided it would be sensible in advance of any decision to consider investor interest in such projects and how any competition for licences might be managed. The workshop and discussion paper have allowed stakeholders to feed into this initial thinking.

The key high level issues which have emerged are that:

- A number of investors are actively interested in the potential extensions;
- There will be no government subvention available for distribution so it is important that the towns are commercially viable and careful thought will be required as to how this is considered in any licence competition;
- There was general agreement from stakeholders that the regulator should not be overly rigid in prescribing the licence design before any competition.
- There was general agreement that there should be a single distribution licence and separately a single transmission licence in any competition.

The Utility Regulator is considering the next steps in progressing a competition design and is planning to consult in more detail once a decision has been made by the NI Executive.

3. Department of Enterprise Trade & Investment Presentation

The Department of Enterprise Trade & Investment (DETI) presentation (see attached) dealt with the strategic benefits of extending the natural gas networks in Northern Ireland. In addition the history of the project to date and timetable of next steps to delivery were outlined. There was a brief discussion following the presentation.

One respondent queried whether the policy drivers were as clear as stated in the presentation, in particular with reference to UK Government policy which is to reduce reliance on imported gas and focus on renewable heat. In response DETI made it clear that energy policy was a devolved matter for the Northern Ireland Executive.

There was general agreement amongst potential investors that before their interest in this investment opportunity could be translated into active participation in a competitive award of licence process they were keen to see a decision from the Northern Ireland Executive with regard to the level of subvention that would be available for network extension and the towns to be included in the distribution network. On this issue DETI outlined the process they were going through to secure this funding including the development of an Outline Business Case for the Department of Finance & Personnel. While the aim was to have a decision by autumn 2012 DETI were not in a position to indicate the level of subvention that could be made available. However based on precedent any subvention would be directed at transmission assets only.

Potential investors were clear that if subvention was only to be made available for transmission assets then investors could only be expected to provide a roll out of the distribution network that was financially viable. It was recognised by DETI that the distribution licence had to be financially viable for the project to attract investment and that this might curtail the nature of the business model which could be delivered as it has in the past.

Postalised Distribution

There was a brief but very useful discussion on the possible postalisation of distribution tariffs, along similar lines to the postalised transmission tariff. It was agreed however that it would be very helpful if an indication of the direction of policy travel on this issue could be provided to potential investors ahead of any award of licence process. The following points / comments were made by respondents.

- Clarity was required ahead of the award of licence process.
- Postalisation would be attractive to potential investors.
- Any impact on tariffs in other areas was likely to be marginal given the relative scale of the network extension.
- The allowed revenue of existing licensees would be unaffected by postalisation.
- Potential impacts on existing large consumers need to be fully considered.

4. Questions Posed by Utility Regulator

The Utility Regulator presented on the various issues and options that had been identified, in the discussion paper published on 16 May 2012, as needing to be considered in the design of the licence award process and the regulatory regime. The Utility Regulator was clear that this should not be regarded as exhaustive and was happy to discuss further with interested parties any issues or options which were not covered in the presentation or discussion paper. The Utility Regulator presentation took the form of an interactive discussion with participants responding to the questions. These generally followed the questions set out in the discussion paper and given the overlap between the workshop and discussion paper we have set out in this section a synopsis of both the discussions and responses on these questions.

Question 1: We request that any developer interested in obtaining the necessary licences should indicate this in their response to the discussion.

Four investors have expressed an active interest in investing in the potential gas network extensions in Northern Ireland.

Question 2: We would welcome views on whether the principles set out in section 3 are appropriate.

Many respondents agreed with the principles. One wanted a greater focus on fuel poverty. One wanted reference to safety and reliability of the network. One suggested a 'policy context' criterion.

Question 3: We welcome views on how potential deviations between tendered and actual cost levels should be taken into account as part of the distribution award of licence process.

A number of respondents suggested that the competition should request operational structure detail and evidence of existing efficient performance. Any deviation could then be handled through price controls. It was also suggested that the use of current tender costs could be useful.

One respondent expressed concern that any attempt by the Utility Regulator to tie bidders to unit rates for network construction would be difficult given the non linear nature of costs. And therefore there would need to be some indication of scale of works anticipated for this to be an effective strategy for price discovery. This scale information would include length of pipe needed, size of pipe needed and consumption volume assumptions. Another respondent suggested that rather than looking forward an alternative approach might be to judge bidders on the basis of previous performance in terms of cost etc. However concern was expressed that such an approach would exclude companies from Great Britain as their cost base is driven by maintaining existing mature networks rather than constructing new ones.

Question 4: We welcome views on the approach in section 4 on dealing with the construction risks associated with transmission. We would also welcome views on which risks should be shouldered by consumers and which companies are best placed to manage.

Three respondents suggested that the risk balance which applied to the construction of the North West and South North Pipelines was about right. One suggested total risk should be minimized.

One respondent commented that consumers could not be fully insulated from the risks of building transmission assets and that this fact needs to be fully recognised by all consumers in Northern Ireland given the postalised nature of transmission tariffs.

Question 5: The Utility Regulator seeks respondents' views on how best the licence process could be designed to balance our statutory duties with reference to different business models.

A divergent range of views were expressed on this issue. One respondent highlighted the imperative that the chosen business model was financially viable. One suggested the business model should ensure customers in fuel poverty are connected. One suggested that it could start out as a thin model and develop further into a fat model if appropriate. One highlighted the need for any model to be consistent with UR and DETI's overall duties. One suggested gas should be made available to the maximum number of customers.

The main issue for respondents was whether DETI had a preferred business model (either BM1 or BM2 as set out in its consultation) and whether this would be prescribed in advance of the award of licence process. The Department was clear that while the objective was to maximise benefits to the widest group of consumers possible this did not over ride the requirement that the distribution licence had to be financially viable.

Some argued that if government subvention was to be forthcoming then the regulatory regime should be designed in such a way that the economic benefits from connection to the natural gas network should be made available to as many consumers, in particular domestic consumers, as possible. There was general consensus that allowed revenue should be profiled over the economic life of the assets such that the level of distribution tariffs remained steady over time.

Another respondent was strongly of the view that it was important to recognise the context of trying to meet environmental, social and economic objectives and that for this reason the maximum number of consumers, in particular domestic consumers, should have access to the gas network.

Question 6: We would welcome any thoughts respondents may have on connections incentives and their importance as a mechanism to distinguish between the bids of potential licensees.

One respondent suggested that the licence should be incentivized to adhere to its connections plan proposed in the bid. One highlighted the potential for using a volume incentive.

Question 7: We would welcome any thoughts respondents may have on user commitment.

One respondent commented that this would be difficult to apply in practice while one suggested the NI Executive should use its influence with government bodies, both local and regional to encourage connection.

One respondent was of the view that dairy companies in particular could be prepared to provide a financial user commitment as the benefits of switching to gas from existing fuels are so large. Certain

dairy companies have already demonstrated their commitment to connection to the gas network by not investing in renewable alternatives. It was also stated that the agri-food industry is characterised by stability and incremental growth and so would prove a stable base load.

Question 8: We would welcome views on the appropriateness of supply exclusivity.

One respondent stated this would depend on the incentive mechanism. One said that the mechanism had a good record in NI and was important in new areas. Two were against any supply exclusivity.

Another was strongly of the view that if there was to be supply exclusivity this would require firm regulation of tariffs until competition developed but it was recognised it could provide flexibility for the licensee to drive connections and network development.

Question 9: We would welcome views on what alternative forms of network development may be considered to extend the gas network and how they could be factored into the design of the licence award process.

Respondents mentioned that bidders could demonstrate experience of using LNG and CNG.

Question 10: How fixed or flexible should the Regulator be in prescribing those factors that potential licensees should compete on?

Three respondents proposed we should present a suite of models for bidders to bid against. One party thought licence conditions would not be needed and just some metrics linked to policy objectives.

Two possible models of how these risks could be effectively managed were considered.

Option 1 – The Utility Regulator could identify the various risks involved in building and operating a transmission business and then leave it up to the bidders to decide how they would allocate these risks between themselves and consumers. This approach provides a framework for investors.

Option 2 – The Utility Regulator could be prescriptive with regard to how the various risks were to be allocated between investors and consumers.

The consensus amongst respondents was that an option 1 type approach would be most appropriate to attract investors

Respondents recognised that the size and nature of the transmission system to be delivered was dependant on decisions yet to be made by the Department of Enterprise Trade and Investment.

Question 11: We would be interested in views on the factors that companies might compete on for transmission and distribution and what other assessment criteria may be necessary for licence award.

Respondents proposed cost of capital, risk sharing, efficiency of operation, innovation, connection levels, service targets as criteria. A number of respondents highlighted the need for any bidder to demonstrate technical competence.

Question 12: We would be interested in stakeholder views on whether the award of licence process for transmission and distribution should occur in parallel or sequentially.

Two respondents supported a parallel process while one was of the view that a sequential process was appropriate. In general however the main issue was to reveal whether the individual town distribution networks were viable or not.

Question 13: We would welcome views on whether there should be a single distribution licence covering the entire area of the network extension at distribution level.

Four respondents favoured a single distribution licence.

One stated that care must be taken not to fragment the investment opportunity in light of the geography and scale of the extension. For this reason it might be best to roll the transmission and distribution competitions into a single competition, albeit with separate transmission and distribution licences.

Another was concerned about the planning issues that might be involved in delivering this major infrastructure investment. However DETI pointed out that similar infrastructure had previously be delivered successfully and that discussions had already been held with the Strategic Planning Unit in the Department of Environment, and that the Northern Ireland Executive were committed to infrastructure as a basis for growing the economy.

5. List of Attendees at Workshop

- Fred Frazer, Irene McAlister – Department of Enterprise Trade & Investment
- Graham Craig, Brian McHugh, Roisin McLaughlin, Shane Lynch, Laura Boyd – Utility Regulator
- Niall Martindale – Phoenix Supply Limited
- Michael Scott, Kevin McSherry, Micheal Parry – Firmus Energy
- Paddy Larkin, Gerard McIlroy – Mutual Energy Limited
- Stephen Parker – Northern Gas Networks
- Robert Wilby - Scotia Gas Networks
- Paulino Garcia – Consumer Council for Northern Ireland
- Michael Bell – Northern Ireland Food & Drink Association
- Stephen Cameron – Dale Farm
- Orla Ward – Bryson Energy
- Bryan Gray – Northern Ireland Manufacturers Association
- Des Connolly – Gemserv