



**Price Control for Northern Ireland's Gas
Distribution Networks - firmus energy
(Distribution) Limited Consultation Response**

20 September 2013

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A. Executive Summary

GD14 is the third price control firmus energy has undertaken in the eight years since our licence was awarded. Therefore there is regulatory precedent for how firmus energy, and indeed the Utility Regulator, have operated under the guidance of the licence and existing legislation. firmus energy believe that it is in the best interests of consumers that this framework should be maintained, as it will facilitate the continuing development of the immature gas network within Northern Ireland. We are mindful of the Utility Regulator's main statutory objective¹ in undertaking its gas functions being to:

"Promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland".

Regulatory certainty and compliance by the Utility Regulator with its legal obligations in that regard is essential in continuing to encourage the necessary investment that will be needed to further develop the gas network in Northern Ireland. This issue was very clearly articulated by the Competition Commission in their analysis of the Phoenix Natural Gas Limited (PNGL) price determination in December 2012, where it was stated that:

"... regulatory certainty is particularly important in the context of natural gas in Northern Ireland given that this is not a fully mature industry, and that future investment in network expansion is expected and desired."

We do not believe the Utility Regulator's current GD14 proposals strike this crucial balance between future network expansion and the needs of both current and future gas customers in our network area. We are clear about the potentially serious consequences that this lack of regulatory certainty could have for the value of our business, and for the confidence which we will need in order to continue investing in Northern Ireland.

The Competition Commission's December 2012 PNGL Determination was clear in highlighting the importance to Northern Ireland of the creation of the gas distribution network in providing both domestic and industrial and commercial customers with the opportunity to substantially reduce their overall heating/energy costs.

firmus energy has performed robustly over the PCR02 period (2009-2013). We have

¹ Energy (Northern Ireland) Order - Article 14

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increased volumes by c.15% over the PCR02 determined volume target, and in doing so we have prudently managed our business and through tight control of costs; spending 8% less than the determined amount of operating expenditure and 0.4% less than the determined capital expenditure; whilst increasing connections by 49% over the determined level.

Table 1: firmus energy's PCR02 Performance (2009-2013)

	UR Determined	MDR/ Extensions	Final UR Determined	Actual/ Forecast	Diff	%Increase/ Saving
Volumes	184Mt	2Mt	186Mt	214Mt	+28Mt	+15%
Capex	£34.8m	£11.5m	£46.3m	£46.1m	-0.2m	-0.4%
Opex	£21.5m	£5.5m	£27m	£24.8m	-£2.2m	-8%

Our GD14 Submission of the 17th December 2012, looked to build on the basis of this strong performance and set out and explained that firmus energy are prepared to invest significantly more capital across our licence area over and above our original 2005 business plan. However, in order for firmus energy to do this it is essential that we continue to witness a clear and stable regulatory regime which continues to respect existing investors' interests and the spirit of the legal and regulatory framework that was established for those interests.

We are concerned the Utility Regulator's GD14 proposals depart from normal regulatory practice whereby outperformance is "*rewarded*", to a system which appears to penalise and restrict firmus energy's future performance.

firmus energy would therefore make the following fundamental points around the GD14 process:

- We would question the lack of clarity and ultimate practice of the Utility Regulator of only finalising its approach to GD14 process on the 26th March 2013; over three months after firmus energy submitted its GD14 Submission (17th December 2012), and whether this undertaking is good overall regulatory practice.
- The Utility Regulator chose to publish its GD14 consultation document when the Utility Regulator itself recognised the need for "*significant further analysis and engagement with the GDNs (Gas Distribution Networks) and all stakeholders before the final determination is published*". We would suggest releasing such a rudimentary document for public consultation does not reflect good regulatory practice and only increases the lack of clarity around the GD14 process.

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- The option to reduce the length of the GD14 Price Control period from five to three years was not transparently consulted upon. Indeed, the Utility Regulator's 3rd December 2012, Consultation on the "*Overall approach for the price controls of NI's gas distribution networks*" stated:

"However we believe it is important to set out the capex and opex allowances for the GDNs for the next price control period and we are therefore minded to produce a full price control in 2013 which would cover the standard five year price control period. Therefore it is proposed that the GD14 price control would run from 2014-2018."

firmus energy would be undeservedly penalised by this change in terms of long-term business certainty and the additional time and cost it will need to undertake another price control in three rather than the standard five years time period. We therefore question the basis of how such a unilateral decision can be made.

- firmus energy's licence is based on "*minded to*" positions. Therefore we are unclear as to the formal licence definition of the Regulator's GD14 Consultation document and whether this is the Utility Regulator's "*minded to*" position; an "*initial position*"; or a "*draft determination*" or just the Utility Regulator's current "*proposal*".
- The Utility Regulator's consistent requests to firmus energy to provide our data in PNGL formats throughout the GD14 process (at extra cost and time to firmus energy), show that firmus energy has been treated as the "*junior partner*" by the Utility Regulator in the process - rather than being afforded our correct and equal position as a distinct and separate distribution licence holder.

Process aside, the content of the GD14 Consultation Document raises equally concerning matters including the following:

- The Utility Regulator's GD14 Consultation document itself makes no recognition of the fundamental differences between firmus energy's licence and PNGL's licence. Nor does it take account of the different stages of development of each NI GDN. This all adds to the lack of clarity around the GD14 process and further enhances stakeholder misunderstanding. Therefore, we would refute any suggestion that Northern Ireland's two GDN's are currently at the same level of development.

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Table 2: Differences between firmus energy and PNGL

	firmus energy	PNGL
Licence Award	2005	1996
Type of Regulation	Price Cap	Revenue Cap
Licence Recovery Period	30 years	50 years
Connection Model	Thin model	Fat model
Properties Passed	c.60k	c.300k
I&C vs. Domestic Volumes	10% I&C vs. 90% Domestic	2% I&C vs. 98% Domestic
Treatment of under-recoveries	Standalone	Within the TRV
Risk	Volume	Connections
Network Distance	c.270km	c.75km
Nature of Network	Rural and Provincial	Urban Conurbation
Customers	c.20,000	c.160,000
Network Length	c.800km	c.3,000km
Average Availability of Gas in Licence area	c. 5 years	c.15 years
Towns Covered	21 ²	13 ³

- In our GD14 Submission we clearly set out that firmus energy are proposing to connect 94% (9,411) more customers during the GD14 period (2014-2018) than our original 2005 Business Plan. However, this proposal was clearly made on the basis that in order to undertake these additional connections firmus energy would need the requisite cost allowance and rate of return. The GD14 Consultation seems to isolate parts of firmus energy's GD14 Submission that offers increased connections. Plainly, this is not a proper basis on which to proceed and therefore firmus energy would question undertaking any further investment than was agreed in our original 2005 Business Plan during the GD14 period, unless additional cost allowances can be agreed upon.
- The Utility Regulator's PCR02 determination sets out the Regulator's then position in regards to the GD14 period. Within the PCR02 determination, the Utility Regulator clearly sets out for GD14 period that based on 2,000 connections per year that firmus energy's opex would be £16.7m (2014-2016).

However, firmus energy within our GD14 Submission has proposed to undertake double the amount of connections per year in the GD14 period, but the Utility Regulator within its GD14 Proposal are now proposing that firmus energy can undertake this increased connection activity with an opex of only £14.2m – a £2.5m

² Antrim (inc. Ballyclare and Templepatrick), Armagh (Tandragee), Ballymena (Broughshane) Ballymoney, Banbridge, Coleraine (Portstewart & Bushmills), Craigavon (Moir, Lurgan and Portadown), Limavady, Londonderry~Derry (Newbuildings) and Newry (Warrenpoint).

³ Belfast, Lisburn, Bangor, Holywood, Donaghadee, Groomsport, Millisle, Newtownards, Carryduff, Comber, Newtownabbey, Carrickfergus and Larne.

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(15%) reduction on the PCR02 Determination (based on 2,000 connections per year). We would challenge why there has been a change in the regulatory precedent and what business and operational rationale has changed.

Within our GD14 Submission we had provided the evidence that over GD14 (2014-2018) we will undertake a further 19,411 connections. Overall, the operating unit cost to serve a customer will fall by 24% with the increasing number of customer connections:

Table 3: Operating Cost per Customer

Price Control	Operating Cost per Customer (£ - 2006 prices)
PCR02	1,189
GD14	903
SAVING	24%

Therefore based on our evidence we completely disagree with the Utility Regulator's assertion made within its GD14 Consultation that firmus energy are inefficient in regards to our operational expenditure.

- It is extremely unhelpful for the Utility Regulator to set out in a public consultation document that its “*post 2016*” modelling is based on the GB GDN rate of return of 4.83%. This has been undertaken without any responsible consultation with firmus energy. It demonstrates to stakeholders, including consumer groups, a baseless expectation that the final rate of return for firmus energy, post 2016, will be broadly aligned to GB GDNs; whilst making no account for the very different revenue, cost and regulatory risks between the GB and NI markets.
- firmus energy would also question why within the Utility Regulator's GD14 Proposals no explicit mention of the netback arrangement is made. The continuing lack of transparency around important issues such as the “*no profit, no loss*” arrangement only adds to the continued perception of instability and regulatory risk in Northern Ireland within our business and will undoubtedly bring into question the viability of our future investment in Northern Ireland. The netback arrangement was correctly highlighted in the Utility Regulator's PCR02 Determination⁴ which stated:

“Firmus also currently operate as a bundled distribution and supply business using a ‘netback’ mechanism. This means that firmus will set a price to

⁴ firmus energy Distribution PC02 (2003-2013) Price Control Decision, Utility Regulator, 15th January 2009

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compete with other fuels in the 10 towns, from which wholesale gas costs, transmission costs and supply opex are deducted with the residual revenue being used to pay off the distribution network. If the residual revenue is not sufficient to finance the cost of the network, this difference is accumulated in an under-recovery account to be recovered in the future when there will be more customers and a higher level of volumes being transported through the network”.

With regard to Northern Ireland's overall energy policy and direction, we would raise the following concerns:

- The Department of Enterprise, Trade and Investment's (DETI) Strategic Energy Framework (SEF) sets out Northern Ireland's energy policy. The importance of natural gas in providing consumer choice and helping shift Northern Ireland's dependence on coal/oil for household heating is clearly highlighted in the SEF, along with the benefits of natural gas to consumers in Northern Ireland of:
 - Lowering business costs and increasing competitiveness (Evidence: firmus energy has saved customers between £50-60m⁵ in reduced energy costs since 2005);
 - A cleaner fuel which produces less CO₂ than oil or coal (Evidence: firmus energy has helped to remove 400,000 tonnes of carbon dioxide from the atmosphere. The UK Government will set the 2014-2015 carbon price support rates equivalent to £9.55 per tonne and therefore firmus energy has contributed over £3.8m to the UK's carbon reduction targets);
 - Greater consumer choice and convenience. Natural gas is a major contributor in helping to alleviate fuel poverty in Northern Ireland. (Evidence⁶: Natural Gas is 20-30% cheaper than Home Heating Oil, and consumers only pay for what they use and not what they store (unlike Home Heating Oil, Solid fuel and LPG). Natural Gas also provides consumers with various payment options – Prepayment, Direct Debit and Standard Credit. In addition, consumers do not have to store or carry natural gas unlike other fuels); and

⁵ Based on the a weighted average in the difference between the cost of natural gas vs. heating oil/coal/LPG and electric across the I&C and domestic sectors.

⁶ Further evidence of greater consumer choice and convenience can be found in the Consumer Council for Northern Ireland's Report, “*Customers Experience of Natural Gas*”, July 2012.

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- Greater security of energy supply for Northern Ireland (Evidence: Northern Ireland House Condition Survey 2011 showed; 68% of households use Home Heating Oil; 14% of households use solid/electric/dual fuel heating; and 17% of households use natural gas. The importance of Security of energy supply was highlighted in the Utility Regulator's 3rd April 2013 consultation on Gas Network Extensions in Northern Ireland).

Since our licence was awarded, firmus energy has clearly delivered against DETI's strategic policy objectives and we are therefore extremely disappointed that the short-term vision of the Utility Regulator's GD14 proposals seems to run counter to DETI's stated strategic policy aims of developing Northern Ireland's natural gas network and reducing Northern Ireland's dependence on coal/oil for household heating.

- The Utility Regulator's own Social Action Plan⁷ set out the Utility Regulator's strategy to reduce financial insecurity in Northern Ireland by growing the gas network. The Regulator's Social Action Plan recognised that the following criteria would be considered in this undertaking as *"intensifying characteristics for financial vulnerability"*:
 - Age;
 - Disability or chronic illness;
 - Rurality; and
 - SAP⁸ rating of a property.

Since 2005, firmus energy has delivered against these objectives by developing a rural gas network from Derry/Londonderry to Warrenpoint that has provided households who previously had Home Heating Oil/LPG/coal/Economy 7 with a cheaper, more convenient and low-carbon heating system by converting to natural gas.

In addition, due to the economic development of firmus energy's network which has in part focused on converting NIHE estates to natural gas, around 90%⁹ of domestic

⁷ http://www.uregni.gov.uk/uploads/publications/2009-11-09_Social_Action_Plan_FINAL.pdf

⁸ The Standard Assessment Procedure (SAP) is the methodology used to assess and compare the energy and environmental performance of dwellings.

⁹ Experian MOSAIC Survey, August 2013.

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properties that the firmus energy network has passed are “*low income*” households or have “*low disposable income*”. We are therefore extremely surprised that the Utility Regulator has chosen not to recognise firmus energy’s achievement in this regard and to build on the success on the PCR02 Market Development Review within GD14, which supports the aims and goals of reducing financial insecurity in Northern Ireland.

- Throughout the GD14 Consultation document the Utility Regulator seems to have overlooked that Northern Ireland is suffering from one of the deepest recessions in living memory and that the majority of households and businesses are struggling to make “*ends meet*”¹⁰.

firmus energy believe the consultation document and its proposals are fundamentally flawed. Therefore, we strongly urge that the Utility Regulator amends, or justifies why they have chosen not to take account of this overarching economic factor into its GD14 proposals. It is inconsistent to ignore the fact that Northern Ireland is in the midst of the most significant economic recession in a generation and that firmus energy will not be adversely impacted by factory closures and a very depressed housing market. This position is untenable given the current economic climate and highlights the increased commercial risks which the Utility Regulator continues to unreasonably place upon firmus energy.

In summary, the Utility Regulator in preparing its GD14 Proposals seems to have overlooked firmus energy’s strong performance in PCR02 and this needs to be rectified in any final GD14 Determination:

1. Operating Expenditure

- firmus energy was 8% under-spent on operating expenditure.

2. Capital Expenditure

- firmus energy’s capital spend was managed to remain within budget.

3. Volume

- Increased gas volumes which will help to reduce use of system charges going forward.

4. Connections

- All of the above have been achieved whilst delivering 49% more connections to our distribution network.

¹⁰ BBC News – “*NI faces further 'financial squeeze'*” – 11 September 2013.

B. The GD14 Process

- General

The administration and management of the GD14 price control process has been less than transparent from the outset. It appears many of the goalposts seem to have changed (Price Control Duration, Submission dates, PCR02 Precedent etc.), and the deadlines that have been set have been unreasonable.

We have previously set out in correspondence¹¹ many of the procedural problems with the GD14 process to date. These could have been avoided if there was a clear direction and agreement over the reporting format from the Utility Regulator from the outset of the process.

The Utility Regulator's approach and management of GD14 is in stark contrast to Ofgem's approach to RIIO (Revenue=Incentives+Innovation+Outputs). Within RIIO, Ofgem has gone to significant lengths¹² to clearly and transparently set out their position and processes involved at the earliest possible stage. They have provided supporting documentation, spreadsheets etc. which clearly show to all stakeholders exactly how the process will run and the format in which data should be provided.

The proposed 3 year price control for GD14, is counter to the approach of Ofgem who have provided the GDNs in Great Britain with increased regulatory certainty, by ensuring the RIIO-GD1 price control sets out the outputs that 8 GDNs need to deliver for their consumers and the associated revenues they are allowed to collect for the 8 year period from 1 April 2013 until 31 March 2021.

- Timing

firmus energy wrote to the Utility Regulator requesting clarity around the GD14 process on 31st August 2012. Our aim was to ensure that there was a common and transparent understanding of what would be involved in the GD14 process. Unfortunately, we did not receive a substantive response to this letter and ultimately the Utility Regulator's consultation "*Price Control for Northern Ireland's Gas Distribution Networks GD14 - Consultation on Our Overall Approach*", was only published on the 3rd December 2012 – only ten working days prior to the date we agreed (17th December 2012) with the Utility Regulator to submit our

¹¹ Emails to Paul Harland - 14th & 29th May 2013.

¹² <https://www.ofgem.gov.uk/network-regulation-%E2%80%93-riio-model/riio-gd1-price-control>

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GD14 Submission. This was further compounded when the Utility Regulator published their final GD14 approach document on the 26th March 2013 – over 3 months after firmus energy had provided the Utility Regulator with our GD14 Submission.

Condition 4.4.7 of firmus energy's Distribution Licence states:

“The Licensee shall provide to the Authority the Best Available Values (calculated in accordance with Conditions 4.5 and 4.6) in respect of each Periodic Review, together with the Licensee's proposed Designated Parameters for that Review, by the earlier in time of:

- (a) the date occurring 12 months prior to the end of each Formula Year $t = n$; and*
- (b) the date occurring two months after the date on which the Authority has provided to the Licensee its proposed values for the Designated Parameters for that Review.”*

Accordingly, we are concerned that the Utility Regulator continues to imply that firmus energy was late in submitting our GD14 Submission. firmus energy agreed with the Utility Regulator to bring forward our Submission date - over and above our licence requirement (12 months prior to the end of each Formula Year i.e. 31st December 2012) - to the 17th December 2012, and we fully complied with this request. Therefore, the following comments in the Utility Regulator GD14 Consultation document are simply incorrect;

“This price control process has been carried out over a shortened period as we did not receive the GDN submissions until December 2012.”

“We originally intended that the price control submissions to be received in September 2012, but subsequently only received them at the end of the year.”

No mention is made within the Utility Regulator's GD14 Consultation document of the fact that firmus energy has worked with and provided the Utility Regulator with detailed annual cost reports to help provide enhanced transparency and regulatory understanding of our business. This has been in addition to our licence requirements to provide standards of performance, an annual development plan and to respond to reasonable and ongoing ad hoc information requests. Therefore, in the case of firmus energy, no “*information asymmetry*” with the Utility Regulator should exist for the GD14 Price Control and we are therefore disappointed that none of these additional actions by firmus energy appear to have been recognised by the Utility Regulator's office.

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- Consistency with PCR01 and PCR02

In addition, during the GD14 process the Utility Regulator has largely ignored decisions made within firmus energy's previous price control (PCR01 and PCR02) determinations. The Competition Commission's December 2012 PNGL Price Determination is very clear that whilst a regulator cannot be completely bound by regulatory precedent, if it results in outcomes which are at odds with an appropriate balance of its statutory objectives, adherence to prior decisions and clear practice are important aspects of regulation. As the Competition Commission's August 2012 PNGL Provisional Determination¹³ set out:

"in line with normal regulatory practice, our view is that any revision of previous regulatory determinations should be well reasoned, properly signalled, be subject to fair and effective consultation, be clear and understood, and normally be forward looking."

In formulating its GD14 proposals the Utility Regulator seems to have departed from the agreed regulatory approach of firmus energy's previous price controls (PCR01 and PCR02) and the existing PCR02 price control arrangements are now at odds with their statutory obligations. We believe this is at odds with the Competition Commission's Provisional PNGL Determination which commented:

"regulatory certainty is particularly important in the context of natural gas in Northern Ireland given that this is not a fully mature industry, and that future investment in network expansion is expected and desired. Clear regulatory signals are important so as to avoid uncertainty."

- Price Control Period

As previously stated¹⁴, we are greatly concerned around the lack of clear practice within the GD14 proposals and around the Utility Regulator's decision to unilaterally, without any consultation with firmus energy, reduce the length of the GD14 Price Control from 5 to 3 years. We refer to an email from the Utility Regulator of the 25th April 2013, to our office which stated:

"We have set out our current thinking that the price control should run for three years. However this decision will not be taken until the final determination"

This statement is contrary to the initial GD14 consultation document of the 3rd December

¹³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/phoenix-natural-gas-limited/provisional_determination.pdf

¹⁴ Letters to the Utility Regulator of 24th April, 10th May and 18th May 2013 and email of 29th May 2013.

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2012¹⁵, which stated that:

“We propose that at the GDN price control we will set price limits for a five-year period. We will do so in a way that ensures that the company’s operational and investment costs can be met and objectives delivered effectively and efficiently, providing best value for money to consumers”.

“...we are therefore minded to produce a full price control in 2013 which would cover the standard five year price control period. Therefore it is proposed that the GD14 price control would run from 2014-2018.”

“we are proposing to produce a full price control in 2013, to cover the five year period from 2014 to 2018.”

In our response to the 3rd December 2012 consultation, firmus energy set out that:

“We agree with the Utility Regulator’s proposal that the GDN price control should set price limits for the next five year period, as it is essential that there is a stable and predictable policy and regulatory regime within Northern Ireland. This will help to provide the certainty that is needed to encourage investment and enhance the competitiveness of the Northern Ireland economy and brings confidence and benefits to consumers.”

Therefore, we remain perplexed that only 4 months later the Utility Regulator published a proposed unilateral change to this overall approach (*“Update on our Overall Approach”* of the 26th March 2013), which states:

“we are minded to shorten the duration of GD14, to a 3 year control period. This would mean that GD14 would run from 2014 – 2016.”

The Utility Regulator’s 3rd December 2012 consultation was therefore severely lacking as it made no explicit mention that the Utility Regulator was considering anything other than producing a *“full price control in 2013, to cover the five year period from 2014 to 2018”*.

In the Utility Regulator’s December 2012 consultation, it was acknowledged that a 5 year control is *“standard”*, which by implication means that a good reason would be required to deviate from this.

The Utility Regulator’s justification for the change to a 3 year price control period was set out in their *“Update on our Overall Approach”* of the 26th March 2013, which stated:

“some of the PNGL allowances requested have no drivers/inputs explaining how they have been built up, but simply hard coded numbers, with no explanation.

¹⁵ Price Control for Northern Ireland’s Gas Distribution Networks GD14 Consultation on Our Overall Approach, Utility Regulator, 3rd December 2012

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PNGL has noted in its response to the approach that it does not believe it appropriate to pursue cost reporting and thus have not submitted their price control information in this format. While we accept that cost reporting is a process that requires continuous improvement its development is critical to ensuring transparent information sharing and a smooth price control process."

Therefore, this decision is prejudicial to firmus energy, despite firmus energy providing the Utility Regulator with annual cost reporting data, and in our GD14 Submission we provided drivers/inputs and explanations on how our allowances were built up. We therefore question the regulatory precedent of penalising a licence holder, in this case firmus energy.

- Summary

The above issues and the Utility Regulator's consistent requests to firmus energy to provide our data in PNGL formats throughout the GD14 process (at extra cost and time to firmus energy), show that firmus energy has been treated as the "*junior partner*" by the Utility Regulator in the process - rather than being afforded our correct and equal position as a distinct and separate distribution licence holder.

All in all, we believe that many significant lessons need to be learnt from how the GD14 process has been undertaken by the Utility Regulator. It is in the interests of both the Utility Regulator and the GDNs to ensure that future price controls are undertaken in a structured manner; with a clear and agreed understanding of all parties on how the process will operate and how data should be submitted and recorded. Only then will future price controls begin to reflect the established principles of best practice as the Competition Commission set out in its PNGL Provisional Determination:

"Regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, as identified by the Better Regulation Task Force in 1997."

firmus energy need to be provided with the necessary regulatory certainty to continue our investment in Northern Ireland. Therefore we would ask that GD14 is undertaken on a consistent 5 year basis, as was the originally understood.

C. Regulatory Certainty

Our parent company is willing to invest over and above the original 2005 Business Plan to bring the benefits of natural gas to even more business and domestic customers than was initially envisaged.

Our GD14 Submission of 17th December 2012 looked to build on the basis of our strong performance during PCR02 and proposed connecting a further 19,411 customers across our network areas – an additional 9,411 over and above our original Business Plan

Our parent company has invested £83m in our distribution business to both build the network and to cover start up costs incurred in the early years of the business. Since its formation firmus energy has benefited from having a well funded parent company with the financial strength that has ensured that the loan facilities required to continue its investment programme have always been available as and when required to fund profitable investment opportunities. Given the recent global financial crisis which has significantly impacted the economies of all of the major developed nations readily available finance is no longer something that can be taken for granted and firmus energy has benefited from being part of the BGE Group.

However, in order to do this we were clear that we would need support from the Utility Regulator in terms of receiving a rate of return which reflects the immaturity of our market (Evidence: firmus energy are still building 100km or 15% of our total network each year) and a fair level of operating expenditure. Unfortunately, as the Utility Regulator's GD14 proposals currently stand, they do not provide firmus energy with a fair level of expenditure and suggested rates of return to achieve this.

firmus energy is only 8 years into its 30 year business plan of developing a provincial "Greenfield" gas distribution network. As such, we remain a growing business and whilst firmus energy as a whole is only 8 years old some of our towns have only connected to the network in the last 12 months (Bushmills¹⁶, Bessbrook and Ballyclare) so our market cannot be considered "mature". The risks to firmus energy's business remain the same as when our licence was awarded in 2005:

¹⁶ Utility Regulator, "Decision paper on the extension of firmus energy licensed area", 6th November 2012.

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a) **Revenue risk**

Under the current and proposed price control arrangements, firmus energy is exposed to revenue risk in relation to the volume of our customers' gas demand. This is not the case for many utility companies who are subject to revenue controls under which they are remunerated irrespective of the level of demand.

b) **Cost risk**

firmus energy is exposed to significant risk in terms of the cost of its network development. Whilst a significant amount of capex has already been undertaken, there is a significant amount of capital investment still required to complete the roll out of the network. Feeder mains are needed to supply new build and NIHE estates as well as industrial and commercial customers. Services and meters are needed to continue customer growth and there will be ongoing meter replacement costs as existing meters will reach the end of their lives.

c) **Regulatory risk**

firmus energy is subject to the risk that there will be reform to the current regulatory regime. Therefore the regulatory framework in Northern Ireland needs to be consistent with:

- Regulatory best practice;
- Regulatory precedent and changes that could have been anticipated in light of the Utility Regulator's statutory duties; and
- The reasonable expectations of investors at the time of investment.

We also would wish to highlight that under the terms of firmus energy's licence we recognise that we are exposed to risks in terms of capex and opex targets, but there was no provision under our original agreement for the Utility Regulator to change the Rate of Return on under-recoveries. For this now to be suggested represents a fundamental change to the commercial terms of our licence. There is no provision or indeed obligation for this in our licence.

These overarching business risks have been compounded by the reality that Northern Ireland is in one of the deepest and prolonged economic downturns in living memory. We are still at the stage of persuading households, who due to the recession have low consumer

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confidence¹⁷, of the benefits of connecting to natural gas, against the known and traditional heating sources such as Home Heating Oil, Electricity, Coal and LPG.

The Competition Commission's PNGL Final Determination¹⁸ highlighted and recognised the differences in risk between a connections based licence as occurs with Phoenix Natural Gas (PNGL) and a volume based licence as firmus energy operates:

"It appears to us that the connections incentives in PNGL12 are not of the same magnitude as the previous volume incentive. This is because PNGL is currently only exposed to limited financial penalties (or rewards) if it underperforms (outperforms) its connections targets as:

(a) PNGL's exposure to capex risk is low, because PNGL's capex allowance is adjusted ex post for the actual number of connections.

(b) PNGL's exposure to revenue risk is low, because PNGL only receives a variable allowance of around £2.2 million a year through the Advertising, Marketing and PR mechanism, which is linked only to the actual out-turn of new domestic owner occupier¹²connections (with no variable elements for other types of connections), whereas previously PNGL was exposed to revenue risk relating to the volume of gas consumed by all (new and existing) customers."

Public policy with regards to heating in Northern Ireland is also changing and posing further real risks to firmus energy's business. We note the effects of the increased cost to consumers of the Climate Change Levy (CCL) which has a 3-4% impact on the gas price¹⁹ and the impact of the Renewable Heat Incentive (RHI) scheme²⁰ and the Renewable Heat Premium Payment²¹ (RHPP). Due to the provincial nature of our network, many households have the ground space (unlike Belfast) to install a biomass boiler, heat pump etc. and therefore we are concerned that the levels of incentives within the RHI²² and RHPP²³ will lead to customers who would have switched to natural gas, to switch to renewable alternatives.

The Utility Regulator's 3rd December 2012 consultation on "*The Overall Approach to GD14*" highlighted that the gas industry in Northern Ireland is still in a development phase. Indeed

¹⁷ Northern Bank, Consumer Confidence Survey, July 2013

¹⁸ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/phoenix-natural-gas-limited/phoenix_natural_gas_limited_price_determination.pdf

¹⁹ HM Revenue and Customs letter of 5th August 2013 to firmus energy, "*Climate Change Levy (CCL): Northern Ireland Gas Supplies*".

²⁰ <http://www.detini.gov.uk/deti-energy-index/deti-energy-template-menu-5.htm>

²¹ The Northern Ireland, Renewable Heat Premium Payment (RHPP) scheme is a government support scheme to help domestic householders install renewable heating and hot water systems in their homes.

²² <http://www.detini.gov.uk/rhi.pdf>

²³ RHPP Grants available: Air Source Heat Pump £1,700; Biomass boiler £2,500; Ground Source or Water Source Heat Pump £3,500 and Solar Thermal Hot Water £320

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the Competition Commission also highlighted this lack of maturity in its December 2012 PNGL Determination:

“Most regulated utilities consist of assets which are well established and for which, in the main, only replacement investment is needed and where expansion of the network is modest. The major financial and engineering risks have already been taken. By contrast, and perhaps uniquely, gas distribution is not yet a fully developed and mature industry in Northern Ireland.”

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D. Operating Expenditure

firmus energy prudently managed our operating expenditure budget in PCR02, and even though we have increased connections by over 49% above the determined level we were able, with stringent financial controls, to ensure that our operational cost is 8% below the determined allowance.

We are respectfully requesting that we are provided with a suitable level of operating expenditure that will enable us to develop and maintain our growing network and customer base.

Table 4: firmus energy's PCR02 Operating Expenditure Performance (2009-2013)

	UR Determined	MDR/ Extensions	Final UR Determined	Actual/ Forecast	Diff	% SAVING
Opex	£21.5m	£5.5m	£27m	£24.8m	£2.2m	8%

We have set out our comments below, using the headings within the GD14 consultation for ease of reference.

Connections Assumptions

As our GD14 Submission set out, during PCR02, firmus energy has undertaken the following connections:

Table 5: PCR02 Connections

	2009	2010	2011	2012	2013
New Build	1,317	1,800	2,525	3,219	4,019
NIHE	2,651	3,875	5,365	6,921	8,121
Existing	1,681	2,499	3,462	4,849	6,849
SME	808	1,002	1,218	1,421	1,671
Contract I&C	125	144	162	167	172
Total	6,582	9,321	12,732	16,577	20,832
PCR02 Determined	5,742	7,818	9,898	11,948	13,980
% increase	15%	19%	29%	39%	49%

Our GD14 Submission proposed a significant increase (94% or 9,411 connections) over and above the level of connections that were planned for the same period in our PCR02 Submission assumptions.

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Table 6: Planned Connections for GD14.

	2014	2015	2016	2017	2018	Total
New Build	800	800	800	800	800	4,000
NIHE	1,200	1,200	1,000	800	800	5,000
Existing	2,000	2,000	2,000	2,000	2,000	10,000
SME	150	100	50	50	50	400
Contract I&C	2	2	2	2	3	11
TOTAL	4,152	4,102	3,852	3,652	3,653	19,411

These additional connections were presented within our GD14 Submission on the basis that (*quid pro quo*) support from the Utility Regulator in terms of receiving an investment rate of return and a fair level of operating expenditure would be forthcoming.

However, as the Utility Regulator's current GD14 proposals stand, they do not provide firmus energy with a reasonable level of operating expenditure to achieve this proposed increase in connections and therefore firmus energy would be unable to consider undertaking further significant investment during the GD14 period, unless these additional cost allowances can be settled upon.

In regards to connection assumptions, the Utility Regulator has stated in Section 6.7 of the GD14 Consultation Document that:

"The targets in respect of owner occupied, NIHE and I&C connections were accepted as submitted".

We would highlight that in Section 9.3 of the Consultation Document the Utility Regulator has increased the Domestic Connections by 200 in 2016. firmus energy would therefore ask for a consistent and accurate approach throughout the Utility Regulator's GD14 Consultation document and to be provided with full justification of any increase in connection targets over and above our submitted levels.

○ **Connections Incentive**

We are unable to accept the Utility Regulator's proposed Market Development Incentive for the following reasons;

The PCR02 Market Development Review

Throughout PCR02 firmus energy has operated on a combination of fixed marketing allowances plus a connections incentive. This has been a very successful approach as it has

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provided both for general communications necessary to inform the Ten Towns market about the features and benefits of this new alternative fuel source as well as providing a mechanism to directly stimulate and encourage increased numbers of connections.

The current PCR02 connections incentive (Market Development Review), as initiated by the Utility Regulator, has been an undoubted success in growing connections in the firmus energy licence area. This has enabled firmus energy to connect 49% customers over and above the PCR02 determined level and therefore has been successful in achieving the Utility Regulator's main statutory objective to:

"Promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland".

Utility Regulator's Proposed GD14 Market Development Incentive

Within firmus energy's GD14 Submission we stated that:

"We are content that the MDR (Market Development Review) incentive continues on a similar basis for the GD14 period but we believe it could be calculated more simply. The amount of the allowance will depend on the determined levels of Pi for the relevant customer categories, their capex connection cost and any connection related opex to be excluded. We would be happy to engage with the Utility Regulator to discuss this."

However, without prior consultation with firmus energy, the Utility Regulator has stated within the GD14 Consultation Document that:

"In order to simplify the mechanism and also align the approach between the NI GDNs we propose adopting the connections incentive mechanism for FE in the same way as it is applied to PNGL moving forward"

In light of the Competition Commission's PNGL determination comments that a regulator should adhere to prior decisions unless it is at odds with an appropriate balance of its statutory objectives, we would therefore ask for the justification for the change to the current approach. In addition, the Utility Regulator's GD14 Proposals provide no explanation of why the existing PCR02 MDR model, having increased connections by 49%, is now at odds with the Utility Regulator's statutory objectives.

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Northern Ireland's Energy Policy

firmus energy would question the Utility Regulator's overall commitment to DETI's SEF²⁴ following the proposed changes to the PCR02 Market Development Incentive. The SEF sets out the importance of developing the natural gas network to help provide consumers with choice and help shift Northern Ireland's dependence on coal/oil for household heating. Additionally, the Utility Regulator's own Social Action Plan set out the Utility Regulator's strategy to reduce financial insecurity in Northern Ireland by growing the gas network.

Errors within the Proposed Market Development Incentive

firmus energy believes there are fundamental oversights within the Market Development Incentive as proposed by the Utility Regulator for the GD14 period. These are as follows:

1. Licence differences between firmus energy and PNGL

firmus energy would fervently challenge the suggestion that firmus energy and PNGL should have the same connections model due to critical differences in our licences. firmus energy's licence is based on a "*thin or skinny*" model and the PNGL licence is based on a "*fat*" model. Indeed, the Utility Regulator's 3rd April 2013 consultation on *Gas Network Extensions in Northern Ireland* highlights the difference between these two business models:

"In both business models the spine of the distribution network is constructed in the manner which most efficiently supports the connection of industrial & commercial supply points. In one business model which we shall term "skinny" only new build domestic supply points and those existing domestics which are adjacent to the distribution network are targeted for connection. In the other business model which we shall term "fat" however the distribution network is further extended to maximise the number of existing domestic supply points targeted for connection."

Therefore, it is inappropriate to align firmus energy and PNGL's connection incentive mechanisms as each company has a very different connection model which is reflected in our licences and business models and this is also reflected in the proposed alternative approach to awarding the Gas to the West licences.

Natural gas has been available in Greater Belfast since 1996 (17 years ago) and therefore has been promoted for at least an additional 9 years than the firmus energy licence area. In

²⁴ Strategic Energy Framework for Northern Ireland, Department of Enterprise, Trade and Investment (DETI), September 2010

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our network area the first town, Ballymena, only connected to natural gas in 2005 (8 years ago) and in the case of Bushmills and Bessbrook they have just connected to natural gas in the last few months. As such natural gas is still perceived as a new fuel source within the firmus energy network and there is a lower level of understanding of its costs and benefits. In June 2013, Millward Brown conducted research with Home Heating Oil users living in gas supplied streets in the firmus energy network area. This revealed the following:

- Over 60% did not know that natural gas would reduce their home heating costs;
- Almost 60% did not know that converting to natural gas would free up space around their home;
- Over 40% did not know that natural gas would give them instant hot water at all times; and
- Over 40% did not know that that natural gas would mean never having to worry about running out.

Table 7: Original Developments and Agreed Licence Extensions.

	Development Area	Industrial and Commercial Availability	Domestic Availability
Original Licence Area	Ballymena	2005	2006
	Ballymoney	2006	2006
	Coleraine	2006	2006
	Limavady	2006	2007
	Derry	2006	2007
	Antrim	2007	2007
	Craigavon	2007	2007
	Banbridge	2007	2007
	Newry	2007	2008
	Armagh	2009	2009
Licence Extensions	Portstewart	2011	2010
	Ballyclare	2012	2012
	Warrenpoint	2011	2011
	Craigadoo	2013	2013
	Coleraine Quarries	2014	2014
	Bushmills	2013	2013
	Bessbrook	2013	2013
	Glenavy	2014	2014

The Utility Regulator's proposals in regards to the Market Development Incentive are counter intuitive to the evidence within the Competition Commission's PNGL final determination:

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“We were told by both main parties that natural gas was still a relatively new fuel to most Northern Ireland consumers and that there was a significant job to be done to ‘sell’ the fuel to the Northern Ireland public. The use of oil, we were told, was ingrained and there was a reluctance and mistrust of converting to natural gas, even in homes where income might be well above the average and so conversion costs would be more affordable.”

We would therefore question why the Utility Regulator is now proposing to “unwind” the successful PCR02 Market Development Review in light of such comments.

Within the Utility Regulator’s 26th March 2013 Final GD14 Approach Determination it stated that it would consider “local regional variations for all allowances granted.” Therefore, any Market Development Incentive should take account of local regional variations between PNGL and firmus energy in regards to the proposed connection allowance incentive.

2. Non- Additional Connections

In regards to the proposed connection incentive mechanism, the Utility Regulator’s GD14 Consultation Document states that:

“As already discussed for PNGL, we consider that there will be a certain number of OO connections that would occur anyway without any direct marketing or selling to these customers. We describe these connections as “non-additional”. Since fe could in theory avoid any sales-related costs to connect such customers, no allowance will be applicable for these customers. We have assumed (as for PNGL) that 25% of all new connections will fall into this category”

firmus energy fundamentally disagrees that 25% of all new connections will be non-additional and this is a significant and uncommunicated departure from the agreed PCR02 Supplementary Market Development Review 2010-2013²⁵ which stated that:

“We (the Utility Regulator) retain our original assumption of 100 non-additional connections pa in OO (owner Occupied) and 10 pa in SIC (Small Industrial and Commercial.”

In addition, comparability between the firmus energy network and the PNGL network in this regard is not justified as the firmus energy network is at a significantly different level of maturity to that of PNGL. We would therefore, request sight of the research behind the Utility Regulator’s assumptions that 25% of all new connections in the firmus energy network area will be non-additional.

²⁵ PCR02 Supplementary Market Development Review 2010-2013, Utility Regulator, 16th April 2010.

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firmus energy's own research and analysis of our network area highlights the fundamentals required to stimulate demand and deliver connections to natural gas. Advertising presence, price perception and company reputation are vital stimulators of increasing interest in connecting to natural gas.

In June 2013, we undertook research with Millward Brown which asked Home Heating Oil users in our network area if they would be prepared to connect to natural gas and only 16% of households asked said that they would be currently be prepared to connect with the rest stating that they are happy staying with Home Heating Oil. 87% of households stated that available “*grants or incentives*” would be significant influences on their decision whether or not to convert to natural gas. Therefore, there can be no justification for the Utility Regulator's assumption that 25% of households in the firmus energy network area will connect to natural gas without any direct marketing or selling; as our research clearly shows only 2%²⁶ of households in the firmus energy network area may convert without this support and can therefore be deemed “non-additional”.

In August 2013, firmus energy undertook a Experian MOSAIC analysis of our “*properties passed*” in the firmus energy network area which shows that 90% of these properties are low income or have pressure on disposable income. This is due to the fact that the majority of the domestic properties passed are ex-NIHE homes where the household had exercised their “*right to buy*”.

Unless the Utility Regulator can provide evidence to support their assertion that 25% of all new connections will be non-additional, any proposed model should either replicate the PCR02 determination, or be updated to reflect our evidence based approach – 2% non additional.

3. Payback Period Used

Our analysis of the Utility Regulator's proposed GD14 Model used to calculate the infill allowance and the existing connections allowance has highlighted some modelling errors

²⁶ firmus energy's June 2013 Millward Brown research found that only 16% of households with home heating oil central heating surveyed would currently be prepared to convert to natural gas. In addition, the survey found 87% of oil burning households in the firmus energy network area would need a grant or an incentive to convert to natural gas. Therefore it can be taken that only 2% of households will convert to natural gas without any support (87% of the 16% households currently willing to convert to natural gas).

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which have resulted in the connection allowance being significantly underestimated.

The basis behind the Market Development Incentive model is that there is a revenue assumption which then has the cost of the infill mains, the domestic services and the gas meter itself subtracted from it. This then produces an allowance per connection – which the Utility Regulator proposes to be £480 per connection for firmus energy.

The Utility Regulator's capex model has used an infill mains value £507 per connection as per their calculation in Chapter 8: Capital Expenditure (Infill Mains - Existing Housing Domestic I&C). In order to calculate the capital cost of an infill mains, the Utility Regulator has used a **recovery period of 40 years** (as per firmus energy's agreed Depreciation Policy).

However, within the Market Development Review model, which has a capex element consisting of Infill mains and services– the Utility Regulator has only provided for a **recovery period of 15 years**.

Both of the above models need to be consistent and reflect firmus energy's agreed Depreciation Policy for infill mains. We have therefore re-calculated the Connections Incentive Mechanism (Using the Utility Regulator's model discounted over 40 years rather than 15 years) and determine that firmus energy on this basis alone should be granted an allowance of £1,301 per domestic housing connection, compared with the originally proposed allowance of £480.

On the basis of this evidence we would ask that the model is amended to reflect firmus energy's depreciation policy, namely gas distribution mains are depreciated over 40 years.

4. Infill Mains

In calculating the proposed GD14 connection allowance incentive the Utility Regulator has chosen to deduct the cost of infill mains per connection, but firmus energy did not include any cost for infill mains within our GD14 Submission. It is arithmetically and logically incorrect to remove a cost that was not included in our model in the first place.

No infill mains are constructed by firmus energy to existing domestic housing estates.

The Utility Regulator's approach to firmus energy in this regard is inconsistent with the Utility

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Regulator's approach to PNGL, as the GD14 Consultation document states in relation to PNGL that:

"We believe that it is appropriate to include infill costs typically incurred that should be attributed to new connections. Accordingly, our calculations below for determining the proposed per connection allowance for GD14 also take into consideration infill costs. While much of infill has already been constructed, it has mainly been built to ensure domestic properties have been passed and it is appropriate that such costs should be taken into account in this calculation"

Since, the Utility Regulator is proposing to use the same connection incentive for both firmus energy and PNGL it is inequitable that firmus energy are being penalised by having a "thin" volume model driven by connecting large I&C, NIHE and new build customers rather than the PNGL "fat" model which looks to maximise the number of domestic connections.

We would respectfully ask for these anomalies to be removed and the cost of infill mains not to be deducted from our allowance.

5. Manpower

In addition to the incorrect removal of infill mains allowance, firmus energy would challenge the value of the manpower assumptions used within the model. The Utility Regulator has used manpower estimates relating to the 2008 model (5 years ago) as its overarching firmus energy staff assumptions. As set out in our Manpower comments within Operating Expenditure we have reformatted our costs – the resulting knock-on effect will now need to be reflected with the GD14 incentive mechanism.

As well as our adjusted staff submission affecting the outcome of the incentives mechanism manpower cost, we are also of the opinion that there will be an additional knock-on effect to applicable corporate overhead costs.

6. Advertising and Marketing

The proposed Market Development Incentive is a considerable departure from the existing successful PCR02 arrangements for advertising and marketing cost. We would question why the Utility Regulator is not affording firmus energy an equitable approach in the development of its network.

Within the Competition Commission PNGL Determination Report it was recognised

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advertising and marketing monies had helped PNGL to meet its connection targets. We would therefore question the Utility Regulator's decision to cut firmus energy's advertising and marketing budget within this proposed mechanism. Indeed the Competition Commission within its recommendations suggested that:

"we recommend that UR undertake analysis whether it is indeed the case that the connections incentives in PNGL12 are not of the same magnitude as the previous volume incentive. Should this be the case (i.e. should it turn out that the connections incentive is not of the same magnitude as the previous volume incentive), we recommend that the UR consider (and consult on) whether it is in the public interest to make changes to the connections incentives or any other part of the regulatory framework as a result of this analysis"

firmus energy is unaware of analysis by the Utility Regulator to substantiate these proposals for the proposed connections incentive for firmus energy, and/or any consultation on whether it is in the public interest to make changes to the current PCR02 connections incentive which has enabled 49% more connections than had been determined for PCR02.

7. Further observations

In addition, to the points raised we would also like to make the following points regarding the model:

- The fixed allowance of £19k relating to marketing for I&Cs is calculated using a ratio of small I&C connections to all connections. The model however incorrectly includes New Build and NIHE connections within that calculation.
- The GD14 incentive mechanism has removed an incentive for new I&C connections which was embedded in the PCR02 mechanism. Should there be no allowance for I&Cs as proposed, we could only secure the funds for this through additional domestic connections. This seems, to us, inequitable. Our licensed area is still growing. We have only recently entered into towns such as Bushmills, Bessbrook, Ballyclare, Warrenpoint and Portstewart. It is especially these areas that will require additional incentive allowances. Therefore, as per our GD14 Submission we would ask that the Utility Regulator provides a £150k allowance for I&C conversion incentives, as in the current economic climate an I&C incentive allowance of £150k is fundamental in stimulating new connections. It is encouraging that the Utility Regulator, at our meeting of 12th September 2013, agreed the model needed to be amended to include an Incentive Mechanism for I&C connections.

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- The Utility Regulator has removed £100k per annum from the mechanism as a recharge to firmus energy (Supply). Within the consultation there is no explanation why this has occurred or how this amount has been calculated. Intrinsically it seems to run counter to the agreed “*Netback*” arrangements; pursuant to which our licences operate. As the 2005 Side Letter states (at para 5.5):

“The Licensee has agreed that it will undertake its operations under the Supply Licence on a no profit, no loss basis.”

- The Utility Regulator has suggested an average burn of 410 therms per annum per existing property. However, as firmus energy pointed out within our GD14 Submission, the average burn per domestic property was 393 therms per annum. Indeed, our updated analysis would indicate that the average burn has now reduced to 350 therms per annum for existing households. If the model is to reflect the firmus energy licensed area it should accurately reflect the average burns as set out above. Gas burn in firmus energy's domestic housing stock is lower due to the government supported oil boiler replacement scheme and NISEP funded schemes requiring insulation measures being adopted in each property we convert to natural gas. Also, all gas boilers are now condensing gas boilers which can be between 10-15% more energy efficient than conventional gas boilers.

In conclusion, the Utility Regulator's model proposes that the number of domestic households firmus energy would need to connect each year in order to recoup our actual costs for advertising and incentive, manpower etc would be **3,907** additional residential connections.

This is significantly higher than our business as usual model as per our original 2005 business plan of 2,000 (in total) connections per year. In firmus energy's GD14 Submission we proposed that we could connect 2,000 residential households each year – over and above NIHE, New Build and Business customer connections. However, this additional workload was presented within our GD14 Submission on the basis of (*quid pro quo*) support from the Utility Regulator in terms of receiving an investment rate of return and a fair level of operating expenditure.

However, as the Utility Regulator's current GD14 proposals stand, they do not provide firmus energy with a reasonable level of operating expenditure to achieve this proposed increase

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and therefore firmus energy will be prevented from undertaking continued levels of investment unless the requisite cost allowances can be agreed.

In order to further explain our lack of acceptance of the Utility Regulator's proposed Market Development Incentive for GD14 we have taken the Utility Regulator's model and changed one of the parameters. We have inserted into the Utility Regulator's model the current average burn for existing households (350 therms per annum); the result show a decrease in the per connection allowance from £480 to £227. The graph below shows the consequences of these changes and highlights our opposition to the proposed incentive mechanism.

Table 8: Breakeven Point – Market Development Incentive

Condition	Allowance per Connection	Connections required to break even	Costs to Recoup through mechanism (less I&C incentive)	Actual costs recovered with connections of 2,000	difference / shortfall
Current UR Proposal (Average 410 therms per annum)	£480	3,907	£2,062,000	£720,000	£1,342,000
UR Model with 350 therms per annum average burn	£227	5,607	£2,062,000	£340,500	£1,721,500

The table above shows the implications of the Utility Regulator's Incentive mechanism model on firmus energy's operations.

The Utility Regulator's model takes into account the revenue produced by an average domestic connection (burning 410 therms per annum) and then subtracts the cost of that connection (infill mains, services and meter). The model uses a discount/payback period in order to arrive at a Net Present Value (NPV) for each connection. The difference between NPV and the firmus energy's Capex cost represents the allowance per each connection that will contribute to covering the cost of Advertising, Marketing, PR, Manpower and Corporate Overheads that was removed by the Utility Regulator from our GD14 submission.

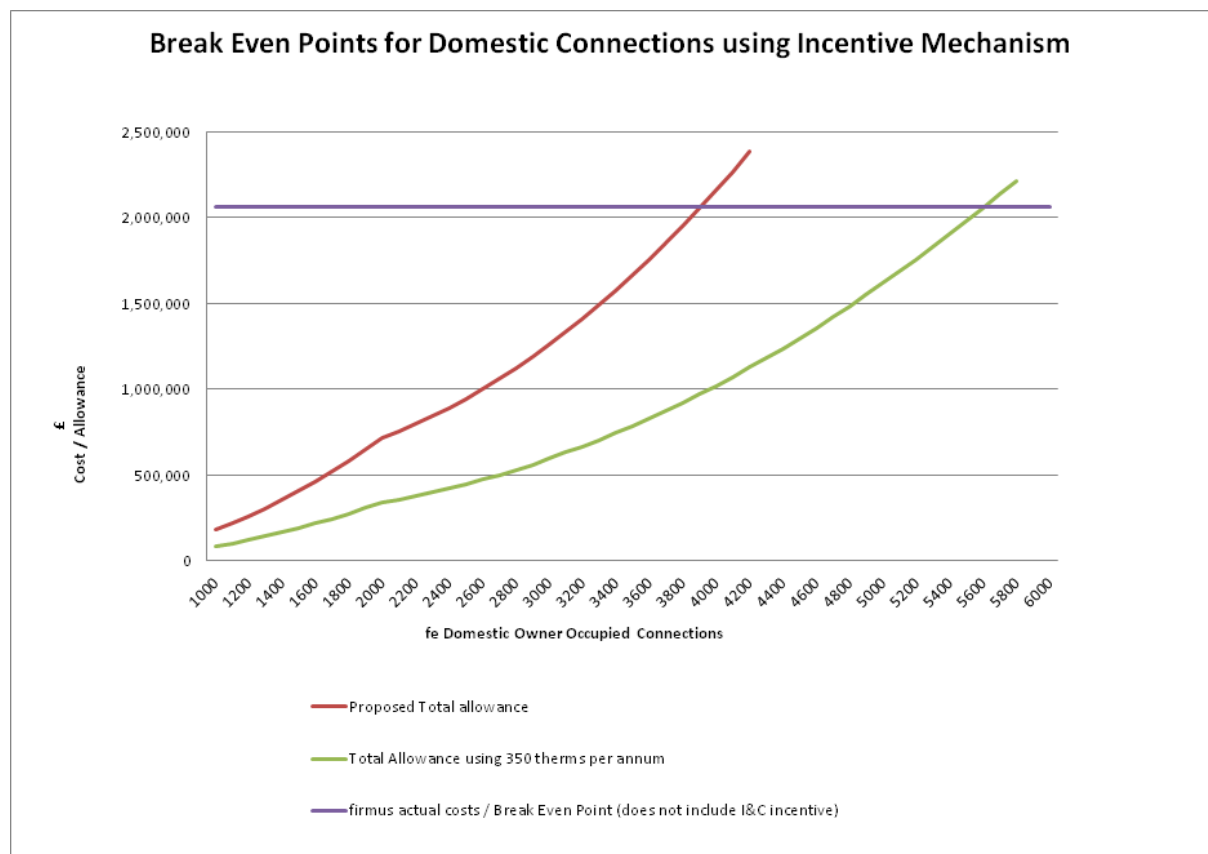
At present the Utility Regulator proposes that an allowance of £480 should be allowed for each domestic connection in order for firmus energy to recover its costs. Unfortunately this would mean that we would have to double our proposed connections to break even (3,907 connections per annum). In the event that we hit our target of 2,000 connections, then we would only recoup £720,000 of our Advertising & Marketing, manpower costs would be £1.3m short of our required costs for the year. This seems extremely inequitable.

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The second row in the table above highlights the problem with the model in the event that the Utility Regulator changes the input variable of average burn per domestic household. Should the regulator decide that a more accurate average burn per household was 350 therms per annum (which our current volume data point to), then the results are as tabulated above. This would provide an allowance of only £227 per connection and mean that firmus energy would require 5,607 connections each year to “match” Advertising/Marketing & manpower opex “cuts”.

These firmus energy breakeven cost points are graphically demonstrated in the diagram below.

Table 9: Breakeven Point Graph – Market Development Incentive



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8. Recovery Period Analysis and Exclusion of Infill Mains from the Incentive Mechanism Model

The table below shows the result of the Utility Regulator using more appropriate recovery periods and also not removing infill mains from the model's revenue stream in line with firmus energy not submitting a cost for this.

Table 10: Recovery Period Analysis and Exclusion of Infill Mains from the Incentive Mechanism Model

Recovery Period	Infill included in Analysis	UR proposed Allowance per domestic connection
15 years	Yes	£480
15 years	No	£987
40 Years	No	£2,142

As is clearly displayed in the tables above the Utility Regulator has not attempted to recommend a balanced allowance within its proposal and instead has opted to give firmus energy the lowest possible connection figure of £480.

firmus energy are of the opinion that by following the Utility Regulator's methodology, and in particular adhering to a 40 year capex recovery period and no inclusion of infill mains, firmus energy should receive a connection allowance of **£2,142** per domestic house.

Therefore, the Utility Regulator's current GD14 Proposals have departed from normal regulatory practice and rather than building upon PCR02 performance UR has proposed a mechanism for GD14 which will "*penalise and restrict*" firmus energy's future growth and development plans.

○ **Emergency and Network Maintenance costs**

Overview

Safety is firmus energy's key priority. We have a statutory obligation to maintain a safe and reliable network. We are regulated in terms of emergency and safety response procedures by the Health and Safety Executive for Northern Ireland (HSENI).

Since our licence was awarded in 2005, ensuring the safety of employees, contractors and the general public has been the overriding priority for firmus energy; which has been

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achieved through the promotion of a positive health and safety culture and adherence to legislation and recognised safety standards.

Therefore, we are unable to accept the Utility Regulator's proposed Emergency and Network Maintenance Costs.

Legal and Regulatory Framework

firmus energy's health and safety management system is based on best practice guidance from the HSENI. We have worked hard to ensure that we have received no HSENI or Department for Regional Development (DRD) Road Authority enforcements in our 8 years of operation. We are therefore deeply concerned that within the Utility Regulator's GD14 proposals is challenging HSENI best practice guidance in regards to emergency and maintenance procedures. As the Utility Regulator's current proposals stand they will place customers and the public more generally at a greater risk of injury.

firmus energy's distribution network and operations are subject to a framework of law and regulation which requires us to operate in a safe and responsible manner. firmus energy work very closely with the HSENI to ensure our compliance with (*inter alia*) the following laws and regulations:

- Health and Safety at Work (Northern Ireland) Order 1978;
- Gas Safety (Management) Regulations (Northern Ireland) 1997;
- The Pipelines Safety Regulations (Northern Ireland) 1997;
- The Gas Safety (Installation and Use) Regulations 1998; and
- The Pressure Systems Safety Regulations (Northern Ireland) 2004.

As part of the Gas Safety (Management) Regulations (Northern Ireland) 1997, the HSENI started their periodic audit of our Safety Case in 2010. This Safety Case is being reviewed by the HSENI in 2013 (and the first stage has been accepted) on the basis of firmus energy's current emergency and network maintenance procedures, and therefore we are deeply concerned that the Utility Regulator's current GD14 Proposals will require a change in our *modus operandi* in regards to emergencies and maintenance.

PCR02 Determination

The Utility Regulator's PCR02 determination stated that:

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“PBR (Parsons Brinckerhoff Rune) has carried out a high level review of fe’s emergency cost provision. PBR has concluded that fe’s costs per Public Report Escape (PRE) are falling and that the number of PRE’s are growing with the number of consumers, although more slowly. Indeed based on the information available PBR have concluded that the fe costs per PRE are similar to those in GB.....The Utility Regulator accepts PBR’s view on future maintenance liabilities & emergency response costs”.

Therefore, firmus energy would suggest that the Utility Regulator’s current proposals are “at odds” with its statutory objectives, and as to whether they have as per their 26th March 2013 GD14 approach update document considered *“local regional variations for all allowances granted.”*

firmus energy’s GD14 Submission

firmus energy is obliged to provide specific emergency services to comply with these regulations and therefore we provide:

- A 24 hour, 365 days a year emergency telephone service (Freephone) to deal with Public Reported Escapes (PREs); and
- firmus energy’s standards of service are that we aim to attend an uncontrolled PRE within one hour of being advised and a controlled (where a gas escape is suspected and the emergency control valve has stemmed the release of gas) PRE within two hours.

In addition, under Article 60 of the Gas Order, firmus energy has to undertake the following obligations:

- a) To make arrangements, in the event of the accidental escape or ignition of any gas in the line, to ensure immediate notice is given to the Northern Ireland Fire and Rescue Service, the Police Service of Northern Ireland; and any other body which the Department requires; and
- b) To provide maps and information to enable the relevant body to carry out its duties. As part of this obligation, firmus energy operates a “*Dial Before You Dig*” safety initiative to assist construction organisations to safeguard their operatives and safely avoid damage to our network.

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firmus energy reports its performance with regard to PREs in its annual Standards of Service performance to the Consumer Council.

Table 11: PRE Standards of Performance

PRE		2007	2008	2009	2010	2011	2012
Controlled	Target	90%	90%	90%	90%	90%	90%
	Actual	100%	99.7%	100%	100%	100%	100%
Uncontrolled	Target	90%	90%	90%	90%	90%	90%
	Actual	97%	97.5%	100%	99.6%	100%	99.8%

We respond to c.2,000 Public Reported Escapes per annum. We have received no HSENI, Gas Safe or indeed Consumer Council complaints for our work in this regard. Therefore, we are extremely surprised that the Utility Regulator's current proposals for GD14 do not give proper weight to our excellent and efficient performance in regards to PREs to date.

Table 12: Number of PRE's per Annum²⁷

PRE	2007	2008	2009	2010	2011	2012
Controlled	202	463	673	1,510	1,295	1,928
Uncontrolled	37	40	40	41	42	37
Total	239	503	713	1,551	1,337	1,965
Customers	1,707	3,513	6,582	9,321	12,732	16,577
PRE per Customer	0.14	0.14	0.11	0.17 ²⁸	0.11	0.12

In light of the Competition Commission's PNGL determination comments that a regulator should adhere to prior decisions unless it is at odds with an appropriate balance of its statutory objectives. We would therefore challenge this regulatory approach and question why the existing PCR02 emergency and maintenance costs and procedures are now "at odds" with the Utility Regulator's current thinking. To date, firmus energy emergency and maintenance performance has fully supported the Utility Regulator's principle statutory objective of the "*development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland.*"

○ **Call Centre Costs**

firmus energy current emergency call centre arrangements with the National Grid emergency call centre at Hinckley were negotiated by PNGL in 2007 on the basis of a single emergency

²⁷ As per our submitted Standards of Performance to the Consumer Council for Northern Ireland.

²⁸ December 2010 was Northern Ireland's coldest calendar month in the last 100 years. Source: Met Office (www.metoffice.gov.uk)

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freephone number (0800 002 001) for both Northern Ireland GDNs. The current arrangements were agreed with HSENI to ensure the quality of the service provided for this critical service satisfied the requirements within our gas licences as well as HSENI legislation and regulation.

Within its GD14 proposals the Utility Regulator has proposed that a 50% saving of the fixed modelled call centre costs is incorporated into the proposed future allowances as they believe savings could be made by firmus energy and PNGL working more closely together and putting a single contract in place.

As firmus energy and PNGL are already working in partnership on gas safety and response activities, we are therefore deeply concerned that the Utility Regulator within its GD14 proposals is challenging procedures that have been agreed with the HSENI and ultimately could place the public in general at significant risk.

As firmus energy highlighted in its GD14 Submission, our current contract with National Grid (Hinckley) is due for renewal next year, in March 2014. Following discussions with HSENI, we are already working in conjunction with PNGL in developing a new contract. However, both companies will ultimately be guided by HSENI as to the preferred approach and provider.

The 2014 contract will be our first contract since 2007; during that time firmus energy's customer numbers have grown more than tenfold.

Table 13: Difference between the number of firmus energy customers in 2007 and 2014

	2007	Mid 2013	% difference
Customers	1,707	19,392	1,036%

The fixed cost element (£84,957 for 2013) of our current contract is based on our customer base and therefore we see no justification for the Utility Regulator's proposal of a 50% reduction in these costs. firmus energy does not believe the Utility Regulator's current position can be justified as it runs contrary to agreed health and safety practice. We are unable to accept the Utility Regulator's argument that the level of emergency first call outs will reduce as firmus energy increases its customer base as an increasing number of the general public in Northern Ireland will be able to define the difference between the smell of natural gas and other odours.

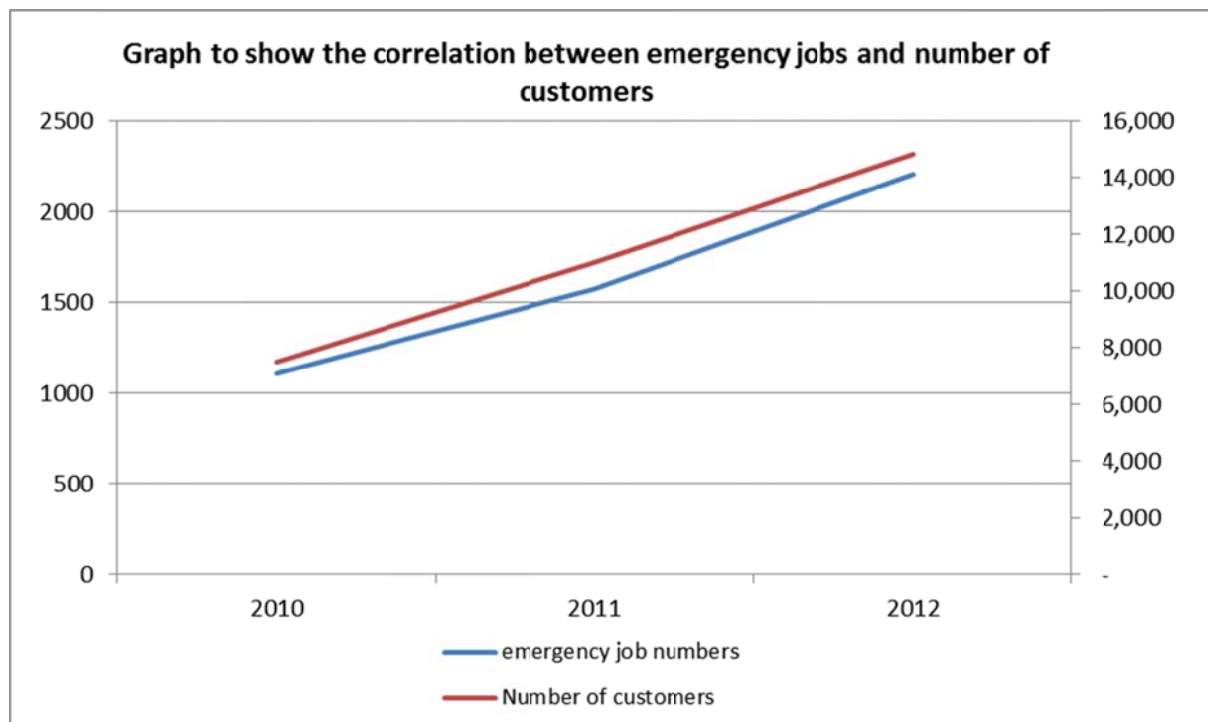
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Indeed with an increase in customer numbers and therefore an increase in emergency calls, there is a business case for any future emergency handling service to increase the fixed cost element as the number of customers/calls increase as well as increasing cover for high volume of calls experienced during winter peak periods.

Historical data shows a rise in the number of response calls and a direct consistent correlation between the number of customers and the number of response jobs. From 2010 to 2012 the correlation between the number of response jobs and the number of customers is 15% and hence our differing view with the Utility Regulator's GD14 proposal that we should start to see a reduction the volume in these calls.

Given the significant safety implications, we plan to seek a meeting with HSENI and the Utility Regulator to discuss this.

Table 14: Correlation between emergency jobs and the number of customers for the firmus energy network area.



We do not agree with the Utility Regulator's proposals for emergency call costs, however we would be interested to know how the Utility Regulator within its proposals will treat any calls received over and above the number they have allowed for firmus energy – as firmus energy has a responsibility under legislation to respond to every smell of gas and gas alarm call

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received from within our licensed area. Therefore the number of calls we receive are outside firmus energy's control as these calls are generated from members of the public who believe they smell natural gas and if the area/address is within our licence area, firmus energy are legally required to undertake a site visit to investigate all potential/reported smells of gas.

The Utility Regulator should understand that during "*out of hours*" (Weekends and 5pm-9am Monday to Friday) firmus energy has contracted the services of an external call centre (Messagepad). Part of Messagepad's service is to reroute emergency calls that come to firmus energy's normal customer number (08456 08 00 88) onto Hinckley. These costs were included within firmus energy's GD14 Submission and no provision has been made for these costs within the Utility Regulator's GD14 proposals. Our "*out of hours*" procedure has been agreed with HSENI and we therefore vehemently disagree with the Utility Regulator's proposal to remove these essential costs and we would urge for these to be reinstated.

In addition, we are concerned that the Utility Regulator's proposed model for GD14 has produced an allowance of circa 980 emergency jobs per 10,000 customers for PNGL in 2014. PNGL has a much more established customer base and have been in operation since 1996 (17 years). On the other hand for firmus energy in 2014, the Utility Regulator has proposed an allowance of circa 720 emergency jobs per 10,000 customers. firmus energy would question the discrepancy in approach and the rationale behind this decision.

Furthermore, firmus energy in 2014 plans to increase its customer base by over 4,000 new customers, an increase of around 20%. PNGL in 2014 plans to increase its customer base by adding 8,778 new customers, an increase of 5%. The Utility Regulator's GD14 model does not reflect this relative percentage increase within its overall calculation and it therefore should be amended to reflect this.

firmus energy is keen to work with the Utility Regulator, HSENI and PNGL to ensure we get the best overall deal for the customer in regards to call centre costs. We are content for these costs to be treated as pass-through costs, as it is essential that we ultimately operate a call centre service that is efficient and meets the HSENI best practice criteria with regards to Health and Safety legislation and regulation.

Indeed, we again believe the Utility Regulator's proposals are a clear departure from the precedent set in firmus energy's previous price controls (PCR01 and PCR02).

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○ Emergencies (First Call Costs)

The Utility Regulator and PBR accepted firmus energy procedures with regards to emergency costs in the Utility Regulator's PCR02 determination. In PCR02 the Utility Regulator stated that:

"PBR have concluded that the fe costs per PRE are similar to those in GB.....The Utility Regulator accepts PBR's view on future maintenance liabilities & emergency response costs....The Utility Regulator has also provided an allowance to take account of the increased maintenance costs (store, standby allowance and callout costs) resulting in the retendering of the engineering contract."

firmus energy would therefore question why the Utility Regulator's GD14 proposal is so inconsistent with the Utility Regulator's PCR02 determination.

The Utility Regulator in its GD14 proposals sets out that:

"There is assumed to be a lower degree of flexibility in the workload/flexibility of FE emergency manpower than PNGL can derive from its contract with PES for emergency response."

The only "non-productive" time relates to time taken to drive to and from a location of the PRE in the firmus network area. It is therefore completely incorrect and inaccurate to equate firmus energy and PNGL in this regard. As firmus energy's GD14 Submission set out:

"in comparison to the other gas distribution network in Northern Ireland (PNGL), firmus energy's network is more dispersed and provincial in nature. The North-West and South-North Pipeline in the firmus energy licence area covers a distance of 271km between Derry and Warrenpoint. This compares to a distance of around 75km (Larne-Belfast-Donaghadee) in PNG's Belfast Licence area."

As firmus energy's and our Period Contractor's engineers need to travel further to (as set out above) and from a PRE location than the equivalent within Belfast there is an appropriate and justified reason for this²⁹. It is unfounded for the Utility Regulator to state:

"lower degree of flexibility in the workload/flexibility of FE emergency manpower than PNGL can derive from its contract with PES for emergency response."

firmus energy has an average response time of 37 minutes. This would compare very

²⁹ Over the North-West pipeline firmus energy has 2 JCB Excavators - 1 JCB covers Derry and Limavady area due to the large workload in Derry. The other JCB covers Antrim, Ballymena, Ballymoney, Coleraine, Bushmills, Portstewart – distance of approximately 65miles and a JCB's maximum speed is 30mph and an average fuel consumption of <10mpg.

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favourably with comparators. firmus energy believes it has much greater flexibility with regard to workload and emergency response provision.

firmus energy would like to make the following points about the Utility Regulator's GD14 proposals in regards to this cost line:

- The fixed cost associated with emergency response comprises an emergency retainer and stores cost.
- Due to the 271km distance within the firmus energy network and the HSENI agreed industry standard response time of one hour for an uncontrolled gas escape call; firmus energy pays a retainer to operatives who are “on call” outside of normal working hours. The retainer includes four 1st responder operatives and 2 emergency teams to be “on call” to cover the North-West (2 responders and 1 emergency team) and the South-North pipeline (2 responders and 1 emergency team) and then a call out payment is made if an actual PRE emergency call is made.
- firmus energy maintains two stores (one in the North-West and the other the South-North) for its 271km distance of coverage of the network to provide emergency materials /equipment to be able to attend to calls efficiently.
- Within the GD14 Proposals the Utility Regulator has modelled £6k per area as a fixed emergency cost. firmus energy believes this figure is unrealistic.
- The Utility Regulator's Model considers domestic meter installation jobs (faults) as “planned” emergency jobs and therefore does not take these into account when deriving the average cost per emergency. The average variable cost per emergency job for 2010-2011 was £185. However, the Utility Regulator's GD14 Draft Determination shows firmus energy's GD14 submission as £126, £125 and £124 for 2014-2016 respectively. firmus energy's submitted costs (including domestic meter installation jobs) produces a variable cost per emergency of £206 for the 2014-2016 period which is more in line with the 2010-2011 average, taking into account the uplift for the retendering of the engineering contract and cost of materials used; which have not been considered by the Utility Regulator.
- The Utility Regulator's GD14 Model has removed the modelled fixed cost from the

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emergency call costs from 2009 to 2012. There is no fixed cost element within the emergency call cost line as these costs are the variable costs only for responding to an emergency. firmus energy reported the fixed cost (emergency retainer/stores) as a separate line in response to the Utility Regulator's Information Request No.2. Including the fixed cost element for the period 2014-2016 produces an average total emergency cost per job of £256. This element needs therefore to be included within the Utility Regulator's GD14 model.

- The Utility Regulator's GD14 proposal has removed the costs involved for any emergency team to respond to situations where there is a suspected smell of gas which on inspection turns out to be a "no trace". These costs should be reinstated.
- Within the Utility Regulator's GD14 proposal there has been no consideration of the costs of PRE emergency maintenance materials that were included within firmus energy's GD14 Submission costs lines. These costs should be reinstated.

- **Maintenance Activities**

firmus energy would highlight that the Utility Regulator's treatment of Maintenance Activities is inconsistent with their PCR02 Determination. The Utility Regulator's PCR02 Determination states that:

"PBR have concluded that the fe costs per PRE are similar to those in GB.....The Utility Regulator accepts PBR's view on future maintenance liabilities & emergency response costs....The Utility Regulator has also provided an allowance to take account of the increased maintenance costs (store, standby allowance and callout costs) resulting in the retendering of the engineering contract."

The Utility Regulator within its GD14 Consultation has stated there was a;

"lack of detailed information from fe".

firmus energy strongly disputes this. To date we have provided the Utility Regulator with this information several times:

1. Annual Cost Reporting;
2. firmus energy's GD14 Submission; and

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3. Utility Regulator Information Requests.

As previously set out in this consultation response, from the outset the administration and management of the GD14 price control process has not been completely clear or transparent. We are extremely concerned that for such a business critical activity the Utility Regulator has not ensured there is a mutual understanding of the processes involved.

firmus energy has spent significant time and resource preparing cost analyses in various guises and formats which the Utility Regulator has requested.

The Utility Regulator's actions in this regard are very different to the RIIO process where Ofgem has gone to significant lengths to clearly and transparently set out the processes involved at the earliest possible stage, with supporting documents, spreadsheets etc. which show all stakeholders exactly how the process will run and the format in which data should be provided. Therefore we feel it is unmerited and disingenuous that the Utility Regulator has chosen to make these comments; especially as we are the only Northern Ireland GDN to comply with the Utility Regulator's 2010 requirement for annual cost report data.

With regard to Utility Regulator's proposed costs for Maintenance Activities we would make the following points:

- Pressure Reduction Station (PRS) maintenance costs have not been taken into account within the Utility Regulator GD14 Proposals. These costs need to be reinstated as they are an essential cost element to ensure the safety of the network under PSSR legislation (Pressure Systems Safety Regulations (Northern Ireland) 2004).
- The Utility Regulator's Model has assumed, based on historical costs, £225k as a fixed cost rolled forward. As a relatively young network company firmus energy has not been required to carry out significant major maintenance on its assets to date. Therefore, it is entirely inappropriate for the Utility Regulator to reduce firmus energy's submitted costs by 50% because costs have been historically low.

As firmus energy's assets age, greater maintenance cost will be required for example, the pressure reducing equipment used for customer and district equipment requires annual maintenance and annual Pressure System Safety Regulations (PSSR) checks, but also they will require a comprehensive overhaul every 5 years.

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There have to date been limited instances of this type of maintenance work, but the frequency of this work will now naturally increase as the firmus energy network develops and ages.

Table 15: Maintenance and Overhauls(Pressure Reduction Stations and Meter Rigs)

Year	Meters ≥65 Commissioned	DPRM ³⁰ s ≥160 SCMH ³¹	Total	Maintenance Visits	Overhauls
2006	22	0	22	1	n/a
2007	96	13	109	23	n/a
2008	123	20	143	119	n/a
2009	77	14	91	242	n/a
2010	50	25	75	319	n/a
2011	44	25	69	369	n/a
2012	51	22	73	413	131
2013	23	7	30	464	143
2014	25	5	30	494	91
2015	20	5	25	524	75
2016	20	5	25	549	69
2017	20	5	25	574	204
2018	20	5	25	599	173

In addition, other maintenance will now need to be undertaken (bridge surveys and inspections, valve manhole lids, critical valves etc.) as assets start to reach a stage in their life expectancy where more detailed inspections are necessary – which has not been the case in the early years of firmus energy’s network development and therefore no previous historic cost has been incurred for these items.

The Utility Regulator’s maintenance model includes a variable cost. The Utility Regulator has chosen to derive this model on a cost ratio based on PNGL Industrial and Commercial and domestic customer numbers. As the Utility Regulator is aware, firmus energy’s customer base is significantly different to PNGL, as the firmus energy network area has a considerably higher percentage of Industrial and Commercial customers than PNGL (10% vs. 2%) and due to the current written scheme of examination, many of these installations require annual maintenance and PSSR checks. Therefore the Utility Regulator’s modelling is inaccurate and is not reflective of firmus energy’s actual customer base and we would ask for this to be amended. Providing allowance for firmus energy based on PNGL customers only goes towards

³⁰ DPRM – District Pressure Reduction Modules

³¹ SCMH – Standard Cubic Metres Per Hour

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reinforcing our belief that firmus energy has been treated as the “*junior partner*” within the GD14 process; rather than being afforded the correct status as a distinctly different licence holder who has specifically different costs due to a very different licence and level of maturity.

- The Utility Regulator seems to have misunderstood firmus energy’s GD14 submission in relation to our submitted Personal Protective Equipment (PPE) costs. Under Health and Safety legislation³², firmus energy must supply flame resistant PPE to all relevant engineering staff who undertake site duties and who also attend gas emergencies. There is also a requirement to provide a number of basic items of PPE to other members of firmus energy staff who may carry out duties on new build sites or other sites where the use of PPE is mandatory.

In addition, each engineer needs to be provided with a personal gas monitor (for carbon monoxide and other potentially harmful gases) and gas detection equipment to help trace the location of a gas escape. The gas detection equipment used by the engineers requires monthly checks to ensure it is recording known gas quantities within acceptable tolerances and requires a six month calibration similar to that required for personal monitors and pressure gauges. Due to wear and tear over 8 years of operation, a number of items of detection equipment are now in need of replacement. This is therefore not a cost that would have been historically incurred during the PCR02 period and therefore it should be included with GD14 costs.

-
1. ³² Health & Safety at Work Order
 - Section 8 – Employees cannot be charged for anything done or provided, to comply with the relevant statutory provisions e.g. PPE
 2. Construction (Head Protection) Regulations.
 - Every employer must provide suitable head protection for each employee and maintain it and replace it.
 3. Personal Protective Equipment at Work Regulations.
 - PPE is defined as all equipment including clothing affording protection against weather, which is intended to be worn or held by a person at work and which protects them against one or risks to their health & safety.
 - Reg. 4 – Every employer shall ensure that suitable PPE is provided to their employees who may be exposed to risks except where the risk has been adequately controlled by other means i.e. PPE should be a last resort, not the first line of defence. PPE shall not be suitable unless:
 - It is appropriate for the risk and conditions of its use
 - It takes account of the ergonomic requirements and health & Safety of the wearer
 - It is capable of fitting the individual
 - It is SFARP able to combat the risk without increasing overall risks
 - It complies with UK legislation i.e. CE marked
 - Reg. 7 – Every employer shall ensure the PPE provided is maintained, including be replaced and cleaned, in sufficient state. Maintenance must be in proportion to the risks involved.

To this we have identified the risks involved with Gas Operations as being higher than that of adverse weather, thus we have supplied inherently flame retardant PPE to those who work with live gas operations (engineers), and only provide hi-viz and weather-proof PPE to others (sales).

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Due to the site conditions that the majority of engineers are subjected to there is a requirement to have PPE clothing cleaned several times throughout the year and there is also a requirement to replace a number of items of PPE clothing on a yearly basis.

It has been calculated that PPE spend will be approximately £32k in 2014 (mainly due to the replenishment of equipment) and this figure will reduce to £13k for 2015 and £13k for 2016.

- The Utility Regulator has modelled a 10% efficiency adjustment which we feel is inappropriate, as not only is the Utility Regulator choosing to use the most favourable industry costs within their modelling they are also reducing these costs by a further 10%. This approach is unsustainable and inappropriate for firmus energy as we are already a new and developing GDN, with a modern network system which is already extremely efficient, as previously recognised by the Utility Regulator.

- **Asset Management System**

In firmus energy's GD14 Submission, we stated that:

"firmus energy plans to implement PAS55 during GD14 to ensure the optimal management of our physical assets. As previously mentioned in this Submission, firmus energy has a relatively new and growing network, however within GD14 we will begin to undertake a replacement of some of our early implemented assets as their lifespan will begin to exceed the ten year manufacturers' guarantee. Therefore, to ensure overall cost savings for consumers we would like to implement this "defacto world-wide specification system" within GD14, to ensure the replacement of our physical assets is cost effective, and takes place at the optimal time. We will write to the Utility Regulator separately on this issue to discuss the process and the costs involved."

In our discussions on the 16th April 2013 with Rune Associates it was agreed that our current asset management system was; *"fit for purpose and appropriate for the size and age of firmus energy's business"*. However, going forward a PAS55 type asset management system should be introduced. Therefore, it is inconsistent that the Utility Regulator within its GD14 proposals states that:

"We are not minded to grant any allowance for implementing such a system given that this system should have been part of how FE set up its business and it would actually be beneficial to FE. We note also that UR has never made an allowance to PNGL to implement an equivalent system, and Ofgem has never made an allowance to a GDN for this activity."

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Nevertheless, we support FE's intention and do expect FE to go ahead with implementing a comprehensive asset management system based on PAS55 principles that will drive cost effective optimisation of maintenance and replacement policies during the GD14 period.

We are proposing a reduction of 10% to the baseline maintenance costs to reflect that FE has not implemented, or even started to develop an asset risk management system such as PAS55. Our opinion is that FE should have developed such a system from set-up in 2006. It is considered best industry practice to operate such a system, and would in fact be beneficial to FE."

Prior to the GD14 Consultation, the Utility Regulator had made no mention of the need for firmus energy to have PAS55 before now. Indeed, the Utility Regulator's PCR02 determination document makes no mention about PAS55 and therefore this decision is inconsistent with previous discussions as previous Utility Regulator decisions on allowable maintenance costs were not related to the application of PAS55.

Furthermore, the GD14 Proposal penalises firmus energy for not having a system that we were not previously required to introduce, and for which we could not have recovered the costs, this seems to go beyond the bounds of normal regulatory practice. Therefore, we would request that the 10% reduction in costs is removed.

○ **Manpower**

Overview

Manpower costs are a key component of ensuring the success and development of firmus energy's 2005 licence agreement. The Utility Regulator within its GD14 proposals has used 2008 as the base point for its GD14 Proposals and in doing so has decided to base its manpower allowance on the model and manpower numbers derived from the costs and employees retained by firmus energy during 2008 (five years ago).

Clearly, firmus energy is a very different company now to what it was five years ago, and it can no longer operate efficiently or effectively based on the 2008 staffing levels. Therefore, we would vehemently challenge the Utility Regulator's current manpower proposals.

Utility Regulator's GD14 Proposals

The Utility Regulator in its proposals has used 2008 as the base point for its GD14 Proposals and in doing so provided firmus energy with 46 FTE (Full Time Equivalent Staff) to operate our Distribution Business.

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This proposal is even inconsistent with the PCR02 determination which provided firmus energy with an average of 56 FTEs. In addition, over the PCR02 period firmus energy connected 49% more customers than the determined target and therefore we need more staff to deal with these additional customers and our proposed increased connection levels (4,000 per year compared with the 2005 licence target of 2,000 connections per year). We would therefore request appropriate allowances from the Utility Regulator.

In firmus energy's GD14 Submission, we requested the following staffing levels:

Table 16: GD14 Manpower Levels

	2014	2015	2016	2017	2018
Manpower	60	62	62	62	62

firmus energy requires 4 additional FTE's over current staffing levels to assist with Market Opening within our Transportation Services Team. However, the Utility Regulator's model has only used the 2008 staffing levels and then allowed firmus energy four extra staff for the GD14 period.

Whilst we welcome the 4 additional staff, there is no logical rationale in implementing a model based on staffing levels and costs from 5 years ago, as the dynamic of the distribution business was considerably different at that time. This can be seen by examining the current organisational drivers and comparing with those in 2008.

Table 17: 2008 vs. 2013

Driver	2008	2013	% Difference
Annual Ten Towns Volume – Therms	c.24 million	c.53 million	c.120% increase
Ten Towns Customers	c.3,500	c.20,000	c.470% increase
Network Size – Kilometres	c.360 km	c.800km	c.120% increase
Connections per year	c.1,900	c.4,200	c.120% increase

Within the GD14 Proposals the Utility Regulator has stated the following reasons for their current manpower allowance and for using the 2008 model and associated FTEs in their assessment:

- firmus energy's submitted number of FTEs fluctuates substantially between 2009 – 2012;
- Due to these fluctuations Utility Regulator has decided to use 2008 actuals as a baseline for determining the GD14 allowances; and

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- 2008 was the last year in which the Utility Regulator had full and consistent manpower figures.

We have submitted GD14 Manpower costs to the Utility Regulator in 4 formats to date:

1. Regulatory Accounts;
2. Annual Cost Reporting;
3. firmus energy's GD14 Submission; and
4. Utility Regulator Information Requests.

Therefore, we again make the comment that the GD14 price control process has not been clear or transparent from the outset. firmus energy has spent significant time, effort and resource preparing these costs in the various formats which the Utility Regulator has requested.

However, to try and minimise our differences on this issue, firmus energy has carried out the following actions:

- 1) We have re-modelled our manpower data to reconcile precisely with the regulatory accounts submitted for 2009 – 2012. This clearly shows how the manpower cost has been apportioned and breaks down our submitted figures and FTEs into more detail. This will be made available for Utility Regulator analysis and it is our opinion that Utility Regulator will now be able to model firmus energy manpower allowance based on the actual costs in PCR02 rather than those costs applicable to distribution in PCR01.
- 2) The format of our manpower submission has also been amended to mirror that which was considered acceptable in 2008 and also incorporates a pay band structure that the Utility Regulator could now deem necessary for their regulatory analysis.
- 3) The pay band structure used in the manpower format has been compiled by examining the current band structure of firmus energy and previous pay scales. Due to the wide scale of these bands and therefore the overlapping nature of them, for clarity we have represented all employees within an average pay band of four evenly separated levels.

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- 4) We have provided an explanation for the fluctuations in the Distribution FTEs during the period of 2009 – 2012. In 2011 we reallocated various Distribution employees into a Electricity project to help to develop a platform for electricity – Oracle CC&B (Customer Care and Billing). Replacement staff were not fully in post until that latter part of the year. firmus energy realised that this was unsustainable because numerous distribution employees were being asked to increase their personal workloads to unreasonable and unmanageable levels. As a result a business decision was taken to mothball the non-critical elements of CC&B and these employees returned to undertaking their original distribution roles, and this is why normal FTE levels returned in 2012. firmus energy would therefore argue that an upward or indeed downward spike in the overall trend line of manpower - as seen in 2011 - should not be used in assessing the general long-term FTE requirements of the organisation.

Our revised GD14 submission costs for 2014 - 2016 still remain the same and are detailed in Table 12 below.

Table 18: firmus energy GD14 Manpower Submission

Original firmus energy Submission			Reformatted firmus energy Submission		UR Allowance	
Year	FTEs	Manpower Opex (£000)	FTEs	Manpower Opex (£000)	FTEs	Manpower Opex (£000)
2014	60	2,091	60	2,091	48.5	1,636
2015	62	2,210	62	2,210	50.5	1,666
2016	62	2,430	62	2,430	50.5	1,863

firmus energy believe that in the analysis of the organisation, any exceptional years such as 2010/2011 should be seen as an “outlier”.

By flattening out these spikes, it is clear that Manpower follows a distinct trend that justifies firmus energy’s submitted Manpower costs for 2014 – 2016 rather than those suggested within the Utility Regulator’s GD14 Proposals.

Table 19: firmus energy Distribution Manpower Costs (2012 prices)

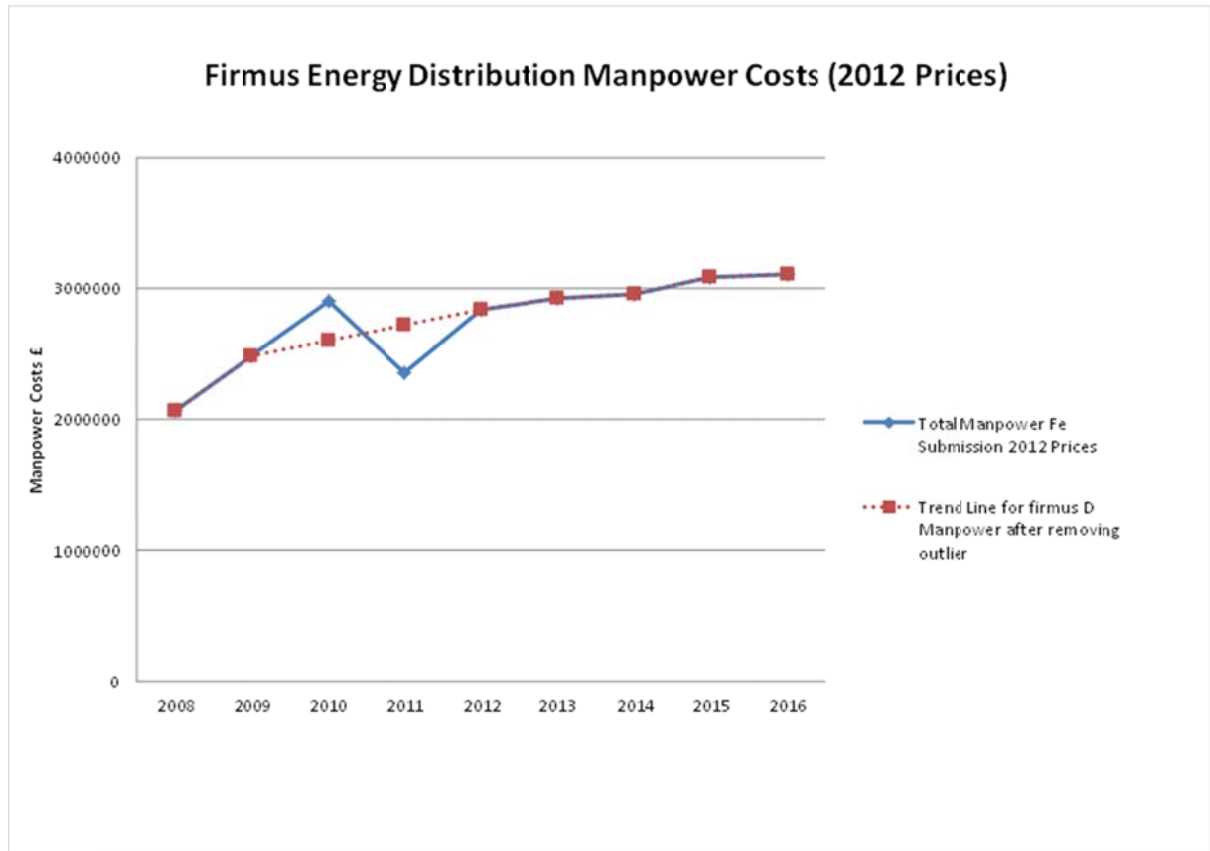
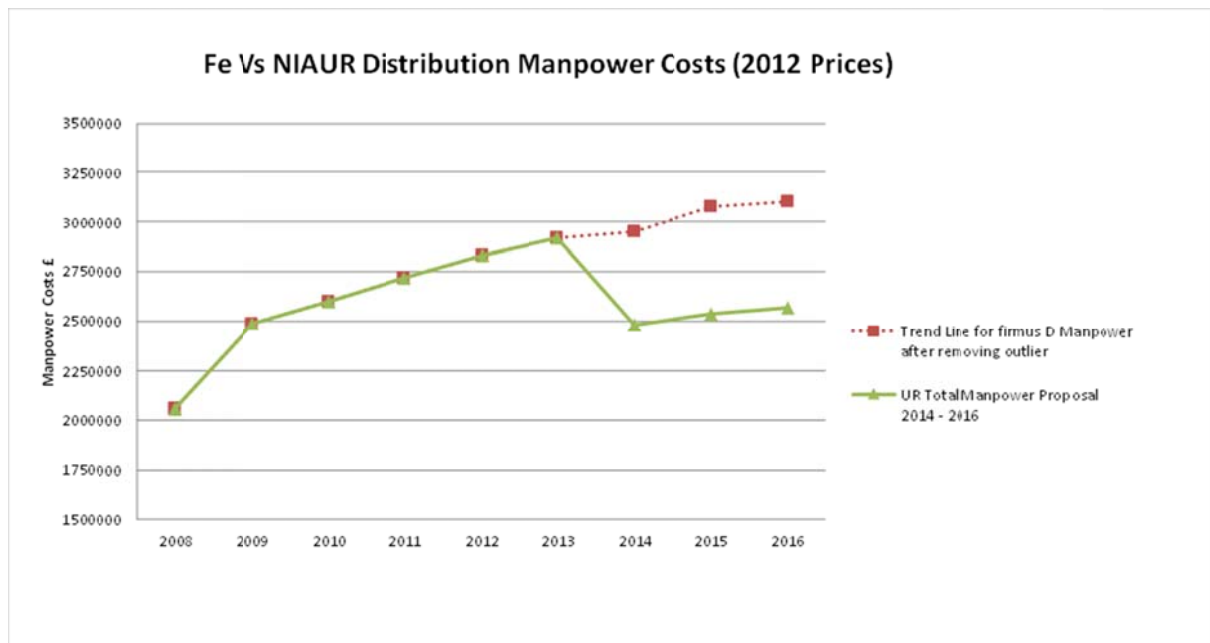


Table 20: firmus energy vs. Utility Regulator Manpower Costs (2012 prices)

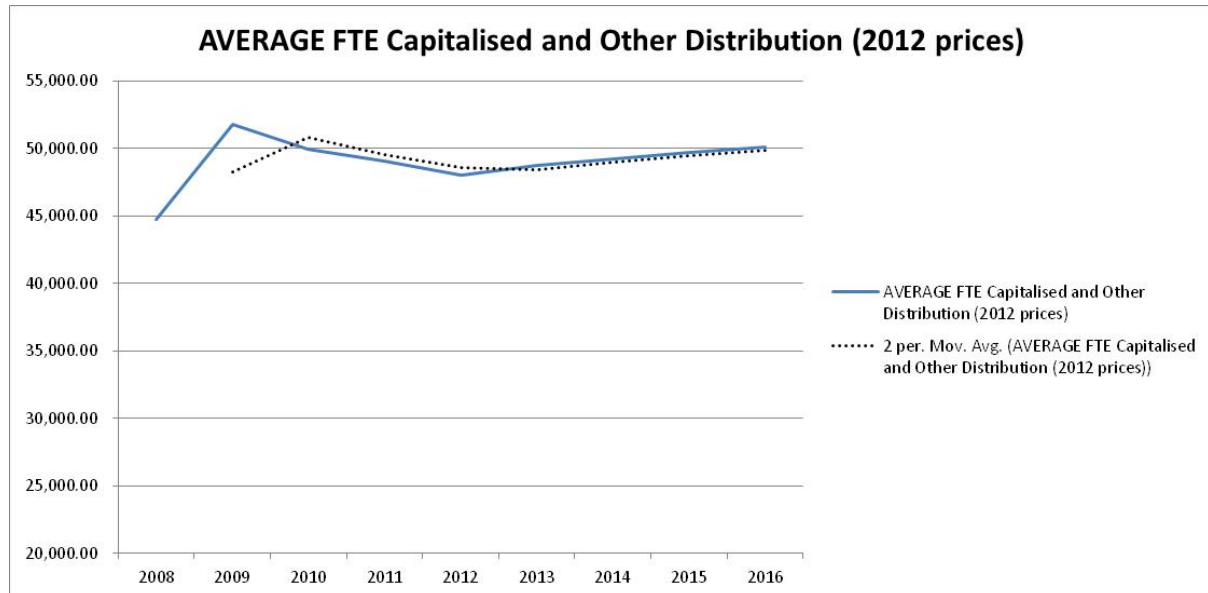


We are of the opinion that our regulatory accounts also show a stable average cost of FTE in

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the distribution business over the course of the last 5 years. It is this continued flat average cost of FTE that we believe is evidence that firmus energy are not inflating their estimated manpower costs in a manner that Utility Regulator is suggesting within its GD14 Proposals.

Table 21: Average FTE Capitalised and Other Distribution (2012 prices)



In addition, to the Utility Regulator's proposal that our manpower allocation be cut by approximately £500k each year over the course of the price control, the Utility Regulator has indicated that around 33% of our manpower costs are to be retrieved through the Connections Incentive Mechanism. We are of the opinion that by using the outdated and flawed 2008 base model for our costs, the Utility Regulator has in turn misrepresented the value of those costs to be recovered through the Connections Incentives Mechanism. This is considered in more detail within our comments regarding the Utility Regulator's proposed Connections Incentives Mechanism.

We acknowledge and are grateful that the Utility Regulator, at our meeting of the 12th September 2013, agreed with firmus energy GD14 Submission of 62 FTE's for the GD14 Period.

○ **Office Costs**

firmus energy's offices are located in converted "shell" units within Kilbegs Business Park in Antrim. Antrim provides firmus energy with access to all of the towns within our network area within one hour's journey time (average response to PRE's is 37 minutes). Within our GD14 Submission we included costs for rental, business rates, cleaning, security, light, power and heat within this cost area.

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In regards to the Utility Regulator's GD14 Proposals we make the following comments:

IT Support

Regarding the Utility Regulator's GD14 proposals, the following comments have been made:

"IT Support. FE has requested £61k per annum for IT support from 2014-2015 and this has been agreed subject to FE confirming subsequent to this consultation publication and its parent company no longer uses the IT system the request relates to (FELIVE)."

firmus energy can confirm that our parent company no longer uses the Integrated Utility System (IUS); which is also known as FELIVE. Bord Gáis Energy has moved onto Oracle (CC&B) system in 2008.

Heat and Light, postage, courier and cleaning costs

As for heat and light, postage, courier, and cleaning costs the Utility Regulator makes the following comments within the GD14 Consultation:

"All of these cost lines are set to increase significantly in the last one or two years of PCR02 with the new higher levels extended by FE into its GD14 requested allowances. However, we have not been able to ascertain the rationale for these expected increases and have therefore taken average spend over recent years to determine our proposed allowances. For this group of costs we are collectively permitting £232k versus a requested £338k for the three years of the price control."

The reason for these increases in firmus energy's submitted GD14 costs is a result of renewed cleaning contracts, increased levels of site security, building maintenance and energy costs over the years. Furthermore our Direct Mailing operations to promote connections has continued to expand as we develop the network and build upon our Experian MOSAIC market research findings, and as a result of this we have seen an increase in our postage costs.

Our 2012 actual costs from the Regulatory Accounts have now been made available and these figures validate the firmus energy GD14 Submission costs. The table below details the 2012 actual costs against our submission and the proposed Utility Regulator's allowance.

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Table 22: GD14 Office Costs

Office Cost	2012 Actuals	firmus energy GD14 Submission 2014	firmus energy GD14 Submission 2015	firmus energy GD14 Submission 2016
Heat & Light	21,129	32,510	32,510	32,510
Cleaning	32,443	30,000	30,000	30,000
Postage (Non Billing) & Courier	54,820	50,000	50,000	50,000

Office Cost	2012 Actuals	2014 UR Allowance	2015 UR Allowance	2016 UR Allowance
Heat & Light	21,129	19,411	19,411	19,411
Cleaning	32,443	20,641	20,641	20,641
Postage (Non Billing) & Courier	54,820	37,197	37,197	37,197

These updated actual figures need to be reflected within the Utility Regulator's final GD14 Determination

Other Items

In terms of **Other Items**, the Utility Regulator makes the following comment in its GD14 proposals:

"We have removed the 5% uplift in rent claimed by FE. We have also provided lower allowances than requested for a number of less material cost lines such as office rental, security, service charges, stationery and 'other office costs'. Allowances for the remaining categories have been set broadly in line with historical spend (after adjusting for any sudden spikes in cost)."

The Utility Regulator has not provided firmus energy with any justified rational for these proposed costs. In addition, we would question whether this level of detail is consistent with the Better Regulation Task Force proportional approach and the Utility Regulator's stated "proportional" approach of the 3rd December 2012, and the 26th March 2013. Therefore we would respectfully ask for these costs to be reinstated.

○ Parental Recharges

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Our parent company, Bord Gáis Éireann (BGÉ) currently provides a number of services to firmus energy including central corporate services, grid control and transportation services, as well as health and safety support. Contracting BGÉ has protected firmus energy from having to employ third party providers.

We welcome the Utility Regulator's allowance in regards to our submitted grid control, GIS and meter reading costs, however do not understand the Utility Regulator's justification for its proposed GD14 allowance for central services cost. However, in its GD14 proposals the Utility Regulator has fundamentally misunderstood the reasoning behind the services provided by BGÉ to firmus energy. The Utility Regulator is minded to set allowances for the GD14 period at those granted in PCR01 (i.e. the average of actual cost for the period 2006-2008). This is unreasonable and wholly underestimates the true cost of servicing a growing company which has changed significantly since 2008. This can be seen by again examining the current organisational drivers and comparing with those five years ago (2008).

Table 23: firmus energy 2008 vs. 2013 Performance

Driver	2008	August 2013	% Difference
Annual Ten Towns Volume – Therms	c.24 million	c.53 million	c.120% increase
Ten Towns Customers	c.3,500	c.20,000	c.470% increase
Network Size – Kilometres	c.360 km	c.800km	c.120% increase
Connections per year	c.1,900	c.4,200	c.120% increase

Since our licence was awarded, firmus energy has grown rapidly. The central services recharge has been based on an allocation by business division, an approach agreed by our parent company and the Commission for Energy Regulation (CER). This allocation works on the principal cost drivers of headcount, opex costs and size of business premises.

firmus energy are therefore caught between two Regulators each with differing views on how these costs should be treated. firmus energy would therefore ask that there is a common approach by the Utility Regulator and CER in this regard as it is inconsistent and ultimately inequitable on firmus energy as a company if there is not ultimately an overall balanced regulatory approach across the island of Ireland to these costs.

The table below shows the 2012 central services recharge broken down with drivers identified.

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Table 24: Parental Recharge Drivers

Service	Driver	% of Total Costs	2012(£)
Corporate	Opex Costs	2.8%	69,782
Finance	Headcount	8.0%	316,185
IT	Headcount	8.0%	N/A for 2012
Secretariat	Opex Costs	2.8%	27,365
HR	Headcount	8.0%	69,162
Total	-	-	482,493

From the information above it can be seen that the final central service 2012 cost was similar to our forecast of £475k. This was helped by the fact that due to restructuring of BGÉ there was no IT cost attributed to firmus energy for 2012. Going forward this cost will be a direct charge from a new IT Provider and not a recharge from Group.

Below is the breakout of the central service cost from 2014-2016 using the identified drivers outlined above.

Table 25: Parental Recharge Costs

	2014 £	2015 £	2016 £
Corporate	60,474	62,288	64,157
Finance	274,009	282,229	290,696
IT	85,794	88,368	91,019
Secretariat	23,714	24,426	25,159
HR	59,936	61,734	63,586
Total	503,928	519,045	534,617

Financial services make up the majority of this cost. The services provided under the finance function include internal audit and risk management, accounts management IT system (Oracle ERP system), accounts payable, procurement, treasury (including the raising of loan capital to finance expansion of the network) and business planning, group finance and tax. The driver for these costs is firmus energy headcount.

Corporate costs cover the functions of treasury, corporate finance and audit and legal costs. The driver for this is firmus energy's opex cost.

IT costs include maintenance and development of an IT platform which can support integration with the financial reporting system, engineering project planning, Period Contractor payments/invoicing, reporting functionality to produce reports for external

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agencies, tariff maintenance and billing and customer relationship management activities. As mentioned going forward this cost will be invoiced directly from the new IT provider.

Secretariat covers the cost of establishing and maintaining the firmus energy Board as well as Corporate Governance. Secretariat costs will increase as our business grows and becomes a more significant part of the BGÉ business as we need to contribute to the cost of a functioning Board enabling the accomplishment of strategic and financial goals.

HR includes the cost of payroll, in-house training and development and personnel services, resourcing, reward performance, learning/development and employee engagement.

In addition, firmus energy's GD14 Submission included a cost of £100k in 2014 to account for the Gas Transmission Management System (GTMS) system upgrade. The Utility Regulator has stated in their draft determination:

“while other costs included in this category (such as the Gas Transmission Management System (GTMS) upgrade) seem to be unrelated to the distribution business”.

firmus energy would challenge this statement, as this cost is crucial for the firmus energy distribution business to interface with the BGÉ(UK) transmission systems on a 24/7, 365 basis for domestic market opening purposes. Costs of £180k per annum were also included to take account of extra services provided by Bord Gáis Networks due to market opening. These services include providing daily allocation reporting, month-end exit information and monthly re-allocations – all these services are vital to ensure adherence to the firmus energy network code.

○ **Rates**

Our Network Rates costs are directly related to our distribution revenue. In October 2004, an agreement was reached with the then Valuation and Lands Agency that the rateable value for both the Transmission and Distribution networks would be 6.8% of Transportation income. The Department of Finance and Personnel website (www.dfpni.gov.uk/lps/index/property_rating/rate-poundages-2012.htm) provides the Rate poundages for 2012 for each district. For the ten districts (Antrim, Armagh City & District, Ballymena, Ballymoney, Banbridge, Coleraine, Craigavon, Derry, Limavady and Newry) where we have significant network the Non Domestic Rate Poundage ranges from 0.560 in Coleraine to 0.622 in Armagh with an average of 0.590. The Network Rates charges included in our GD14 Submission were calculated from the agreement with the Valuation

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Agency and the related accruals have been included in our statutory and regulatory accounts as reviewed by our auditors. firmus energy (Distribution) Ltd is listed as a company having a gas transportation hereditament in the schedule to the current Valuation (Telecommunications, Natural Gas and Water) Regulations (Northern Ireland) 2010.

Should invoices received following this year's non-domestic revaluation show that the actual amounts payable differ from the accruals, the appropriate charge or credit will be included in the accounts at that time. In view of the uncertainty relating to this cost, firmus energy has requested for these to be treated as a “*pass-through*” with appropriate retrospective adjustments if necessary.

In the retrospective mechanism model sent by the Utility Regulator on 27th August 2013, an adjustment is included to reduce the rates element of the TRV to the cash payments made for office rates. There is no basis in our licence to use cash accounting in place of expenditure, including accruals. Applying this reduction to the TRV would distort the relationship of firmus energy's asset base and accumulated losses to the determined TRV.

In terms of Office Rates, within our GD14 Submission we stated that:

“Office costs are rolled forward at £20k per annum”

The Regulator's GD14 proposals for office rates is that:

“We are proposing to accept the requested allowance for office rates of £20k per annum as this is in line with actual costs incurred in recent years.”

We therefore agree with the Utility Regulator's proposals both in terms of Network and Office rates as set out in the consultation paper subject to the inclusion of network rates expenditure accrued to date.

○ **Fees and Consulting**

firmus energy's submitted costs for Fees and Consultancy are based on our actual costs for PCR02, and it acknowledges the additional legal costs for undertaking the five-yearly period contract review, our Price Control Submission, and statutory licence changes.

In the GD14 proposals the Utility Regulator agreed that firmus energy's submitted costs for

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Consultancy, Legal and Recruitment fees are reasonable and are poised to grant these allowances as requested. We welcome this approach.

We disagree with the Utility Regulator's position with regards to audit fees. firmus energy based our submitted costs on our actual 2012 audit costs of £30,048. As our GD14 Submission showed our actual auditing costs as shown in the table below have increased due to our distribution business growing. Our Audit firm - Deloitte - have stated that they have based their uplift in fees on firmus energy's increased revenues and customer numbers. As the distribution business has grown, the resulting auditing man-hours, processes and testing have increased proportionally.

Table 26: Annual Audit Costs

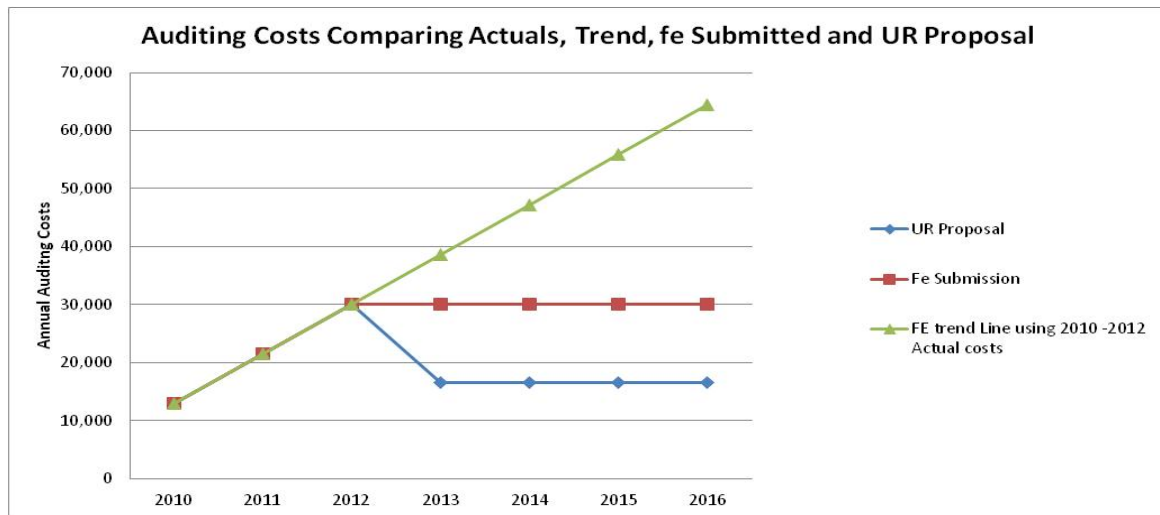
Audit Costs	2010 £	2011 £	2012 £	2013 £	2014 £	2015 £	2016 £
UR Proposal					16,500	16,500	16,500
fe Submission	12,892	21,553	30,064	30,000	30,000	30,000	30,000
Fe trend line using 2010- 2012 actual costs	12,892	21,553	30,048	38,654	47,232	55,810	64,388

Table 26 shows actual costs from firmus energy's Regulatory Accounts, as well as a trend forecast, firmus energy's GD14 Submission and the Utility Regulator's GD14 Proposal.

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From the graph below, it is clear that the 2014 – 2016 submitted auditing costs are not only reasonable, but could well be an underestimate of future audit costs.

Auditing Costs Comparing Actual, Trends – firmus energy submitted vs. Utility Regulator's proposals



In addition to our baseline consultancy costs, which have been accepted by Utility Regulator, firmus energy has requested an extra allowance of £100k in 2014 for additional consultancy employed for IME3 implementation, Safety Case Review and market opening in 2015. This £100k has been denied due to a distribution Network Code being in place already and the majority of market opening processes now being Northern Ireland wide.

firmus energy would suggest that the ongoing IME3 and any other unforeseen additional legislative licence compliance issues will require further bespoke consultancy allowance. These areas will require additional outside consultancy input to ensure full legal compliance.

The Utility Regulator has also stated that with the market opening for large Industrial and Commercial customers in October 2012 firmus energy will not require any additional consultancy works for full domestic market opening in 2015. firmus energy strongly disagrees with this assumption as the need for a domestic and small SME NDM (Non-Daily Metered) Model will be paramount to firmus energy opening its market fully to suppliers from April 2015. This comprehensive piece of work, will take our model used for our large NDM I&C customers and develop it into a much more complicated domestic NDM Model. This complex work requires unique knowledge of the Network Code and highly specialised modelling skills based on usage rates in the firmus energy network area and average

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temperatures within Northern Ireland. For this reason firmus energy are inclined to use TPA Solutions who are also credited with the PNGL Network code and models. Their unique skills and rates are reflected in our request for the additional consultancy fees allowance in 2014. firmus energy would request that the Utility Regulator would allow these costs in a consistent manner to their PCR02 determination in which consultancy costs in relation to market opening were ring-fenced.

- **Licence Fees**

firmus energy agree with the Utility Regulator's proposal that licence fee costs are treated as a "*pass-through*" cost, and this is consistent with the approach the Utility Regulator has previously taken in the PCR02 determination.

- **Insurance**

As part of the network separation process of IME2 and IME3 the Networks and Energy (incl. firmus energy) businesses were placed under separate standalone insurance programmes. Therefore firmus energy's distribution business now has a standalone Primary Public/Products Liability policy.

firmus energy recently (September 2013) retendered and procured new insurance costs for our business. The cost of firmus energy's insurance is extremely competitively priced in the marketplace; especially taking into consideration the exposure, the low excess of £10k for each claim and the projected increase in customer numbers. It is also worth noting that the new insurance contract includes new policies covering crime (including cyber), pension trustee liability and directors' and officers' liability.

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The table below shows our retendered rates for 2014-2016:

Table 27: firmus energy updated GD14 Insurance Costs.

Insurance	2014 £	2015 £	2016 £	Driver
Primary Public/Products Liability	133,846	155,821	176,457	Customer Numbers
Employers Liability	8,559	8,844	8,844	Employee Headcount
Motor Fleet	1,515	1,515	1,515	No. Of Vehicles
Office (inc. Computer and Building)	2,122	2,192	2,192	Headcount
Environmental Impairment Liability	2,525	2,718	2,889	Customer Numbers
Directors & Officers Liability	3,026	3,026	3,026	No. Of Directors
Crime (inc. Cyber)	5,366	6,092	6,248	Revenue
Pension Trustee Liability	1,132	1,170	1,170	Headcount
Death in Service	41,976	43,375	43,375	Headcount
3 rd Party Liabilities	53,000	57,041	60,637	Customer Numbers
Life Assurance	7,125	7,362	7,362	Headcount
Total	260,190	289,155	313,716	
Submission	231,505	269,514	305,207	

firmus energy has advertised via the Official Journal of the European Community so every relevant insurance company has been given the opportunity to compete for the next period contract with firmus energy. By disregarding this competitive process the Utility Regulator is overlooking the fundamental efficiency of a competitive open market tender process.

As highlighted, these updated figures differ from our December 2012 GD14 Submission. These updated figures need to be reflected within the Utility Regulator's final GD14 Determination.

- **Smaller Items**
 - **Bank Charges**

Within the consultation document, the Utility Regulator has provided no explanation why it has disallowed £14k (52%) from firmus energy's submitted bank charges, since the amount firmus energy submitted was based on actual charges received during PCR02. Our submitted costs are based on actual transaction fees (BACS, CHAPS, cheque processing

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etc.) rather than any costs incurred due to borrowing. firmus energy would therefore request further justification from the Utility Regulator on their proposed reduction or for these costs to be reinstated

- **Professional Subscriptions**

Within the consultation, the Utility Regulator has not provided an explanation why it has disallowed £10k (28%) from firmus energy's submitted professional subscriptions, since the amount firmus energy submitted was based on actual charges paid during PCR02.

firmus energy's GD14 Submission was based on subscription costs of £400 per professional for each year of the GD14 price control period. firmus energy currently employs 30 professionals for whom we pay subscription costs. This is in line with the Utility Regulator's PCR02 determination which stated that:

"Professional subscriptions average £400 per FTE (25 staff members) and forecasts for PC2 have been prepared on the same basis which appears reasonable. The forecast has been accepted."

The payment of Professional Subscriptions is included in staff contracts and firmus energy therefore ask for these costs to be reinstated.

- **Training**

Within our GD14 Submission we set out that:

GD14 training costs have been based on an average of £1.4k (2006 prices) per employee. In addition, we have taken account going forward that every three years our engineers will have to undertake a gas emergency and fire-fighting training course at £1.5k(2006 prices) per participant. Currently we have 19 engineers who would need to undertake this course so we have included an additional £28.5k (2006 prices) to training costs in 2013 and 2016 to account for these costs. The annual total also includes a total of £3k (2006 prices)for IGEM courses for our all our engineers.

Within the GD14 Consultation, the Utility Regulator has provided no explanation of why it has disallowed £164k (55%) from firmus energy's submitted training costs. Indeed the consultation document goes further to suggest:

"The only exception is training where there is a significant proportionate increase between 2012 and 2013 which does not appear to be justified"

As set out to the Utility Regulator in our GD14 and subsequent information requests the

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increase is due to HSENI informing firmus energy that under Regulation 7 of the Gas Safety (Management) Regulations, we have to provide a 24hr emergency contact and respond accordingly, and as part of this all of our on-call emergency engineers need to undertake the “Gas Emergency and Fire Fighting Course” from 2013 and which needs to be renewed every 3 years at a cost of £1.5k per participant. Currently we have 19 engineers who would need to undertake this specific course so we have included an additional £28.5k to training costs in 2013 and 2016 to account for these costs (£57k in total). As a responsible Network Operator and employer this training is required to enable firmus energy to meet our statutory duties under Health and Safety legislation. firmus energy would therefore ask for these costs to be reinstated.

In addition to the “Gas Emergency and Fire Fighting Course” under Health and Safety Regulations and Legislation we also have to provide the following training:

Table 28: Engineering Staff Health and Safety Training

Course	Frequency	Overall Cost (£)
Gas Safe	1 year	600
Emergency Procedures	3 years	Internal Course
Design Policy	3 years	Internal Course
Site Inspections	3 years	Internal Course
Incident Reporting	3 years	Internal Course
Branch Saddle	3 years	750
Flow Stopping	3 years	750
Media Training	3 years	750
Leak Management	3 years	1,200
Risk Assessments	3 years	1,200
Gas Fires	3 years	1,200
Gas Explosions	3 years	1,200
CO Incident Training	3 years	1,200
Confined Spaces	3 years	3,200
CSR	3 years	11,880
Streetworks	3 years	11,880
IUS	5 years	Internal Course
Manual Handling	5 years	Internal Course
FAAR/GIS	5 years	Internal Course
Distribution Training	5 years	Internal Course
Butt Fusion	5 years	750
Electro Fusion	5 years	750
Gas Controls	5 years	750
Gas Appreciation	5 years	750
Environmental Mgmt	5 years	750
EUSR SHEA	5 years	1,200
Auditing	5 years	1,460
DSEAR	5 years	2,000
EUSR SCO (PtW)	5 years	2,500
EUSR SCO (NRO)	5 years	5,480
Energy Awareness	5 years	5,480
Symology	One-off	Internal Course
Synergy	One-off	750
GIRS	One-off	1,200
GL8	One-off	4,800
Nebosh Diploma	One-off	5,000

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Nebosh Certificate	One-off	7,000
NVQ Level 4	One-off	9,000
TOTAL	-	120,430

Within the Utility Regulator's PCR02 determination the Regulator stated that:

"Utility Regulator considers that a forecast based on £1000 per FTE is not unreasonable for a young company."

firmus energy would therefore request these costs be reinstated.

- **Travel and Transport**

Within the GD14 Consultation, the Utility Regulator has provided no explanation why it has disallowed £124k (17%) from firmus energy's submitted travel and transport costs. firmus energy would therefore challenge the Utility Regulator on rationale for this reduction.

firmus energy's GD14 Submission set out that our future costs have been calculated on PCR02 (actual) levels of approximately £3.7k per employee and rolling them forward through the GD14 price control period, with a one per cent increase per year (due to increase in network growth, connections, and PRE's means that staff have to travel further and more frequently).

Our GD14 submission also highlighted that employees, who have a role which involves significant travel, as well as Senior Managers within the organisation, have the option to receive a car allowance or company car at similar cost to the business. All mileage expenses are claimed in line with firmus energy's agreed travel policy, currently 25 p/mile for car allowance recipients and 45 p/mile for non car allowance recipients.

The Utility Regulator's PCR02 determination in regards to Travel and Transport set out:

"Average annual expenditure during the period was approximately £3786 per annum per FTE. Fe forecast this expenditure will increase at 1% real per annum during PC2.....The fe forecast has been accepted excluding the above RPI increase."

firmus energy would therefore request what has substantially changed with regards to the PCR02 determination to justify a change in the Utility Regulator's approach in GD14. We would ask for these costs to be reinstated.

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○ firmus energy Supply Price Control

Bord Gáis Éireann has invested significantly in the firmus energy network licence area on the basis of a bundled distribution and supply businesses pursuant to an established regulatory framework, made up of the terms of the licences granted in March 2005, further to which there have been three price controls to date, and the legislative regime set down, inter alia, in the Gas (Northern Ireland) Order 1996 (as amended).

The Utility Regulator's letter of the 2005 Letter, which sets out the "Netback" arrangements; pursuant to which our licences operate. The 2005 Letter states (at para 5.5):

"The Licensee has agreed that it will undertake its operations under the Supply Licence on a no profit, no loss basis."

And that (at para 5.6):

"The Licensee will undertake its operations on the basis set out above, whilst it has any exclusivity under the Supply Licence and until there is no net under-recovery of the revenue across all of the conveyance categories".

The Utility Regulator's Decision Paper of the 24th February 2011, regarding the relinquishing of firmus energy's supply exclusivity in the ten towns area, provides as follows:

"The decision is to replace the existing staggered timetable for the relinquishing of firmus energy's supply exclusivity such that the large Industrial and Commercial (I&C) market in the ten towns area opens in October 2012 and the small I&C and domestic market opens in April 2015."

Accordingly, the Netback arrangements will remain in place until April 2015, at the earliest. The lack of adherence to the spirit and intention of the "no profit, no loss" principle in the 2005 Letter is concerning. We believed that there was a mutual and clear understanding with the Utility Regulator, at that time, relating to the equity for both parties which this arrangement delivered. It is therefore difficult for us to accept that the Utility Regulator can continue such a critical and material principle which was fundamental to our understanding as to the basis for operation during exclusivity.

The Utility Regulator's PCR02 determination set out that:

"Firmus also currently operate as a bundled distribution and supply business using a 'netback' mechanism. This means that firmus will set a price to compete with other fuels in the 10 towns, from which wholesale gas costs, transmission costs and supply opex are deducted with the residual revenue being used to pay off the distribution network. If the residual revenue is not sufficient to finance the cost of the network,

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this difference is accumulated in an under-recovery account to be recovered in the future when there will be more customers and a higher level of volumes being transported through the network”.

firmus energy would therefore question why within the GD14 proposals no similar explicit mention of the netback arrangement is made and why despite this agreed arrangement has the Utility Regulator unilaterally deciding to undertake a “Supply Price Control”. The continuing lack of transparency around important issues such as the “*no profit, no loss*” arrangement only adds to the continued perception of instability and regulatory risk in Northern Ireland within our business and will undoubtedly bring into question our view on the viability of future investment in Northern Ireland.

We would like to discuss this issue further with the Utility Regulator.

E. Capital Expenditure

- Overview

firmus energy has prudently managed its capital expenditure throughout PCR02, and even though we have increased connections by 49% above the determined target we delivered this with stringent financial controls to ensure that our capital expenditure allowance within our determined capital allowance.

Table 29: firmus energy's PCR02 Performance (2009-2013)

	UR Determined	MDR/ Extensions	Final UR Determined	Actual/ Forecast	Diff	% Saving
Capex	£34.8m	£11.5m	£46.3m	£46.1m	£0.2m	0.4%

firmus energy's expectation at the start of the GD14 process was that the Utility Regulator would follow the precedent set by the PCR02 process with regards to capital expenditure. We are keen to understand the justification as to why the Regulator has now chosen to deviate from this agreed approach. Within the PCR02 determination, the Utility Regulator determined that:

"Overall PBR (Parsons Brinckerhoff Rune) analysis was generally supportive of fe's unit rates and the Utility Regulator has decided to accept the fe unit rates."

Within our GD14 Submission, we highlighted that:

"firmus energy's Board has agreed to extend firmus energy's Period Contract with McNicholas Construction by eight months from 1 December 2012 to 31 July 2013. The extension will allow for changes to the IT interface infrastructure between firmus energy and the Period Contractor and ensure continuity of construction and operations/maintenance services over the peak winter months.

Therefore for this new contract period (post 31 July 2013) and throughout this Submission firmus energy has modelled costs based on the current Period Contract rates (December 2012) increased by 15 per cent and rebased to January 2006 prices.

Polyethylene pipe and transport related costs vary with the price of oil and, given the recent sustained period of prices above \$100 per barrel, we believe the 15 per cent uplift represents a reasonable interim estimate of the likely increase.

firmus energy has recently sought expressions of interest from prospective service providers via the Official Journal of the European Union. As this process will run parallel to the GD14 price control review, firmus energy will ensure that the most accurate rates are included within the GD14 determination".

However, within the GD14 Proposals, the Utility Regulator has chosen to depart from the agreed approach adopted in PCR02.

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In addition, at the Utility Regulator's Stakeholder event of 6th September 2013, the Utility Regulator highlighted the efficiency of the NI GDN's compared to the GB GDNs. We do not believe this point has been sufficiently acknowledged within the Utility Regulator's current GD14 Proposals.

In recent discussions with the Utility Regulator (12th September 2013), the Regulator stated that their engineering consultants, Rune Associates (Rune), had based their analysis of firmus energy on Ofgem's analysis of the Northern Gas Networks. Rune believed that this network was comparable to firmus energy as it contained both urban and rural areas. firmus energy believes this comparison is baseless and misleading. Based on population alone (see Table 30 as evidence) and not taking any account of the available network in these towns (which is very significantly less in the firmus energy network area due to our immaturity), the size and scale of the Northern Gas Network simply dwarfs that of firmus energy. Therefore the rescaling of the Northern Gas Network costs to firmus energy's levels is completely inappropriate. There is no acknowledgement of the inherent "*economies of scale*" of having such a significantly larger customer base.

Table 30: Comparison in the Populations of the Ten Largest Towns in the Northern Gas Networks area vs. firmus energy's Ten Towns.

	Northern Gas Networks (10 Main Towns)		Firmus Energy Network (10 Towns)	
	Town	Population (000)	Town	Population (000)
1	Newcastle-upon-Tyne (Tyneside)	880	Londonderry/Derry	85
2	Leeds	758	Craigavon	65
3	Bradford	294	Newry	30
4	Sunderland	275	Ballymena	30
5	Hull	256	Coleraine	25
6	York	198	Armagh	15
7	Huddersfield	146	Banbridge	15
8	Middlesbrough	138	Limavady	13
9	Carlisle	108	Ballyclare	10
10	Darlington	106	Ballymoney	9
	TOTAL	3,159	TOTAL	297

In addition, the towns in the Northern Gas Networks area would have received natural gas, well over 30 years before our first town - Ballymena, and therefore there is a very different level of maturity in terms of network development/customer understanding/ age and type of assets etc. between the two Networks which would make meaningful comparisons impossible.

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We would also suggest that comparison between the PNGL Licence area and firmus energy's network is in essence non comparable. The Greater Belfast and Larne area has a population of around 660k, which is over double the size of the towns in the firmus energy network area. The firmus energy licence area is less densely populated covering a distance of 271 km between Derry and Warrenpoint, compared to a distance of around 75 km³³ in PNGL's Belfast licence area. In addition, PNGL have the commercial advantage of being nine years further advanced in its network development than firmus energy, and are therefore more than twice the current age/maturity of firmus energy.

PNGL operate a very different network system to firmus energy, as their system is based on a 7 bar mains framework supplying gas to Belfast, Bangor, Lisburn, Larne and Donaghadee. This in turn supplies 4 bar gas at a large number of Pressure Reduction Installations throughout Belfast and North Down areas ensuring very good supply pressures which minimise pipe diameters and hence installation costs. firmus energy on the other hand have only one supply pressure of 4 bar from each of the AGI's serving the 10 towns area and hence have to install mains of a size to manage the considerable pressure drop in taking gas long distances to supply the dispersed nature of customers on the firmus energy network – evidence and a more recent example would be Bushmills Distillery some 21 km from the supply source of 4 bar at the AGI (Above Ground Installation) at Macfin outside Ballymoney.

- **Basket of Work Approach**

The Utility Regulator's 26th March 2013 GD14 Approach Determination stated that the Utility Regulator would consider *"local regional variations for all allowances granted."* The Utility Regulator stated in their GD14 Proposals that Rune in analysing the forward work capital programmes of PNGL and firmus energy had accepted that both companies work and expenditure splits differed not only from each other but from that used by the GB GDNs. However, the Utility Regulator in its GD14 Proposals has attempted to facilitate comparisons between the three cost models (PNGL, firmus energy and the average GB GDNs) by adopting an analysis technique combining areas of expenditure into a so called *"basket of work"*. This is a significant and uncommunicated departure from the agreed PCR02 process of basing allowances on firmus energy's own unit rates and workloads.

The Utility Regulator has substituted firmus energy's own unit rates and workloads and based their model on a *"basket of work"* methodology using average GB GDNs unit rates and PNGL workloads, and then reducing this overall cost by a further *"Northern Ireland*

33 Distance between Larne-Belfast-Donaghadee.

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Efficiency Factor” to reflect the Regulator’s belief that Northern Ireland GDN unit rates should be lower than GB GDN unit rates.

We believe this “*basket of works*” methodology fundamentally misrepresents the differences between firmus energy’s sparse rural network, PNGL concentrated urban conurbation network, and the significantly more mature and larger GB GDN’s.

Additionally, the Utility Regulator in its GD14 Proposals has ignored the following facts:

- firmus energy is currently in the final stages of its period contract tender process. The anticipated 15% uplift in our unit rates within our GD14 Submission takes into account our ongoing tender process and the likelihood that rates will increase for the new period contract. We have set out in our GD14 Submission, and in previous discussions with the Utility Regulator, that in the interests of accuracy and transparency of our period contract discussion, we are keen to work with the Utility Regulator on this issue and ensure full transparency to ensure our new period contract rates are as accurate as possible for forthcoming price control period (GD14).

Within GD14 the Utility Regulator should accept that there is no better means of achieving the best possible unit rates for firmus energy and its customers via a fully and competitive tender process. Our Period Contract has been advertised through the Official Journal of the European Community so every relevant civils contractor in the EU has been given the opportunity to compete for the next period contract with firmus energy. By disregarding this competitive process the Utility Regulator are overlooking the fundamental processes of a competitive open market tender process.

- It appears that PNGL are currently mid-contract with their contractor and thus PNGL has based their submission on their actual current unit rates. It would appear the Utility Regulator has used PNGL rates for their “*basket of works*” analysis as the PNGL rates appear to be lower than the firmus energy unit rates. However, we are unaware of any consideration, analysis or study having been carried out by the Utility Regulator in order to understand why there are differences between the costs and workloads of the two NI GDNs. It is our understanding that the two contracts are different in nature; especially in regard to management fees and therefore a direct comparison of costs is inappropriate.

Indeed, we have provided the Utility Regulator with all contractual information regarding our current Period Contract. Therefore, if PNGL has done the same, the Utility Regulator

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should recognise that there are clear differences in the contracts that McNicholas have with firmus energy and with PNGL. We understand that we have a different contract methodology to PNGL as the firmus energy contract has an all inclusive unit rate. We are disappointed that the Utility Regulator in its proposals has overlooked these fundamental contractual differences in its GD14 Proposals.

- firmus energy is much smaller than PNGL in terms of customer numbers and gas network. Therefore, PNGL should have greater opportunities to realise “*economies of scale*” and due to the physical differences between our sparse rural network, compared to PNGL’s concentrated urban network the scale and quantum of work differs considerably which impacts on unit rates.
- As previously discussed PNGL’s licence is based on a “*fat*” model which focuses on maximising the number of existing domestic supply points targeted for connection, whereas firmus energy has a “*thin or skinny*” model which reflects the fact that we are still developing our gas network throughout the towns within our network as well as connecting customers. Therefore the Utility Regulator’s proposed “*basket of works*” model will suit PNGL as it is based on a connections model; rather than firmus energy’s volume based model. This again reinforces firmus energy’s belief that it has been treated as the “*junior partner*” within the GD14 process; rather than being afforded the correct status as a distinctly different licence holder who has specifically different costs due to a very different licence and level of maturity to PNGL.

The Utility Regulator inaccurately sets out in its GD14 Consultation that a standard set of rates have been used in the analysis, and these rates have been set to reflect the typical costs reported by the NI GDNs whilst keeping the ratios used by Ofgem for GB GDNs in previous price controls. However, what the Utility Regulator appears to have undertaken in its modelling is to use the standard PNGL rates and then made slight adjustments to take into consideration the fixed costs for each GDN.

The table below shows how the Utility Regulator’s GD14 Proposed unit rates for each NI GDN have actually been based on the PNGL restated works alone. This is different to the picture painted in the Utility Regulator’s GD14 Consultation (Appendix 3: Table 5) which suggests the restated works are based on the 2011 firmus energy’s actual costs. We have a different business model to PNGL and we would call upon the Utility Regulator to base its calculations on firmus energy rates.

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Table 31: Basket of Works Comparison

All 2012 Prices (£)	firmus energy Unit Rates Actual restated and allowed				
	fe Actual Unit Rates 2009-2011 £	fe Restated Unit Rates 2009-2011 £	UR Allowance for Unit Rates (2015) £	% Difference between restated and allowance	
4 Bar and feeder mains	90	87	74	-15%	Decrease
Infill mains existing	67	80	71	-11%	Decrease
Infill mains New Build Housing	50	62	55	-11%	Decrease
Domestic Services	759	658	600	-9%	Decrease
Domestic Meters	180	238	214	-10%	Decrease
I&C Services	2,315	1,724	969	-44%	Decrease
I&C Meters	2,315	1,159	538	-54%	Decrease

All 2012 Prices (£)	PNGL Unit Rates Actual restated and allowed				
	PNGL Actual Unit Rates 2009-2011 £	PNGL Restated Unit Rates 2009-2011 £	UR Allowance for Unit Rates (2015) £	% Difference between restated and allowance	
4 Bar and feeder mains	87	68	70	3%	Increase
Infill mains existing	56	68	70	3%	Increase
Infill mains New Build Housing	55	52	54	4%	Increase
Domestic Services	523	561	576	3%	Increase
Domestic Meters	288	204	210	3%	Increase
I&C Services	1,599	1,643	1,558	-5%	Decrease
I&C Meters	660	701	1,094	56%	Increase

The tables above clearly show that PNGL have had their restated unit rates used with a 3-4% uplift added in relation to fixed costs as well as some favourable assumptions regarding I&C services and meters. This is in comparison to firmus energy's re-stated costs which appear to have been overlooked by the Utility Regulator.

In the GD14 Consultation the Utility Regulator gives no justification for the significant differences between the allowances for PNGL and firmus energy for I&C service and I&C

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meter costs. The table below show how PNGL have been allowed 61% more I&C service cost and 103% more I&C meter cost than firmus energy. This conflicts with the statement within the Utility Regulator GD14 Consultation which states:

“Rune has considered issues which could potentially affect comparability between FE and PNGL but have concluded that there is no material impact on the analysis process and in their opinion; no issues warrant PNGL being granted higher allowance than the other.”

Table 32: I&C Services and Meters – Allowances for firmus energy vs. PNGL

Basket of Work Item	UR Allowance for firmus energy (2015) £	UR Allowance for PNGL (2015) £	% increase of PNGL allowance above firmus energy allowance
I&C Services	969	1,558	61%
I&C Meters	538	1,094	103%

Within the GD14 Consultation document, the Utility Regulator has been at pains to promote the concept that both GDNs should be applying approximately the same unit rates (despite licence, distance, network and maturity differences) when calculating their capex cost. However, the table above shows that this is not the case.

Furthermore, the process used by the Utility Regulator in GD14 of establishing the firmus energy allowances by undertaking a simple exercise of using PNGL's restated rates appears to show a lack of understanding of the fundamental differences between PNGL's and firmus energy's licence and business models. It therefore seems that the Utility Regulator's modelling process has completely disadvantaged firmus energy, rather than looking at the two licence holders' models and development separately and understanding the different licence drivers and cost models underpinning the two companies.

Therefore, we would ask that unless full and appropriate justification can be given, the Utility Regulator must allow firmus energy unit rates that are representative of firmus energy's business model, as was agreed as part of the PCR02 determination.

We would also wish to point out the efficiencies within the firmus energy submitted rates as they are significantly better than all Ofgem's GB GDN synthetic unit rates. This is a significant achievement for such a small and rural GDN which is only 8 years since its licence award.

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• PNGL/firmus energy Performance Comparison

We understand the Utility Regulator's wish to use benchmarking within the price control process. However, benchmarking needs to be meaningful and accurately compare "like with like". Indeed, the Competition Commission in their December 2012 analysis of the PNGL price control determination stated that:

"making meaningful comparisons is not easy. Direct comparisons of distribution prices between Northern Ireland and, for example, Great Britain are likely to be misleading because PNGL's network is newly developed, its customers are only gradually switching to gas, the costs of its initial investments are still being repaid, and its revenues have been deferred. In addition, the geography, density of the network and so on will vary between PNGL's Licensed Area and comparator areas. Given that there are so many differences that need to be controlled for (but where measures of these differences may be difficult or uncertain), we did not think that direct comparisons of prices would be meaningful."

We reiterate our belief that there are significant and important differences between the firmus energy network, and PNGL which the Utility Regulator has failed to acknowledge within its GD14 Consultation document.

As the table below sets out firmus energy is significantly different to PNGL and therefore it is baseless that we should be evaluated on a like for like basis.

Table 33: A comparison between firmus energy and PNGL

	firmus energy	PNGL
Licence Award	2005	1996
Type of Regulation	Price Cap	Revenue Cap
Licence Recovery Period	30 years	50 years
Connection Model	Thin model	Fat model
Properties Passed	c.60k	c.300k
I&C vs. Domestic Volumes	10% I&C vs. 90% Domestic	2% I&C vs. 98% Domestic
Treatment of under-recoveries	Standalone	Within the TRV
Risk	Volume	Connections
Network Distance	c.270km	c.75km
Nature of Network	Rural and Provincial	Urban Conurbation
Customers	c.20,000	c.160,000
Network Length	c.800km	c.3,000km
Average Availability of Gas in Licence area	c. 5 years	c.15 years
Towns Covered	21 ³⁴	13 ³⁵

³⁴ Antrim (inc. Ballyclare and Templepatrick), Armagh (Tandragee), Ballymena (Broughshane) Ballymoney, Banbridge, Coleraine (Portstewart & Bushmills), Craigavon (Moir, Lurgan and Portadown), Limavady, Londonderry~Derry (Newbuildings) and Newry (Warrenpoint).

³⁵ Belfast, Lisburn, Bangor, Holywood, Donaghadee, Groomsport, Millisle, Newtownards, Carryduff, Comber, Newtownabbey, Carrickfergus and Larne.

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With the Utility Regulator's 26th March 2013 GD14 approach update it stated that it would consider *"local regional variations for all allowances granted."* We do not believe these differences have been taken into account by the Utility Regulator in coming to their *'minded to'* position and the significant differences between the two GDNs have been ignored in favour of a *"one size fits all"* model.

- **7 Bar Mains**

firmus energy has no 7 Bar mains within its network and has no plans to lay any 7 Bar pipelines during GD14. Therefore, we agree that no allowance is needed by firmus energy for this cost item.

- **4 Bar and Feeder Mains**

We have previously set out in this chapter our fundamental issues with the Utility Regulator's *"basket of works"* approach and once again we highlight that this model should correctly reflect firmus energy's unit rates and workloads.

In addition, firmus energy does not consider it beneficial to combine the unit rate of >180mm diameter pipe with the unit rate for ≤180mm diameter pipe as it does not allow for a change in work type and ultimately may actually result in the consumer paying more than expected.

Feeder Mains

The Utility Regulator's GD14 Consultation appears to suggest that PNGL propose to install large quantities of infill main and very small quantities of feeder mains during 2014 – 2016.

Furthermore, PNGL have had the opportunity to control mains costs by extensive use of the old *"towns gas"* system in Belfast which they continue to use thus minimising installation costs per metre. firmus energy has not had a similar opportunity in developing its network outside of Belfast.

firmus energy on the other hand are at a early development stage and are still installing a sizeable amount of large diameter 4 bar feeder mains to enable the gas to get to areas where infill mains will be laid e.g. NIHE estates and New Build sites and due to further expansion a percentage of the infill mains for the firmus energy network will be large diameter to allow further expansion within the estates.

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In analysing these costs the Utility Regulator seems to have imposed PNGL's reporting procedures onto firmus energy so that it can make comparisons for its benchmarking exercise. We feel this is inequitable as we have a distinctly different business model to PNGL. We would prefer that firmus energy, as agreed in PCR02, continue to report on the actual cost per diameter. This will enable us to continue to accurately model and report the actual cost to the Utility Regulator. Any proposed changes to firmus energy's current reporting process should be transparently consulted upon and the additional IT development and system changes required will have to be fairly reflected by the Utility Regulator in the allowances it provides to firmus energy. Again, such requests further emphasise, that firmus energy has been treated as a "junior partner" throughout the GD14 process, rather than recognising we are a distinct licence holder in our own right.

Infill Mains

As we enter GD14 the majority of our infill mains projects will be used to enable conversion of NIHE homes from heating oil to natural gas as part of the NIHE's 15 year boiler replacement programme and the connection of New Build development sites. As we set out in our GD14 Submission:

"we are now undertaking additional discussions with NIHE over their 15 year boiler replacement programme which will look to convert heating oil burning NIHE estates to using natural gas. At this stage there still remains some uncertainty around some of these projects progressing to the conversion stage such as the Ballysally Estate in Coleraine, but we will inform the Utility Regulator should these discussions lead to a change in our assumptions. firmus energy will within GD14 look to identify NPV positive extension projects to connect these often more distant NIHE properties/estates".

There are 3 main NIHE regions where we work:

- North East – Coleraine, Ballymena, Antrim etc.
- West – Derry, Limavady etc.
- South – Newry, Armagh etc.

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As we set out in our GD14 Submission, our submitted lengths were based on PCR02 actual lengths:

Table 34: GD14 Infill Main Lengths (Based on PCR02 Actual Lengths).

Property	Metres per connection
New Build Estates	18.1
NIHE Estates	26.0
Existing Housing Estates	N/A
I&C	52.0

As we set out in our GD14 Submission:

“We have not included any infill mains for existing housing as we are basing our assumptions on these properties as being “readily connectable” to our existing network. If the Utility Regulator was interested in firmus energy increasing the infill beyond our existing mains network we would have to revisit this assumption.”

And for the avoidance of doubt this refers to owner occupied properties the total main we plan to lay in GD14 was as follows:

Table 35: GD14 Total Mains to be Laid

	2014	2015	2016	2017	2018	Total
Mains (km)	87	71	63	58	53	332

firmus energy's network investment has focussed on anchor loads such as NIHE estates and New Build developments. Within NIHE estates 44% of our properties passed are ex-NIHE houses where the owner has exercised their “*right to buy*”. These residents have purchased their home from the NIHE. These households therefore “*piggyback*” on the gas distribution mains that has already been laid in order to convert NIHE tenants to natural gas.

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Table 36: Ownership Composition of NIHE Estates³⁶

Town	NIHE Properties - %	Owner Occupied (ex-NIHE) -%	Private Rented (ex-NIHE)- %	Total Households in NIHE Estates
Derry/Londonderry	62.94	34.22	2.84	7,375
Limavady	51.08	42.93	5.99	1,436
Coleraine	62.76	34.11	3.13	2,502
Ballymoney	50.38	44.97	4.65	932
Ballymena	55.25	40.39	4.36	3,138
Antrim	47.27	46.67	6.06	4,027
Craigavon	47.96	45.35	6.69	6,610
Banbridge	46.38	48.35	5.27	1,194
Armagh	42.94	49.18	7.88	1,514
Newry	38.73	53.77	7.55	2,860
Total	50.59	43.99	5.44	31,588

The conversion of NIHE estates is entirely dependent on Government spending priorities. In January there can be a rush to spend NIHE funds by the end of the financial year (31st March). This can be unpredictable for firmus energy and can provide us with logistical problems (working weekends etc.). However, we are very aware that if we miss the opportunity with these conversions NIHE will provide their tenants with new oil heating systems and we will have to wait a further 15 years before we once again receive the opportunity to convert these households.

- **Pressure Reductions Stations**

The Utility Regulator has accepted firmus energy's submitted cost. However as previously mentioned the Utility Regulator have incorrectly removed the cost for PRS maintenance within maintenance costs, for clarity this is a firmus energy cost for firmus energy equipment which must be maintained under Pressure Systems Safety Regulations, 2004.

- **Infill Mains**

The Utility Regulator's proposed 5.9m per property passed/connected as per the actual figure experienced by PNGL in no way reflects the number of metres per New Build property in the firmus energy licence area.

The Northern Ireland Housing Statistics 2011-2012 provides evidence that Belfast has significantly more dense housing than the firmus network area, (55% terraced housing and

³⁶ Mapping Northern Ireland Housing Executive Estates Outside Belfast, NIHE, 2007. These figures take no account of gas availability and are just an indication of the ownership composition of NIHE estates in our Ten Town Network Area.

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16% apartments compared to approximately 31% terraced houses and 8% apartments in the firmus licence area), and therefore the distance between properties will be significantly lower for PNGL than firmus energy.

Table 37: Properties Passed firmus energy vs. PNGL

Company	Mains Laid	Properties Passed	Ratio
PNGL	c.3,000km	c.300,000	c.100 properties per km
firmus energy	c.800km	c.60,000	c.75 properties per km

Furthermore, it is evident that this was due to the number of high-rise apartments connected by PNGL where the length of main reduces per property passed/connected. firmus energy have not connected any New Build high rise apartments to date and do not expect to connect any during GD14.

- **Infill Mains – Existing Housing Domestic and I&C**

firmus energy would challenge the Utility Regulator's GD14 proposal to add both domestic and I&C infill into one rate. This does not allow for accurate analysis of actual costs as mains associated with Industrial and Commercial customers are larger and thus more expensive. Evidence of this is I&C mains are 125mm and 90mm, whereas domestic mains are 63mm and 90mm.

firmus energy would challenge the Utility Regulator's proposal to use a metre per property passed mechanism for calculating the allowance for infill mains as the firmus energy's licence is a volume licence and not a connections based licence.

- **Infill Mains – New Build Domestic**

firmus energy disagrees with the Utility Regulator's comment within its GD14 Proposals that:

"FE have no historical data on the number of metres per New Build property".

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As previously stated we submitted the following in our GD14 Submission of 17th December 2012:

Table 38: Submitted GD14 New Build Infill Main Lengths (Based on PCR02 Actual Lengths).

Property	Metres per connection
New Build	18.1

All infill mains laid for New Build are for actual connections. Evidence would suggest during 2009 - 2011 the metres per property connected/passed has been, 18.5m, 22.6m and 16.7m respectively. This is why within the firmus energy model the average figure of 18.1m was considered as a fair and representative figure.

Evidence for this, is that during the housing boom up to 2007, we found that the land for New Build sites was at a premium so builders tried to squeeze as many properties onto a site as possible. This often meant New Build sites, even in our rural towns, had apartments (2 storey) or townhouses (terraced) with small or indeed no gardens. With the economic downturn, property developers have changed their approach, and in the interests of attracting buyers they are providing greater spaces between properties which increases the length of main per property connected/passed.

- **Domestic Services**

Combining domestic services (NIHE, Existing, and New Build) does not accurately provide the required allowances for the differing costs experienced across the three sectors of domestic services. For example, New Build services are the cheapest type of service. They are approximately 2.5 times cheaper than an existing service, as the builder/developer will provide their own trench/backfill/reinstating support for pipe laying.

firmus energy has considered the information in the Utility Regulator's GD14 Consultation. PNGL has stated 27% of their new connections will be this cheaper New Build type (2,300 of 8,400 in 2014) compared to the assumption of 20% (Evidence: 800 of 4,000 overall connections) for firmus energy. If this has been the experience of PNGL in past years, this will skew the actual figures and weight them with a lower cost. This reinforces the case that the Utility Regulator's rates for firmus energy should not be in any way based on PNGL workload.

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- **Domestic Meters**

firmus energy's GD14 Submission was based on our current actual allocation of credit and prepayment meters in the firmus energy network area:

Table 39: GD14 Domestic Meter Type Split

Property	Credit	Prepayment
New Build	20%	80%
NIHE	5%	95%
Existing Housing	20%	80%

We fail to understand how the Utility Regulator has arrived at the restated value of domestic meters in the GD14. firmus energy would like some further information and transparency from the Utility Regulator on how this allowance has been calculated. We would ask that the Utility Regulator reflects the evidence in the above table which provides our actual meter split.

- **I&C Meters and Services**

firmus energy would question the Utility Regulator's GD14 proposal of combining all Industrial and Commercial meters and service costs together. This is contrary to PCR02 Determination, and does not take into account the smaller numbers of Industrial and Commercial connections experienced by firmus energy as compared to the PNGL model derived allowances. The table below shows the evidence that Utility Regulator's proposal will mean that by connecting a small number of larger customers, costs will be quickly rise above the proposed allowance.

Table 40: I&C Meter Costs

Type	Name (2012 work)	Actual Cost	Meter Size (scmh)	UR allowance 2014	Shortfall
Large IC	Springvale (Kingspan)	£12,249	650 single	£517	-£11,732
Medium IC	Foyle college	£5,343	160 single	£517	-£4,829
	Marlborough House	£11,756	250 twin	£517	-£11,239
Small IC	Rowan House (SARC)	£579	16	£517	-£63
	Brooklands (Derry)	£3,124	65 single	£517	-£2,607
	Covenanter Residential HA	£1,720	40	£517	-£1,203
	Total	£34,771		£3,102	-£31,669.11
PNGL	Sample meter	£559		£1,096	+£536

We are unable to consider these domestic meters costs and firmus energy does not

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understand how the Utility Regulator has arrived at the restated value of Industrial and Commercial services. In addition, the Utility Regulator has proposed vastly different rates for PNGL and firmus energy, whilst stating that there is no difference between the two companies.

Table 41: I&C Services

Type	Name (2012 work)	Actual Cost	Service diameter	UR allowance 2014	Shortfall
Large IC	Springvale	£3,737	90mm	£942	-£2,795
Medium IC	Foyle college	£7,979	63mm	£942	-£7,036
	Marlborough House	£12,887	63mm	£942	-£11,945
Small IC	Rowan House (SARC)	£5,031	63mm/32mm	£942	-£4089
	Brooklands (Derry)	£4,808	32mm	£942	-£3,866
	Covenanter Residential HA	£7,789	63mm	£942	-£6,847
	Total	£42,231		£5,652	-£36,579
PNGL	Sample service	£2,084		£1,560	-£524

The GD14 Consultation document sets out that:

“As PNGL has not been able to demonstrate that they track costs to differentiate between small loads and large loads, we propose to allow the same cost per meter for replacement as for new meter provision”.

However, as our GD14 Submission set out, firmus energy has differentiated between the meters used for small loads and large loads and therefore we believe our allowed costs should accurately reflect this.

- **Other Capex Items**
 - **Telemetry**

As firmus energy set out in our GD14 Submission:

“Within our capex budget for GD14 in addition to costs for new governor stations, we have also included an additional £116k (2006 price base) over the period so that we can undertake an extension and upgrade of our current flow and pressure telemetry system. We are seeking to upgrade our current system, as we are finding an increasing number of faults with the system, which is forcing us to use valuable engineering staff resource and time to check and recalibrate the systems. As competition within the firmus energy licence area increases following market opening, it will become even more important that our telemetry equipment can provide reliable data in a timely manner.”

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firmus energy believes that going forward we will need to implement a more comprehensive monitoring system which will help us to deal with gas emergencies and market opening.

At present firmus energy use Technolog's PMAC (Pressure Monitoring and Control) system to monitor the distribution system at key locations. The data is accessed in the firmus energy office via PMAC on a PC dedicated to this function only, utilising a modem connection to the BT landline network to download information from Newlog 4 devices spread across the distribution system. PMAC is set up to notify High Pressure and Low Pressure alarms at any of the monitored sites and in turn these alarms are sent to the Distribution Control Centre in Dublin. Operators inform the 2nd tier firmus energy standby manager of any alarms as and when they appear on the PMAC system.

At present flows at daily metered sites are monitored using the Technolog Cello devices which cannot provide real time flow information, this information is provided next day.

firmus energy is currently investigating an alternative solution which utilises wireless technology to collect and transmit data using an SMS system on an open network basis, this information is collected and made available via a web based system which also has the capability to flag high and low pressure alarms and send information via a text message to daytime and night time standby engineers for their attention, avoiding the requirement to have personnel in a control room monitoring alarms. The advantage of this system is that real time data is available in relation to flows on the system and this would be invaluable in the event of a supply emergency scenario where load shedding would be required. Large customers can be monitored in real time to ensure that they have stopped using gas when instructed to do so by their supplier.

- **IT and Office**

In order to facilitate full Market Opening in April 2015, firmus energy needs to develop a NDM Model for non-contract customers. As we have previously discussed with the Utility Regulator we have had initial discussions with TPA Solutions, who we understand have developed a similar model and IT system for PNGL.

In order for this model to be statistically robust, firmus energy plans to install 180 telemetry readers across the ten towns areas in order to collect the necessary statistical data to be used in the provision of the main Non Contract Model, required for full market opening.

The telemetry recorders will be purchased, installed and (depending on their location) will be

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read on a weekly or monthly basis. This will be done manually as the remote-SMS technology will not be suitable.

TPA Solutions has suggested that it will take 400hrs to build and document such a model. As set out in our GD14 Submission the estimated capex costs for the Full Market Opening systems upgrade are as follows:

Table 42: Domestic NDM Model

TPA Solutions Costs 2013		
TPA Solutions. Procurement of NDM Contract Model	(as Detailed Above) Agreed Contract based on approx 100 hours Consultancy and Travel Expenses	£40,000

Capex Costs 2014		
Allowance for New Semi-Automated Switching system		£50,000
Telemetry Recorders 180 Nr	Supply and Installation (@£750 per Unit)	£135,000
Recorder Meter Reading	firmus energy to provide daily and monthly readings of all recorders as described previously by TPA Solutions	£40,000
Recorder Maintenance	Including Re-Calibration and Battery replacement	£7,500
Additional In house Data Management and Analysis		£5,000

Capex Costs 2015		
TPA Solutions. Procurement of Non Contract Model	Estimated by TPA to be approx 400 hours and in line with Contract Model Cost	£160,000
Allowance for New Semi-Automated Switching system		£50,000
Telemetry Recorder Meter Reading	firmus energy to provide daily and monthly readings of all recorders as described previously by TPA Solutions	£40,000
Recorder Maintenance	Including Re-Calibration and Battery replacement	£7,500
Additional In house Data Management and Analysis		£5,000

- **Traffic Management Act**

Within our GD14 Submission we included 10% uplift for the cost of possible Traffic Management Act implementation. This was lower than the PCR02 determination which stated that:

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“A cost provision amounting to a unit uplift rate of 35% for mains and services will be included in the cost allowance to take account of the possibility that the introduction will increase capex unit rates. Any difference between this and what the Utility Regulator considers appropriate will result in a retrospective adjustment at the time of the next review.”

In its GD14 proposals, the Utility Regulator has suggested that:

“There is uncertainty in terms of the timing of implementation of the TMA legislation, and the effect on operating costs. To address these issues FE has included an estimated uplift of ten per cent to those capex cost items that will be impacted. In recognition of the uncertainty we have agreed with FE 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 FE (in the event actual costs turn out higher) and consumers (in the more likely event that implementation is delayed, or that the impact is less than our assumption).”

firmus energy welcomes this proposal and feel that it is appropriate and justified in correctly balancing the needs of the company and gas consumers.

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F. Volumes

Since 2005, firmus energy has been open and transparent with the Utility Regulator regarding our volume levels. We provide quarterly volume and connection reports to the Utility Regulator. As the Regulator is aware, during PCR01, delays in achieving expected connections resulted in significantly lower volumes than forecast. However since 2009, firmus energy has achieved and surpassed volume targets set within PCR02, with the support of the PCR02 Market Development Review Mechanism and due to environmental legislation which has encouraged food processors that used tallow (animal fat) to power their steam generation to connect to natural gas for their process heating.

Table 43: firmus energy's PCR02 Volume Performance (2009-2013)

	UR Determined	MDR/ Extensions	Final UR Determined	Actual/ Forecast	Diff	%
Volumes	184Mt	2Mt	186Mt	214Mt	+28Mt	c.15%

90% of firmus energy's volumes come from the industrial and commercial customers, and therefore we do not agree with the view expressed within the Utility Regulator's GD14 Consultation that, in the midst of the most significant economic recession in a generation, our volume projections would not be affected by factory closures.

This position is simply untenable given the current economic climate and highlights the increasing commercial and volume risks which firmus energy is exposed to.

PCR02 Performance

Special Review

We are mindful that despite the Utility Regulator stating in the GD14 Consultation document that our PCR02 performance is "very welcome", the Utility Regulator has suggested carrying out a Special Review in respect of volume outperformance for the year, 1st January 2012 – 31st December 2012. Any plan to retrospectively review firmus energy's determined volumes will be vehemently challenged by firmus energy.

Our letter of 5th April 2013 to the Utility Regulator outlined our position on the timing of the Special Review, as follows:

"Condition 4.4 of our Distribution Licence sets out the terms and scope of Review Processes, the process for triggering a Special Review and sets out the Designated Parameters and the Determination Values applying in respect of each Formula Year

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(a period of twelve calendar months commencing on 1 January and ending on 31 December). This includes n , the Designated Parameter which defines the timing of the next review.

Condition 4.7.4 (b) permits a Special Review under the circumstances you outline in your letter (i.e. volumes being more than 15% ahead of forecast). Condition 4.7.5 describes the process determining a new value for n (the process for triggering a Special Review). Were the Authority to determine a new value for n prior to the end of June 2013, Condition 4.7.5 (a) would be relevant. It states that the determined value of n would be the "then current Formula Year". In other words, the year of the review (defined by n) would be 2013"

The Utility Regulator's letter of the 17th May helpfully stated that:

"We have considered your interpretation of the issue and are in agreement with your argument regarding the definition of n equating to 2013"

On the scope of the Special Review, again our letter of 5th April 2013 provided as follows:

"Our licence conditions also describe the scope of a Special Review. Condition 4.4.4 describes the scope for any review (Periodic or Special). It does this with reference to n : it defines n as a variable which "denotes the Formula Year immediately preceding the first Formula Year in which the Determination Values and the Designated Parameters that are being established as part of the current Review will apply". In a similar way, Condition 4.4.6 of the licence sets out that, "the Authority will, at each Review, determine the Determination Values and the Designated Parameters that apply in those Formula Years t occurring during the period $t=n+1$ to $t=q$ (inclusive) for that Review."

Therefore, as the Authority would be required under Condition 4.7.5(a) to determine n to equal 2013 (assuming the determination was before the end of June 2013), the review could only determine the values and parameters for 2014 onward, and not for 2013 as your letter suggests. Since we are already engaged in a Periodic Review for the period from 2014 with yourselves through the GD14 Price Control process, an additional special review would be a duplication of effort, and an unnecessary distraction."

Furthermore, and again as set out in our letter of the 5th April 2013, Condition 4.4.6 states:

"the Authority will, at each Review, determine the Determination Values and the Designated Parameters that apply in those Formula Years t occurring during the period $t=n+1$ to $t=q$ (inclusive) for that Review."

Consequently, once n is determined (as agreed it is 2013), the Designated Parameters are to be determined for $n+1$ (2014) onwards only. The importance of n is that it defines the earliest volume forecast which can impact price control revenues. *It is only future volumes for 2014 onwards that require (re)forecasting. While historic volumes (including those for 2013) are relevant in an absolute sense from a forecasting perspective, past performance against those targets is not.* "Volume" is clearly defined in the licence in Condition 4.10.1 as being the aggregate quantity of gas taken from the network. There is no basis in the licence

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for past performance against volume targets (including in relation to 2013) to influence future volume forecasts, which must be estimated on an “*unbiased*” basis.

Therefore, we fundamentally disagree with the basic regulatory principle of this proposed retrospective review for firmus energy as under our licence we have a regulatory incentive to outperform volume targets for the longer term benefit of consumers and we will continue to vigorously challenge any such retrospective review.

We are very clear about the regulatory undertakings that firmus energy undertook in this regard when we agreed to the licence in 2005; and therefore we are clear regarding the conditions around a special review in this regard set out that it is only future volumes for 2014 onwards that require (re)forecasting in this regard.

The Utility Regulator’s position only adds to the continued perception of instability and regulatory risk in Northern Ireland within our business and will undoubtedly bring into question our view on the viability of our future investment in Northern Ireland.

PCR01 and PCR02 Performance

As set out in our GD14 Submission, firmus energy’s licence incentivises outperformance in forecast volumes and penalizes under performance. During PCR01, delays in achieving expected connections resulted in significantly lower volumes than forecast, however since 2009, firmus energy has achieved and indeed exceeded volumes that were set within PCR02.

Several factors have contributed to this favourable performance within PCR02:

- There were exceptionally cold winters in 2009³⁷, 2010³⁸ and 2011;
- Development of CHP projects by Gallagher (in Ballymena) and Tesco (in Antrim, Ballymoney, Derry and three stores within Craigavon);
- Due to environmental legislation, the burning of tallow has become increasingly economically unviable. firmus energy recognised this opportunity and have been

³⁷ <http://www.met.ie/climate-ireland/weather-events/Winter2009-10.pdf>

³⁸ December 2010 was Northern Ireland’s coldest calendar month in the last 100 years. Source: Met Office (www.metoffice.gov.uk)

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successful in persuading several large Industrial and Commercial animal by-products customers to convert to natural gas during PCR02;

Table 44: Animal By-Product Manufacturers Who Have Switched From Tallow to Natural Gas during PCR02

(Please note: Customer details within this table have been redacted due to commercial sensitivity).

Customer	Volume (Mtpa)
TOTAL	4.2

- Additional areas approved by the Utility Regulator (Portstewart, Warrenpoint, Ballyclare, Craigadoo, Coleraine Quarries, Bushmills, Bessbrook and Glenavy); and
- Following the target mechanism set by the Utility Regulator within the Supplemental Market Development Review Determination in April 2010, firmus energy has been able to increase the connections of SME and existing domestic customers.

However, this favourable performance has to some extent been offset by reduced gas consumption due to the overarching economic conditions, and unfortunately some of our larger customers have closed during the PCR02 period, for example, Calcast, Arntz Belting Mourne Country Meats and Dennys.

The following examines the Utility Regulator's appraisal of our P category Volumes and our subsequent response in line with our current 2013 estimated forecasts and economic analysis.

Customer Addition Assumptions.

Table 45: firmus energy's Planned Connections for GD14.

	2014	2015	2016	2017	2018	Total
New Build	800	800	800	800	800	4,000
NIHE	1,200	1,200	1,000	800	800	5,000
Existing	2,000	2,000	2,000	2,000	2,000	10,000
SME	150	100	50	50	50	400
Contract I&C	2	2	2	2	3	11
TOTAL	4,152	4,102	3,852	3,652	3,653	19,411

The Utility Regulator has agreed to accept the firmus energy proposed customer additions in the P1 - P3 Categories in all but the P1 additions in 2016. In this period Utility Regulator has suggested that our additional P1 customers for the year should be 4,000 rather than firmus energy's suggested additional 3,800. This disallowance is in direct conflict to the Utility

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Regulator's acceptance of our connections assumptions as detailed in Section 6; Table 31. In this section of the Consultation document, the Utility Regulator has, contrary to the volumes section, accepted the 2016 decrease from 4,000 to 3,800 domestic connections.

The Utility Regulator has suggested that firmus energy has assumed a steady decline in customer burn year on year from 2013. firmus energy would dispute this suggestion and reiterate that its average burn as a proportion of Year end customers to total volume therms used remains as that forecast for 2013 in the period 2014 – 2016 for these 3 tariffs. Furthermore our GD14 Submission for P1 volumes already included an increase in this ratio.

In line with customer additions that have been integrated into our volumes model, firmus energy has made allowances for the inevitable customer closures within the small medium and large commercial and industrial markets. As previously highlighted during the PCR02 price control period and will further analyse the reasons for this and the rationale behind our projected closures within our GD14 Model.

Submission Model

firmus energy submitted its P1 and P2 volumes originally based on historic volume data and end of year customers for each of these 'P' categories. These historic volumes were used to derive an average burn based on the number of each customer that was connected to the network during that year – providing a factual base for the estimated forecast.

Following our original 17th December 2012 G14 Submission, firmus energy was asked by the Utility Regulator to resubmit this same information within the parameters of a new estimation model. firmus energy is of the opinion that by introducing a new unconsulted volume model – four months after our original GD14 Submission – the Utility Regulator has attempted to renegotiate and inflate an already reasonable volume determination process, which is counter to the process that was deemed acceptable by the Utility Regulator for its PCR02 determined volumes.

P1 Tariff

We recognise that the proposed P1 tariff volumes allowed by Utility Regulator are broadly the same as those submitted by firmus energy. However, based on actual 2013 data we have re-evaluated our 2013 P1 volume estimations and feel it necessary to present these findings.

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Our submitted P1 total volumes in relation to the average burn per annum, as a factor of year end customers, are detailed below along with our most up-to-date P1 volume estimate.

Table 46: P1 Volumes

P1 Volumes	2013 Volume therms	P1 – therms Customers	Average burn (therms per year) for total year end number of Customers
Fe Original P1 Forecast 2013 (estimated December 2012)	6,646,114	18,989	350
Fe Current P1 2013	5,533,061	18,989	291*
Difference	1,113,053	0	59

**This value differs from the previously stated domestic average burn of 350 tpa (see Page 24) as P1 customers also include NIHE and New Build households.*

It is clear from the data above that the average domestic burn has fallen significantly. The table below details our GD14 Submission, the Utility Regulator's GD14 proposals and our revised estimate based on 2013 actuals:

Table 47: P1 Volumes over Price Control Period

Total P1 Volumes over Price Control Period	Therms	Difference from fe submission
UR Proposed Total P1 Allowance 2014 - 2016	29,394,385	17,477
Fe Submitted Total P1 Volume 2014 - 2016	29,376,908	0
Fe Re-evaluated Forecast Total P1 Volume (based on current average burn of 291 tpa)	23,533,992	-5,842,915

The forecast above shows a decrease in our projections for domestic customer burn. This is in part due to a warmer than average summer, however the burn figures also take into account the coldest March Northern Ireland has had in 50 years. Additional reasons for this downturn in volume have been attributed to current trends in Northern Ireland economic conditions and climate. This has resulted in an increased general awareness of utility costs and subsequent frugal approaches to energy spend. The data and evidence behind these assumptions, thus explaining our revised volume estimates for P1 are covered in more detail in this chapter. In conclusion our P1 volumes need to be re-evaluated by the Utility Regulator to reflect actual 2013 data.

The reduced volumes in the firmus energy network area are reflected in the Northern Ireland

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House Conditions 2011 Survey which shows that SAP³⁹ ratings are higher for households outside Belfast.

Table 48: Comparison of SAP Ratings for Urban Dwellings in Belfast vs. Outside Belfast

SAP Rating	Greater Belfast	Towns outside of Belfast
Band A-C	29.4%	33.8%
Band D	42.3%	44.3%
Band E	23.0%	17.7%
Band F-G	5.2%	4.3%

In addition, the Northern Ireland Housing Statistics 2011-2012 show that the average SAP rating for NIHE properties is significantly higher than other dwelling tenures. The higher the SAP, the higher the energy efficiency and so the lower the gas “burn” in the areas.

Table 49: Comparison of SAP⁴⁰ Ratings for Dwelling Tenures

Average SAP Rating	2006	2009	2011
NIHE/Social Housing	62.20	63.44	67.79
Owner Occupied	52.55	56.10	59.93

This finding is further supported by the findings of the 2011 House Condition Survey examination of insulation measures in and outside Greater Belfast:

Table 50: Comparison of Wall insulation Ratings for Urban Dwellings in Belfast vs. Outside Belfast

	Greater Belfast	Towns outside of Belfast
Full Cavity Wall	59.7%	73.8%
Partial Cavity Wall	8.9%	9.2%
No Cavity Wall	31.4%	17.0%

P2 Tariff

It is the opinion of firmus energy that the submitted volumes for P2 should not be increased. We refer to our GD14 Submission where we proposed a constant average burn per P2 customer at year end of 4,650 therms per annum from 2013 - 2016.

³⁹ Standard Assessment Procedure (SAP) is the UK Government's recommended method system for measuring the energy rating of residential dwellings.

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By incorporating this into the Utility Regulator model - that was sent to firmus energy in April 2013 - we can provide evidence that firmus energy's GD14 Submission is fair and reasonable, as shown in the table below.

Table 51: P2 Volumes

<u>P2 Volumes</u>	2013	2014	2015	2016		Therms
Average therms per total year end P2 Customers as per fe submission (therms)	4,650	4,650	4,650	4,650	Resulting Total Volume P2 Therms (2014 - 2016)	26,565,450
Equivalent average therms required per P2 Customers as per UR Model to match fe submission (therms per annum)	5,016	4,844	4,771	4,708	Resulting Total Volume P2 Therms (2014 - 2016)	26,565,450

The Utility Regulator has adjusted our original Submission through its new model of April 2013 by using a higher average burn per customer that decreases over the period of the contract. As the table shows, this Utility Regulator average still remains firmly higher than the overall yearly firmus energy estimated average burn of 4,650 therms. The results remain the same and therefore justify a P2 allowance of 26.5m therms over the period.

It is proposed by the Utility Regulator to add an additional 1.49 million therms to the requested allowance of 26.5 million. firmus energy questions the evidence for this addition and indeed based on 2013 actuals a much lower average burn per customer as was even initially estimated in our GD14 Submission must be taken into account by the Regulator.

In addition to this, firmus energy would support the rationale of the Utility Regulator's model's average burn falling gradually over the period 2013 – 2016 to reach a total of 26.5m therms. This decrease reflects the simple rationale that firmus energy has connected and looks to connect the biggest I&C customers first and any additional customers found are going to be smaller in size (and therefore burn). This in turn will lower the average burn, as shown in the Utility Regulator model and table above. firmus energy would also argue that the current economic conditions (discussed in more detail later in relation to our larger I&C customers), would also apply to P2 customers. The tables below show the extent of our estimated reduction in 2013 volumes using our most up-to-date statistical data as evidence for P2 customers.

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Table 52: Current P2 Volumes

P2 Volumes	2013 Volume	P2 Customers	Average burn (therms per year) for total year end number of Customers
Fe Original P2 Forecast 2013	7,770,150	1,671	4,650
Fe Current P2 Forecast 2013	6,800,235	1,671	4,070
Difference	969,915	0	580

By applying our current P2 average burn to our original P2 additional customer assumptions we can see significant differences in relation to our original Submission, the Utility Regulator's allowance and our revised estimate based on current 2013 statistics.

Table 53: Total P2 Volumes over Price Control Period

Total P2 Volumes over Price Control Period	Therms	Difference from fe submission
UR Proposed Total P2 Allowance 2014 - 2016	28,051,584	1,486,134
Fe Submitted Total P2 Volume 2014 - 2016	26,565,450	0
Fe Re-evaluated Forecast Total P2 Volume (based on current average burn)	23,249,397	-3,316,053

For this reason we would request that the Utility Regulator re-evaluate our full P2 to reflect the actual 2013 data.

P3 Tariff

firmus energy would state again that contrary to the suggestion that we have assumed a steady decline in customer burns over the period of the price control, our submitted forecast for P3 customers during 2013 to 2016 has remained relatively constant.

Indeed, over the period of the price control our P3 burn only falls by 0.3% (12k therms). The reason for this is that we have estimated firmus energy will add an additional two P3 customers at 45,000 therms each per year, but this will be offset by losing the equivalent of 2.5% of total therms (approx. 95,000 therms p/a over the period) in closures each year too.

Utility Regulator has suggested that this volume loss as a result of closures based on a generic rolling percentage is unacceptable and not an accurate modelling assumption. The Utility Regulator is proposing therefore to disregard these losses. This translates as the Utility Regulator stating there will be no factory closures in the next 3 years and as a consequence an additional 850k therms has been added to firmus energy's P3 volume target over the three years.

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We believe this assumption of no closures over the price control to be incorrect and baseless given the ongoing uncertainty around the economic climate in Northern Ireland.

Furthermore, if the Utility Regulator is minded to not allow a generic closure element, then by nature of this approach the Utility Regulator should disregard our proposal for an additional 2 medium sized customers. Adding 2 random customers at 45k therms per annum can only be seen as a similarly generic method of measurement. Likewise we propose that instead of a rolling percentage closure, the Utility Regulator implement and allow a provision for closures of 2 customers every year at 45k therms each per annum.

In addition to our concerns over disallowing any closures, our own customer analysis for 2013 provides evidence that P3 customers are on target to conclude 2013 with a lower total volume than we initially forecast in our GD14 Submission.

Table 54: Current P3 Volumes

<u>P3 Volumes</u>	<u>2013 Volume</u>	
Fe Original P3 Submitted Forecast 2013	3,625,000	Therms
Fe Current P3 Forecast 2013	2,910,261	Therms
Difference	714,739	Therms

This difference in the current P3 forecast shows the need for future P3 volumes need to be re-evaluated to reflect the actual 2013 data.

Table 55: Total P3 Volumes over Price Control Period

<u>Total P3 Volumes over Price Control Period</u>	<u>Therms</u>	<u>Difference from fe submission</u>
UR Proposed Total P3 Allowance 2014 - 2016	11,708,821	850,893
Fe Submitted Total P3 Volume 2014 - 2016	10,857,928	0
Fe Forecast Total P3 Volume (based on current data)	8,717,076	-2,140,852

Again we can provide evidence that the shortfall in therms is due to declining economic conditions impacting on gas demand. This reasoning is further investigated in the next section considering the P4, P5 and P6 Customers.

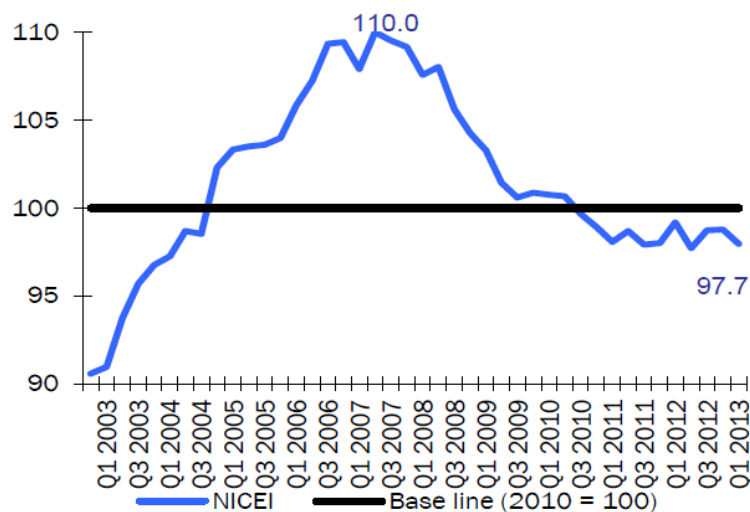
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P4, P5 and P6 Customers and the Economic Outlook.

firmus energy remains concerned that the current state of the economy in Northern Ireland and the risk that the resulting market conditions will significantly affect the volumes of our large Industrial and commercial customers. The Utility Regulator G14 Proposals suggest that over the 3 year price control period there will be no net loss from I&C customers. It is our opinion that this goes against current Government data relating to the Northern Ireland economy and indeed our own statistical information concerning the current downtrend in volumes of our large I&C customers. In order to understand the reasoning for the firmus energy's unease with possible closures, it is beneficial to consider the Northern Ireland Composite Economic Index (NICEI).

Table 56: NI Composite Economic Index 2002-2013

NI Composite Economic Index 2002-2013



Issued by Northern Ireland Statistics and Research Agency (NISRA) Department of Finance and Personnel.

The NICEI is a quarterly measure of the performance of the Northern Ireland economy based on available official statistics. The index has been developed using data from existing quarterly indices of output from the Production, Services and Construction sectors.

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The above graph shows the following:

- The NICEI results for Q1 2013 estimated that economic activity in Northern Ireland fell by 0.8% over the quarter and there has been an annual fall of 1.2% since Q1 2012. This is in comparison to UK GDP increasing by 0.2% over the quarter and was also up 0.2% over the year to Q1 2013, in real terms.
- In Q1 2013 the Northern Ireland Index was 11.0% below its peak value reached in Q2 2007, whereas GDP in the UK was only 4.0% below its peak value (Q1 2008).
- Results for the NICEI Private Sector index show a similar pattern to that for the whole economy. The index has fallen in three of the last four quarters with decreases of 1.1% over the quarter and 1.7% over the year to Q1 2013. The private sector index has returned to levels previously recorded in Q3 2004 and is currently 13.7% below the maximum value reached in Q2 2007.

It is these economic statistics and the obvious correlation with gas consumption that provides evidence of the current downward trend in gas volumes over all P Categories, and reinforces our position that the Utility Regulator should not be basing its proposed allowance on models and suppositions relating to Great Britain. The data clearly shows that Northern Ireland has been suffering economically since 2007, and to a greater extent than Great Britain as a whole. This has a knock on effect on our estimated volumes as can be seen previously in our P1, P2 and P3 revised estimations.

To illustrate this point for Large I&C Customers, the table below shows details of closures during PCR02.

(PLEASE NOTE- We would ask that the Utility Regulator redact any Customer Information).

Table 57: PCR02 Customer Closures

(Please note: Customer details within this table have been redacted due to commercial sensitivity).

Customer	Volume (Mtpa)
TOTAL	0.9

Indeed, as well as outright closures, the current economic climate in Northern Ireland has seen reducing levels of consumption by many of our established industrial customers. For example, in our PCR02 Submission we noted that Michelin Tyres had originally forecast to use 4.2 million therms per annum (Mtpa), however in 2008 they were only using 3.4 Mtpa.

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Unfortunately, this downward trend has continued during PCR02, and in the year to April 2013, Michelin Tyres have only used 3.1 Mtpa which equates to a 27% reduction in anticipated volumes. Overall, the total annual burn for the top twenty largest customers has fallen by 9.8% from our volume peak in February 2011. The table below shows how volumes for the top twenty customers have reduced steadily from April 2012.

Table 58: Volume Change of Our Top Twenty Customers

(Please note: Customer details within this table have been redacted due to commercial sensitivity).

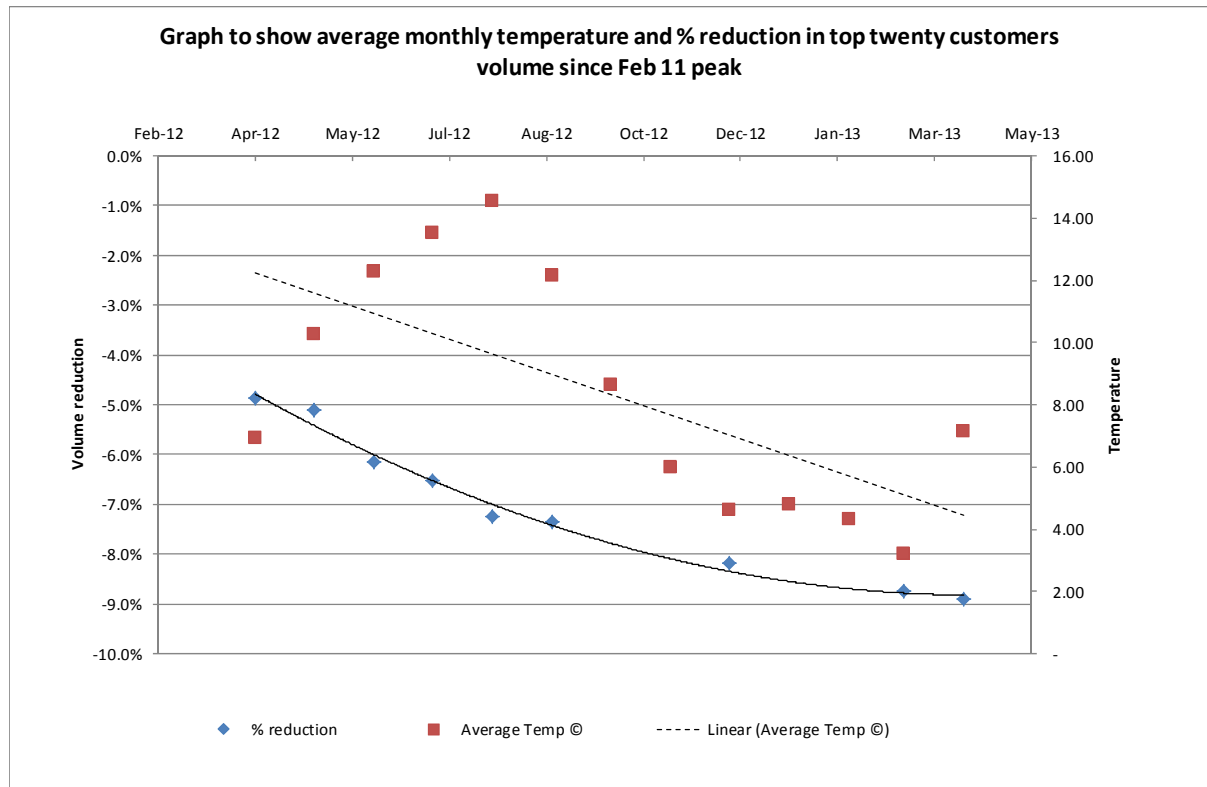
Customer	% Change (since volume peak in Feb 2011) at April 12	% Change (since volume peak in Feb 2011) at September 12	% Change (since volume peak in Feb 2011) at April 13
AVERAGE TOTAL	-4.90%	-7.40%	-8.91%

The graph below shows the relationship between the average monthly temperature and % reduction in the top twenty customer's volume since February 11 peak. It can be seen that even during the coldest March in 50 years (March 2013) volumes were still reducing.

The reasons for these changes are as follows: *(The following paragraphs have been redacted due to commercial sensitivity).*

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Table 59: Graph to show average Monthly Temperature and Percentage reduction in Top Twenty Customers since Volume Peak in February 2011



Therefore, in light of the evidence shown we cannot accept the Utility Regulator's "*minded to*" view that there has not been a steady decline in customer burns and that assumed burns should not differ significantly over the short to medium term.

It is the minded to position of the Utility Regulator that there should be no allowance for closures because it is matched by an assumption that there will be no additional new large connections. This position may make sense on paper, but in practice it is fundamentally flawed because it assumes that two circumstances are a direct reversal of each other and doesn't take into account the time variable between a factory closing and another opening, and it assumes that their consumption will be identical. It also does not take account of the time and cost of the processes involved in connecting a new I&C customer such as:

- Sales Contact / discussions;
- Initial appraisal;
- Engineering design for meter and external works;

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- Financial appraisal;
- In-house approval;
- Negotiation of contract terms;
- DRD notice of works (1 month);
- Period Contractor's 2 week notice for Construction Start date;
- Construction lead-in time (depending on current works and schedule – up to 4 months);
- Lead-in time for ordering meter (12 – 16 weeks); and
- Actual Construction – may last for a few days to 6 months.

With these factors taken into consideration we fundamentally disagree that I&C closures will automatically be replaced by equivalent new connections.

firmus energy therefore request that this time factor and the reduced volumes of 8.9% are taken into account in determining the final I&C volumes for firmus energy.

Example:

(Please note: Customer details within this example have been redacted due to commercial sensitivity).

Customer A Site

Customer A started burning natural gas in 26th July 2007:

- Annual Consumption – c.500k therms.
- Business Closed – July 2008.

Site then occupied by Customer B who started burning natural gas a year later on 26th August 2009:

- Annual Consumption – c.27k therms (c.473k therms less than Customer A).
- Business Closed – 26th May 2010.

Site has remained unoccupied since May 2010.

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Interruption of Service

The Utility Regulator's PCR02 determination states:

“The Utility Regulator considers that it is more likely that an interruptible customer will not be interrupted at all and considers that it would be appropriate to assume zero days interruption. However, in order to reduce fe’s risk exposure 22.5 days interruption per annum has been assumed.”

firmus energy would therefore question what has substantially changed in regards to firmus energy’s risk exposure, and therefore the Utility Regulator’s determination in PCR02, to justify the Utility Regulator’s change in approach for GD14. In the absence of this analysis we would ask for the 22.5 days of interruption to be reinstated.

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G. Adjustments from Previous Price Control

- Retrospective adjustments

In the model Utility Regulator sent to firmus energy on 27th August 2013, there were ten items for adjustment as summarised in table below.

Table 60: Utility Regulator proposed retrospective mechanism adjustments for GD14

Item	2009 to 2013 total £ million Jan 2006 prices
TMA	(10.4)
Connections	8.9
Meters	0.5
A+M+PR	6.9
Rates	(1.7)
Licence fee	(0.3)
NIHE	1.5
Felive	(0.6)
Banbridge	(0.3)
Additional Development plans	4.2
Total	8.7

- TMA – Traffic Management Act

firmus energy accepts that the £8.6 million included in the PCR02 determination for this period was not required and this equates to £10.4 million inclusive of the rate of return.

- Connections, Meters and Advertising & Marketing

We note that the calculations are based on the GD14 submission volumes. If changes are made to allow for subsequent developments, for example, additional NIHE connections, the opportunity could be taken to update these volumes.

- Rates

An adjustment is included to reduce the rates element of the TRV to the cash payments made for office rates. There is no basis in our licence to use cash accounting in place of expenditure, including accruals. Applying this reduction to the TRV would distort the relationship of firmus energy's asset base and accumulated losses to the determined TRV.

- NIHE

Our initial request for additional capex was submitted in May 2012. We are disappointed

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that agreement has still not been reached to reimburse us for the cost of extending the benefits of natural gas to these additional areas.

firmus energy wrote to the Utility Regulator over a year ago on the 10th May 2012 requesting an informal review for increased capital expenditure to convert additional NIHE properties from solid fuel to natural gas. Unfortunately, to date, the Utility Regulator has not responded in writing to that request.

Following our GD14 submission, we received a request from the Utility Regulator on 26th February 2013 to update our letter of 10th May 2012, which we did on the 3rd May 2013. In order to shape our future discussions we would highlight the following in order to achieve a mutually agreeable position:

- these projects are economically viable and contribute to overall network recovery;
- these connections are in line with NI Assembly policy objectives on improving domestic energy efficiency and alleviating fuel poverty;
- in our interactions to date with the Utility Regulator we were given to understand that these conversions were in order, and
- 16 months have elapsed since our submission was made to the Utility Regulator's office.

For information, we would highlight that it is NIHE policy to provide its tenants with a new boiler within its 15 year replacement scheme. Therefore, if we lose the opportunity to convert these NIHE properties to natural gas it will be 2028 at the earliest before these properties could possibly replace their boiler. This would therefore lock these possibly “fuel poor” households into more expensive and carbon intensive forms of heating.

We therefore would challenge the Utility Regulator letter of the 16th August 2014 (16 months after our original request) stating:

“We would highlight that we have never approved any of these amounts and have never indicated to firmus that they would be approved.”

This is not the case, as our meeting of the 27th November 2012 set out. We fail to understand why the Utility Regulator proposes now only to:

“We have indicated to firmus that we are considering including some amount of additional infill and feeder in 2013 and included a figure of £1.5m in 2013 in the GD14 draft consultation as part of our TRV calculation.”

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As our letter of 3rd May 2013 stated we have spent an additional £5m in converting an additional 3,015 NIHE properties to natural gas. These connections were undertaken on an NPV positive basis and therefore should support the goals of DETI Strategic Energy Framework, the Utility Regulator's own Social Action Plan and its principal statutory aim to:

"Promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland".

- felve

We note the exclusion of the felive replacement capex cost but believe the additional opex for felive maintenance as set out in the Utility Regulator's letter of the 25th March 2011 should now be allowed instead.

- Banbridge

We note that licence modifications needed to add the additional wards to our licence area are still outstanding. Once this is complete, we request this cost be added back to the TRV.

- Additional areas

The allowed revenue from additional volumes in these areas has been netted off the capex allowed. We ask UR to confirm that these volumes have also been taken into account in calculating firmus energy's accumulated under-recoveries, including their effect on the parameter gamma.

- **Total Regulatory Value, FE**

- Depreciation adjustment

The level of depreciation affects the determined prices only through the value of Depreciated Asset Value (DAV) at the end of the recovery period in 2035 and the Depreciation Adjustment (DA_B).

The reduction in TRV resulting from the DA_B proposed in the model of 27th August 2013 appears large at £2.8 million. We believe this may be the result of an error in the calculation of depreciation in the original PCR02 determination. If this is the case, we request confirmation that the DA_B adjustment only corrects the error and has no net adverse effect on firmus energy. We believe a similar error, where assets are not removed from the depreciation calculation when fully depreciated, occurs in the current model.

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- Profile adjustment

The profile adjustment value at 2013 in the model of 27th August 2013 is derived from the value calculated in the Version 7 Model sent 18th March 2010, further adjusted for one element of the opex changes arising from the market development review.

The Version 7 of the Model was itself different from the original PCR02 determination so it would be helpful to have all the elements leading to the GD14 determined value for 2013 set out separately.

- **Treatment of under-recoveries**

Through the definition of the Primary Constraint, our licence provides for there to be under-recoveries or over-recoveries relative to the revenue assessed by the Utility Regulator. It also provides for under-recoveries to be recovered later in the licence period and ensures that the financing cost associated with such deferred recovery is taken into account. It explicitly provides for the return on under-recoveries to be set equal to our allowed WACC through to 2035. This was a key commercial component of the licence and the basis on which investment in the business has been made.

The Utility Regulator states in the GD14 document that *“there is no risk associated with these under-recoveries”*. This is not true – they are subject to the same risk as deferred revenue under the profile adjustment, namely the risk to regulatory principles.

As with the debate on splitting the RAV later in the Consultation, providing for a lower cost of financing the under-recoveries would imply the need to increase WACC on other components of firmus energy’s activities. The present allowed WACC represents a weighted average cost of financing for all of our business activities, including owning the regulatory promise in relation to under-recoveries. Reducing the rate of return on the under-recoveries, on the grounds that they are lower risk, would result in the need for increased cost of capital on other aspects of our business in order to secure our financing.

There is regulatory precedent for a lower rate of return to be applied to so-called K-factor revenue (i.e. recovery carried forward as a result of forecast errors) in other regulatory regimes. However, notwithstanding this being understood by both parties, the provision for the Utility Regulator to do this was not provided for in the licence. Such arrangements are not comparable to the under-recoveries, for a number of reasons:

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- There has typically not been an explicit statement on the allowed return for K-factor revenue through to the end of a licence period;
- Forecast errors are, by nature, symmetric – under-recoveries should be equally frequent as over-recoveries. In this context, the level of the rate of return is not as important, because it is unlikely to result in a material reduction in the recovery of the cost of financing the network over time; and
- The magnitude of forecast error should be low.

None of these reasons apply to firmus energy's under-recoveries. We are running under-recoveries based on our assessment of the state of the market, competitor fuels, and to encourage connection and use of the network in the interests of all stakeholders. This is the flexibility for which our licence provides. As a result of the current state of the market, our view is that under-recoveries should persist for some time, again in the interests of all stakeholders.

A reduction in rate of return would therefore not only constitute a change to the basis on which investment was made, but would also result in a significant reduction in expected return, which would need to be compensated for elsewhere in order to ensure we can recover an appropriate return over our licence period.

The Utility Regulator has suggested that the operation of the current regime creates a perverse incentive. We would not agree with this. The current arrangement makes us indifferent *from a financing perspective* of the under-recoveries. However, this is clearly not our only consideration. We balance the risk associated with deferring revenue (i.e. that associated with greater reliance on future regulatory decisions which cannot be readily predicted) with the benefit – for firmus energy and for customers – of encouraging more customers to convert to natural gas by keeping prices lower than competing fuels.

We believe these are the appropriate considerations in managing the issue of under-recovery. We do not believe it is appropriate to set an arbitrary date for the elimination or reduction of under-recoveries without associated analysis of likely market conditions and the impact of such action on volumes. We would be grateful if the Utility Regulator could produce evidence to suggest that 2017 is an appropriate date.

H. Financial Issues

It is unhelpful for the Utility Regulator in a public consultation document to assert that its “post 2016” modelling is based on the GB GDN rate of return of 4.83%. This assertion has been made without any consultation with firmus energy and it sets out a baseless expectation to stakeholders and consumer groups that the final rate of return for firmus energy post 2016 will be reflective of that amount.

The bringing forward of the discussion in such a unilateral manner could potentially erode investor confidence in Northern Ireland and is inconsistent with the Utility Regulator's statutory duties under the Energy Order and with regulatory best practice more generally.

- Introduction

The Utility Regulator, in their GD14 consultation document, made a number of points in relation to the allowed rate of return for firmus. In particular, they noted that:

- firmus energy has a licence condition which sets the rate of return until the end of 2016 at 7.5% (real, pre-tax);
- this should not be seen as setting a precedent for future price controls, for which the cost of capital will be set commensurate with the risks that firmus energy faces going forwards;
- firmus energy is now a more “*mature and stable*” business, and so the allowed rate of return for GD17 should be set more in line with the rates set for comparable GB utilities (quoted as 4.83% pre-tax) – in particular, the Utility Regulator argued that the risk that connections and volumes fail to materialise is relatively low, as any fall in connections would also be associated with a fall in both capex and opex;
- the approach of looking at the riskiness of a business by comparing RAV:totex ratios could lead to a position where the WACC for Northern Ireland utilities is lower than that for the GB GDNs;
- there is merit in exploring whether the TRV should be divided into “*a conventional RAV and a separate “pot” with regulatory commitment to be recoverable from consumers, with the conventional RAB attracting a normal rate of return and the remainder of the TRV being rolled up “at a lower rate to reflect relevant risk”*”; and

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- the level of under-recoveries may not be being optimised by firmus energy, and in particular the return of 7.5% may be providing a perverse incentive on firmus energy to build up under-recoveries – the proposals provide the potential for firmus energy to reduce or even eliminate under-recoveries by 2017.

We set out firmus energy's arguments in relation to these points below.

First, we believe strongly that the GB headline WACC is not an appropriate benchmark for our business beyond GD14, for two key reasons:

- the characterisation of firmus energy as a low risk business is not correct, and will not be correct in 2017; and
- comparisons to the GB utilities need to be made with care, and appropriate adjustments taken into account.

Second, we do not believe the use of the RAV:totex ratio, in the way suggested by Utility Regulator, is in any way appropriate as a mechanism for determining the cost of capital. Nor do we believe there is any merit in splitting the RAV into two components. Any reduction in cost of capital associated with one part of the RAV would have to be associated with an increase on another part, in order to ensure that firmus energy could continue to finance its activities.

Third, we do not believe that the current approach to under-recoveries is providing a perverse incentive. We would caution against setting arbitrary deadlines for the removal of the current accumulated under-recovery, although we agree with the general concept of reducing it and look forward to engaging with the Utility Regulator in discussions on this matter.

The GB headline WACC is not an appropriate benchmark

We argued in our initial GD14 Submission that a WACC of 7.5% is relatively low compared to the risks our business faces. The Utility Regulator is not proposing to adjust the pre-agreed rate of return for GD14, a position which we wholeheartedly commend as representing the long term interests of customers as well as investors.

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Our analysis in our GD14 Submission of 17th December 2012 related to business risk and WACC for GD14; which at that time we believed would run for 5 years (2014-2018) – however and therefore we believe that the majority of the points we made also hold for GD17. We therefore believe the suggestion of using the GB GDNs as a benchmark without making appropriate adjustments for GD17 is inappropriate.

firmus energy is not a low risk business

The Utility Regulator appears to suggest in the GD14 consultation paper that firmus energy's business can be compared to the GB GDNs in terms of risk and maturity.

We do not believe this is a reasonable comparison. As we outlined in our original Submission, firmus energy's key commercial risks can be categorised into:

- Revenue;
- Cost; and
- Regulatory.

Any use of GB GDN cost of capital figures must therefore be adjusted to take into account the differences in risk faced by firmus energy and the GB utilities. Further, it is not appropriate simply to assume that future regulatory changes will bring our risk profile closer to those of the GDNs – until the detail of such changes is debated and clearly understood, it is our current risk profile which is of relevance to investors.

Revenue risk

The Utility Regulator recognises that firmus energy is exposed to volume risk through the current structure of the price control. In addition to this, the Utility Regulator is proposing to further increase our risk profile through a connections incentive.

The Utility Regulator states that:

“We have analysed the risks for both companies from connection and volumes falling below forecast. However any fall in connections would also be associated with a fall in both capex and opex... We can conclude that now that all large industrial loads are connected, the maturity of PNGL and FE, in terms of failing to make future connections putting revenues at risk, is very similar to the GB GDNs”

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This may or may not be true in relation to a connections incentive. It depends on the calibration of the mechanism and the degree of diversity of new connections costs.

However, it is certainly not true in relation to firmus energy's volume exposure. Volumes can change as a result of a change in:

- the rate of new connections;
- the rate of disconnections; and
- changes in average consumption.

Only one of these (new connections) would also have a direct change in capex or opex associated with it. Changes in volumes related to the others would have a direct impact on revenues alone and hence on profitability.

The Utility Regulator's conclusion in relation to the GDNs is clearly not valid unless firmus energy's exposure to volumes is removed. Until the detail of any such change is made clear, we do not believe it is relevant to assert that our revenue risk profile is in any way comparable to the GDNs. It is the risk profile of our business resulting from today's market and regulatory environment which is relevant for our investors, not the risk profile of a future hypothetical business or licence framework. As we stated in our GD14 Submission, the loss of our largest customer could result in a 7% reduction in volumes, and a 6% reduction in revenue. The loss of the largest customers would result in a 50% reduction in revenue, and a 46% reduction in revenue. These numbers will not change markedly by GD17.

This level of risk clearly justifies a premium to that of the GB GDNs, which are not exposed to such volume risk. We note, for example, that the Austrian gas TSO has a 3.5% mark up on their return on equity to compensate for exposure to demand risk.

Cost risk

In our initial Submission, we demonstrated that while a significant amount of capex has already been undertaken, there is a significant amount of capital investment still required to complete the roll out of the network. We noted that only by 2015/16, will capital investment start to fall below the significant levels seen since the start of the network development. firmus energy's ratio of RAV to capex in 2014 is 10.4, well below the GB GDN median of 12.2, and below even the lowest of the GB GDNs. This implies a significant level of risk

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associated with the rollout of this capex programme.

Regulatory risk

firmus energy's revenues are determined by the Utility Regulator. As we noted in our GD14 Submission, we are exposed to the risk that the regulatory regime is implemented in ways which are not consistent with best practice or which are beyond investors' expectations.

In the light of this, it is relevant that two price control decisions by the Utility Regulator have been appealed (PNGL and NIE) in a very short space of time. Such a situation is highly unusual. We would stress that our argument here does not relate to the merit of either case. It is simply a fact that the existence of such a situation increases the perception among investors of regulatory risk (as can be seen through Moody's commentary⁴¹).

The existence of such regulatory uncertainty means that the cost of capital for Northern Ireland utilities is likely to be higher than that for GB GDNs, where the regulatory regime is perceived as being more stable. It will take time for investors to be reassured that the current period of regulatory uncertainty is temporary – particularly given some of the Utility Regulator's comments regarding the scale of potential change to the regime in GD17.

The GB Regime Is Not Comparable Without Adjustments

Even if firmus energy's business were to have the same risk profile as the GB GDNs by GD17, we do not believe it would be appropriate to use the headline WACC quoted in the GB settlement without appropriate adjustments. The most important of these adjustments to address are:

- the investor premium associated with Northern Ireland;
- the difference between the GB and Northern Ireland treatment of debt costs;
- the difference between headline and "*baked in*" investor returns in the GB settlement; and
- firmus energy is significantly smaller than other GDNs in GB and Northern Ireland.

Any approach to calculating firmus energy's WACC which makes use of the GB GDNs must

⁴¹ "New Competition Commission Referral Suggests Regulatory Uncertainty Remains in Northern Ireland", May 2013

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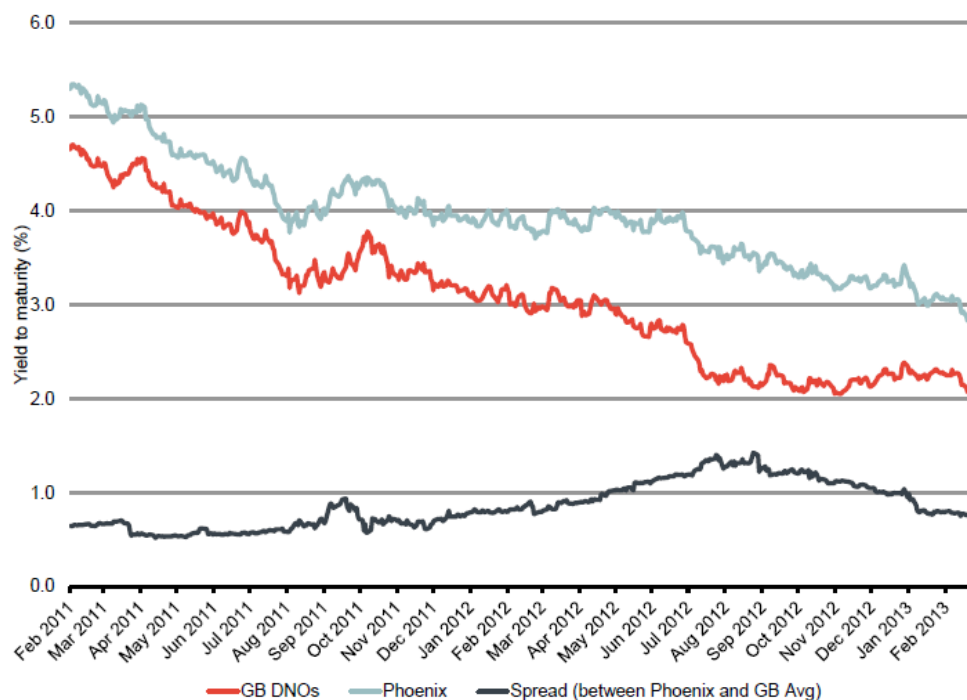
take these factors into account.

NI Investor Premium

firmus energy does not have any publicly traded debt. However, PNGL Limited does have a publicly traded bond, which trades at a premium percentage to comparable bonds from GB utilities. This indicates that even for a more mature business, debt investors require a premium to invest in Northern Ireland activities.

The extent of this premium can be seen comparing the yield on the PNGL bond to those for gas, electricity and water debt instruments of comparable maturity issued by GB utilities. The results of such an analysis are shown in the figure below.

Table 61: Spread between GB and NI gas sector bonds



The average premium over the last six and twelve months (as of 5th March 2013) has been 96 bps and 106 bps respectively.

Since this is a real and observable premium charged by investors, it would be inappropriate simply to assume that investors in firmus energy could be compensated with reference to a

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GB debt or equity cost.

Approach To Covering The Cost of Debt

The Utility Regulator states that “*Ofgem set an allowed cost of capital of 4.2% post-tax, equivalent to 4.83% pre-tax*”. This is not correct. Under the RII framework, Ofgem no longer sets a cost of debt as part of the price control process – the cost of debt is set with reference to a market benchmark adopted by Ofgem (the iBoxx indices). The allowed cost of capital quoted by Ofgem is based on a point estimate of the value of these indices – as of December 2012, the value of the indices was 2.92%, which was the value used to derive the WACC values quoted by the Utility Regulator. But as market rates move, so will the GDNs’ allowed cost of debt.

As a result of this approach, Ofgem needs to take no view as to the likely future direction of debt costs. If the market cost of debt rises, this will be passed through to all GB utilities via movements in the benchmark indices. As such, there is no “*headroom*” provided in the WACC estimates.

The structure of the regime in Northern Ireland is different. The Utility Regulator estimates the cost of debt as an absolute value, which then holds for the entire of the price control period irrespective of market movements. In such situations, there is good regulatory precedent to suggest that the regulator should not simply use a market benchmark at a point in time to set the cost of debt, but that consideration should be given to the need to provide some “*headroom*” to allow for the risk that debt costs increase over the period. In DPCR5, Ofgem provided for 30bps of such headroom, while basing its point cost of debt estimate on market indices.

This is particularly important because we are entering a period during which yields are expected to increase, as the posture of monetary policy tightens over time.

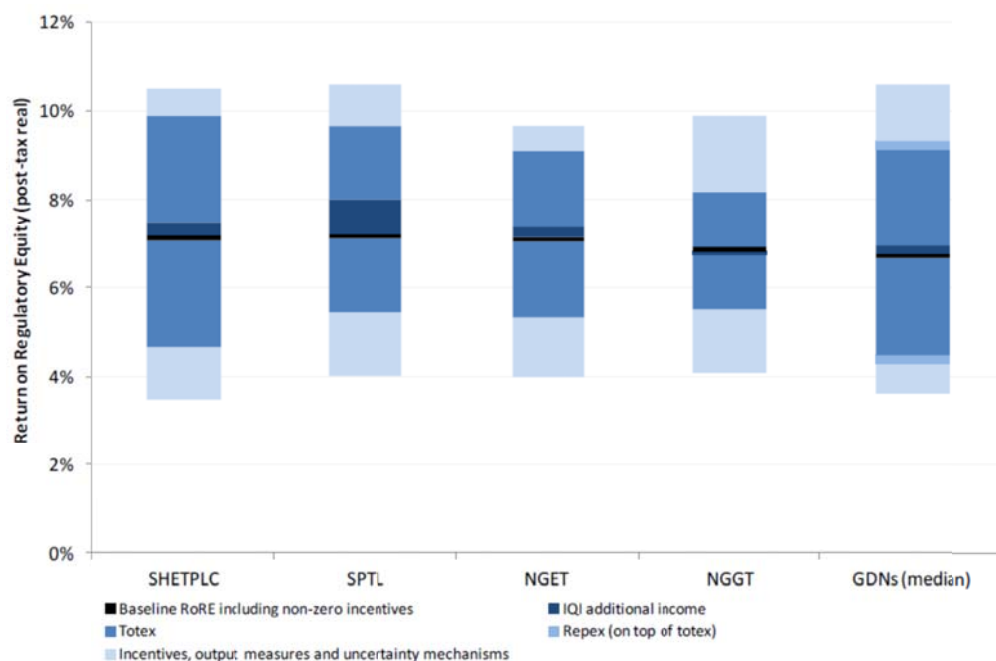
Headline vs. “*baked in*” Return Levels

Even after these adjustments, the headline WACC is not necessarily a good assessment of the expected returns of utilities in the GB sector. This is because the design of regulatory settlements (most explicitly since EDPCR5) has taken a holistic view of the likely financial position of companies. This is most easily seen from Ofgem’s Return on Regulated Equity (RoRE) analysis.

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This analysis looks at the returns to equity holders not just from the headline WACC (or, under RIIO, the return on equity), but from all aspects of the price control settlement. Ofgem uses this analysis to calibrate both the expected return to utility investors, and the range of possible returns – they aim for a range which allows double digit returns on equity on the upside, and a return broadly equal to expected debt cost on the downside.

Table 62: RoRE analysis from RIIO-GD1



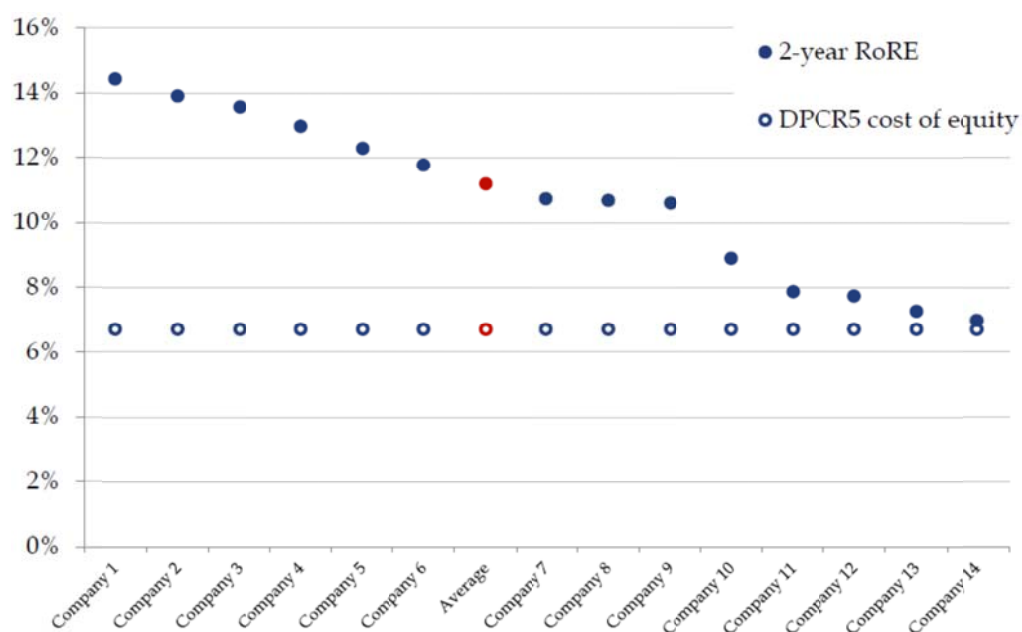
Source: Ofgem

The figure above indicates the nature of Ofgem’s analysis. It is clear that even the median GDN performer will expect to earn some revenue (“*IQI additional income*”) over and above the headline allowed return on equity. The level of further returns expected by a GDN will depend on the precise calibration of the incentive schemes: targets designed to be easy to achieve are effectively a substitute for increased return on equity.

This can be seen from an analysis of the results from previous price controls. The figure below, based on analysis undertaken by Ofgem, shows the effective RoRE earned by the electricity distribution companies since DPCR5, the first price control to explicitly embody the concept of the overall settlement providing an effective rate of return above the headline level.

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Table 63: 2 year RoRE for electricity distribution companies



Source: Ofgem

From the above analysis, it is clear that the expected performance of a distribution company in DPCR5 is considerably above the headline return on equity set by Ofgem. The materiality of this difference (over 400 bps) is such that it is difficult to attribute to asymmetric information or unanticipated company outperformance, particularly after 20+ years of incentive regulation.

When Ofgem proposes the settlement and when utilities accept (or reject) the settlement, it is this overall RoRE which is their focus. Therefore it is inappropriate for the Utility Regulator to adopt the GB GDN headline return as a benchmark and simply “import” it into an NI settlement without first ensuring that the resulting overall NI settlement is likely to result in the same expected equity returns as that for the GB GDN.

Use Of RAV:Totex And Dividing The RAV

The Utility Regulator suggests in the GD14 document that:

- there is a link between the RAV:totex ratio and the overall risk of a utility, and the high values of RAV:totex in Northern Ireland “could lead to a position where the WACC is lower than for the GDNs”; and
- this may be addressed by recognising different aspects of the RAV may have different risks and hence different opportunity costs of capital.

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We do not believe either of these arguments to be valid.

It is true that high levels of spending relative to the overall scale of activity of a business (often measured via a ratio such as RAV:totex) imply higher risk. However, Northern Ireland RAVs are not necessarily a good indicator of the actual scale of the business, and so it would be inappropriate to use such data to imply that Northern Ireland utilities should receive a lower WACC than the GB GDNs.

Neither do we believe there is merit in separating the RAB into different components.

The RAV:Totex Ratio Cannot Be Used To Define Cost Of Capital

firmus energy has previously argued that the level of capex being undertaken by a utility, relative to its overall scale, is a driver of the risk borne by the entity. It is reasonable to assume that, for two similar networks, the one with the larger capex programme faces more risk.

However, we would make two points about the translation of this argument into a cost of capital.

First, we are supportive of the proposal that the Utility Regulator base its cost of capital estimates principally on the CAPM framework, taking into account all relevant factors. The appropriate cost of capital cannot be derived by looking at different proxies for riskiness (including RAV:totex ratios), with a GB GDN benchmark, to set a cost of capital. Notwithstanding the relevance of the GB GDNs as a benchmark (a point we return to below), such an approach would be without theoretical underpinning or regulatory precedent, and as such would be potentially extremely damaging to the investment climate.

Second, even were the RAV:totex ratio to be used to consider the position within an overall range for cost of capital defined by the CAPM methodology for a particular utility, it is important that what is being measured is well understood.

RAV is being used as a proxy for the “*scale of the business*” in an operational sense. The risk associated with large capex programmes relate to the design, procurement, financing, contract management and commissioning processes. These are all essentially operational issues. If a company’s operations are bigger, it will be better able to manage risks

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associated with a large capex programme.

Using the RAV as a proxy for scale is not without its issues. Consider two utilities, one with one very expensive pipeline asset which requires little or no maintenance, and one with a large network of much cheaper assets. They may have the same RAV, but the second will have a much larger operation. It is likely that a large capex programme would be less risk for the second utility.

Because of the particular treatment of assets in Northern Ireland, adjustments to RAV may therefore be required to ensure that reasonable comparisons (i.e. those which take into account scale of operations) are being made with GB.

In firmus energy's case, TRV includes both depreciated asset value and the profile adjustment. In the case of the GDNs, RAV is equal to depreciated asset value alone. Therefore, depending on the size of the profile adjustment, two otherwise similar networks in GB and Northern Ireland could have different RAVs – the NI RAV could be much higher as a result of the profile adjustment. However, the scale of the business' operations would be similar, and so using the RAV:totex metric would yield an *underestimate* of the riskiness of the NI business.

There Is No Rationale To Decomposing The RAV

The Utility Regulator states that firmus energy's TRV is composed of two elements:

- investment in physical assets; and
- deferred revenue (the profile adjustment)

The Utility Regulator further states that:

“The first category is consistent with GB GDN's RAVs which are comprised almost exclusively of the value attributable to historical financial investment by shareholders/lenders.... the other ... categories would not appear in a standard GB GDN RAV and would appear to be lower risk.”

This represents a fundamental misunderstanding of the two components of our TRV, and that of the GDNs.

In GB, GDNs invest in physical assets. Provided this investment is deemed to be efficient, it is allowed into their RAV, which means they are allowed to recover its cost plus the

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reasonable cost of financing it. This recovery takes place over its assumed life, with the depreciation component of allowed revenue refunding the principal, and the WACC component refunding the cost of financing.

At any point in time, the GDN's RAV therefore consists of the cost of assets whose principal has not yet fully been paid back. In each regulatory period, the GDN's allowed revenue is determined to ensure customers pay for further repayment of principal plus the cost of financing the non-recovered component.

Over our licence period (i.e. to 2035), the regulatory arrangements set out in firmus energy's licence (and which constituted the agreed basis for investment) ensure exactly the same thing. In other words, over the full regulatory period, if all expectations are met⁴², firmus energy's distribution business will recover the principal invested in the network plus the reasonable cost of financing that investment. This is the fundamental purpose of the "*Present Value Equation*" set out in clause 4.6.4 of our licence.

It follows that any reduction in the WACC associated with a part of the TRV would have to be accompanied by an increase in the WACC for another part of the TRV – otherwise, over the period the reasonable cost of financing would not be recovered, and firmus energy would be undercompensated⁴³. This would clearly be unacceptable to firmus energy, and would constitute a failure to take account of the Utility Regulator's duty to secure that licence holders are able to finance its activities.

The nature of the compensating change in WACC which would be required to offset any reduction can be seen by considering what the profile adjustment really is.

As we note above, from a financing perspective, owning the RAV at the end of any individual price control period is the same as owning a regulatory "*promise*" to allow recovery on the related assets in successive periods.

For the GDNs, the speed at which investment principal is recovered is determined by the depreciation policy. Our licence provides for more flexibility than that of the GDNs. Specifically, it allows the deferral of components of allowed revenue relating to depreciation and return on existing assets, which would otherwise be charged to customers during the

⁴² That is, assuming no under- or out-performance on any incentive regimes, volume targets etc.

⁴³ This is true even if the sum of the "low" and "high" risk TRVs equate to the original TRV, because it is the cost of financing investment which would be under-compensated.

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period.

Accruing deferred revenue via the profile adjustment is no different in principle to a GDN having a longer depreciation life. A longer depreciation lifetime means holding the regulatory promise on more recovery for more periods and hence a greater need for longer financing⁴⁴. The same is true of deferring recovery⁴⁵.

So, to the extent there is a “*lower risk*” activity, it does not just relate to the profile adjustment – it relates to owning any undepreciated TRV. There is no reason to distinguish between profile adjustment and the rest of the undepreciated RAV – they both equate to holding a regulatory promise, and the risk of the activity relates to the perceived credibility of this promise.

However, any such “*lower risk*” activity is today bundled with all the other activities undertaken by a utility – for example, operating and maintaining the network, building out the network, and financing the initial outlay. The cost of capital observed for utilities covers both sets of activities. Assuming capital markets are reasonably efficient; the observed cost of capital should be a weighted average of the risk associated with all these other activities and the risk of holding a regulatory promise in relation to the undepreciated RAV. If holding the regulatory promise is “*low risk*” relative to the average, then these other activities must be significantly “*higher risk*”.

To be theoretically sound, any proposal to reduce the rate of return on the profile adjustment must therefore be accompanied by a proposal to increase the rate of return on other activities. However, even though more theoretically consistent than the Utility Regulator’s proposal of simply reducing return on deferred revenues under the profile adjustment, we would suggest there are significant practical issues with such an approach. These include that:

- It is not clear that historic investments can be credibly ring-fenced and deemed low risk. Ongoing operational and investment behaviour will affect the ongoing value of the RAB;

⁴⁴ Since the risk associated with the promise depends on the stability of the regulatory regime, it is also the case that deferring revenue increases risk, as it increases exposure to future – unknowable – regulatory policies.

⁴⁵ Deferral can relate to both principal and return, whereas depreciation only relates to principal. However, deferring either increases the need for financing, the basis for the repayment of which is a regulatory promise relating to future recovery.

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- Observing any rate associated with individual activities (rather than the aggregate of a utility's activities) is very difficult, making determining appropriate parameters a real challenge and highly subjective; and
- Once the higher cost of capital on ongoing operations has been determined, this will provide much stronger incentives to cut investment spending relative to the allowance made by the Utility Regulator, since the payoffs to reduced spending are now much higher. If existing assets only receive a low debt-related return, the incentives for stewardship of those assets are weakened.

We note that the idea of splitting RAVs has been discussed for many years in the GB market, and none of the regulators in GB have made any significant move in this direction – a strong indication that there are unlikely to be major benefits and may be significant drawbacks.

The Utility Regulator states that:

“There is some regulatory precedent for an approach which involves separating RAV into more than one pot. For example, Ofcom consulted on and concluded that BT's copper access business was lower risk than the remaining BT business and assessed that the group beta of 1.1 should be split as an equity beta of 0.9 for the copper access business and 1.23 for the rest of BT.”

However, this is not a relevant precedent. This split related to separating two distinct and identifiable business activities, both of which had observable comparators, rather than splitting a single business activity into two components without a clear boundary and with no comparators.

For these reasons, we firmly believe that any attempt to disaggregate the RAV and apply different costs of capital to specific components is inappropriate and should not be considered further.

- **Depreciation**

Throughout PCR01 and PCR02 we have maintained our depreciation policy as agreed with the Utility Regulator when we began our business in 2005. Assets are depreciated on the following basis:

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- Mains & Services - 40 yrs
- Meters - 15 yrs
- Other (Average) - 5 yrs
- IT and Office - 7 yrs

firmus energy has no plans to change their depreciation policy in GD14. However, within the consultation document the Utility Regulator states that:

“We note the differences above between PNGL and FE. For GD14 we see no reason why we should not apply a consistent depreciation approach for both GDNs and will discuss this in more detail with the GDNs before we finalise our model for the final determination.”

We would question why the Utility Regulator is now choosing to depart from the agreed PCR01 and PCR02 determination position. Therefore we would request further information and justification from the Utility Regulator around this proposed amendment. Naturally, to the extent that any amendments are proposed to our licence/policies in this regard, they will be dealt with in accordance with the modification process in our licence.

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I. Draft GD14 Outputs

- Designated Parameters

The Designated Parameters are a central part of the GD14 price control process. As part of our GD14 Submission we believed the parameters should be as following:

Table 64: firmus energy submitted GD14 Parameters.

Designated parameter	Value
r_t	0.075
n	2013
f_t	0.5
q	2035
RPI	RPI
w	0
g	0
h	0
d	0
l	0
δ_t	0
$X_{O,t}$	0
$X_{U,t}$	0
α_t	0.3

Our reasoning for this was set out as follows:

“alpha – Currently 10%; proposed 30%. As shown in the model, firmus energy would need to be able to charge approximately 20% above the proposed determined price for customers in category P6 to recover the accumulated under-recovery in that category by 2035. Any reduction in the determined P6 price would require a higher percentage addition to recover the same cash. We believe a higher value for alpha will allow us to be confident of eliminating the under-recovery while giving us the flexibility to respond to changes in world energy markets.

delta – Currently 0; proposed 0. The model anticipates charging under-recoveries in the P category in which they occurred but leaving delta at 0 would allow us some flexibility in this approach, if necessary.

w, g, h – Currently 0; proposed 0. Rolling incentives are turned off. We believe that these parameters should be left at 0 until the business is more mature and a stable baseline level of expenditure can be established.

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rt – Currently 0.075; proposed 0.075. As discussed in detail above, we believe 7.5% remains the appropriate figure for the main rate of return.

X – Currently 0; proposed 0. We believe that the financing costs and risks associated with our licence should be considered as a whole. We have used the concept of under-recoveries, as provided in the licence, to build volumes to viable levels. We need to continue to grow the customer base, especially in the domestic sector, to reduce the risks to the business from I&C closures.”

We therefore fail to understand why the Utility Regulator is proposing a change in approach from PCR02. We would request further information from the Utility Regulator as to why this is now being proposed without due and transparent consultation with firmus energy. Only once we have agreed opex, capex, and volumes can we finalise these parameters, as we do not wish to disadvantage ourselves against competing fuels.

- **Return on under-recoveries**

firmus energy are surprised that the Utility Regulator has expressed in a public consultation the following viewpoint:

“We would welcome consultation responses on the appropriateness of fe under-recoveries receiving the full cost of capital at 7.5%”

We feel this is an unfairly loaded question, and inappropriate as the issue had not been previously discussed with firmus energy before the release of the GD14 Consultation.

Through the definition of the Primary Constraint, our licence provides for there to be under-recoveries or over-recoveries relative to the revenue assessed by the Utility Regulator. It also provides for under-recoveries to be recovered later in the licence period and ensures that the financing cost associated with such deferred recovery is taken into account. It explicitly provides for the return on under-recoveries to be set equal to our allowed WACC through to 2035. This is a key commercial component of our licence and the basis on which investment in the firmus energy distribution business was made.

This question is a clear and unexpected departure from the determinations of previous price controls (PCR01 and PCR02) and we would therefore have expected that this would have been at least discussed with firmus energy in detail as the licence holder before publication

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of the GD14 Consultation document. This again brings into question the quality of the regulatory practice surrounding the GD14 process.

We therefore believe a decision around the return on under-recoveries can only be made on a no-surprise basis following full consultation with firmus energy and that if a change in policy is to occur it must be correctly explained, justified and agreed.

- **Efficiency Target**

In their GD14 Consultation, the Utility Regulator states that:

“Recent regulatory precedent for efficiency targets is in the range of 0.7% to 1.4% based on ongoing productivity growth in opex activities in the wider UK economy.”

On this basis of this evidence, the Utility Regulator states that:

“We intend to set an efficiency target for both opex and capex of 1% per annum, broadly in line with ongoing UK productivity growth... We do not intend to allow anything for Real Price Effects... This is because we believe that the economy will continue to be relatively low growth”

We do not believe the Utility Regulator’s proposed efficiency target is appropriate for three key reasons:

- We believe the application of an efficiency target will double count efficiencies, given Utility Regulator’s penalising approach throughout the GD14 Proposals;
- We believe there is insufficient evidence to justify the application of a 1% target, given that applied by Ofgem to the GDNs; and
- We believe the Utility Regulator has not considered relevant evidence in relation to its position on Real Price Effects.

Efficiency analysis is generally broken up into two elements:

- **Static efficiency** measures the extent to which the current performance of a company is comparable with or lags behind the efficiency levels of comparator companies. It is typically referred to as ‘catch up’ efficiency as it seeks to measure

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the extent to which a company must make efficiency improvements to '*catch up*' to the efficiency frontier or best practice.

- **Dynamic efficiency**, on the other hand, measures the extent to which a company may be able to achieve productivity improvements in the *future* (over and above its scope for static efficiency gains), owing to technological improvements over time. This is based on the premise that technological improvements will allow a higher level of output to be produced from a given set of capital and labour inputs. In order to provide companies with incentives to continually improve their processes and take advantage of technological improvements, regulators may set a general '*frontier shift*' efficiency target that the regulated entities are required to meet. The scope for dynamic efficiency is influenced both by changes in 'productivity' and changes in input prices, where:
 - **Productivity changes**, also known as '*ongoing efficiency*', can be attributed to technological change over time.
 - **Input price changes**, also known as '*real price effects*' (*RPEs*) represent the expected change in input prices (for example, wages) relative to the Retail Prices Index (RPI) over time. If a company's input prices are expected to increase faster (slower) than RPI in the future, for example, its dynamic efficiency will be (higher) lower than its estimated 'ongoing productivity'.

The dynamic efficiency measure is designed to capture efficiencies that arise as a result of technical progress in the *future*. This is over and above the *current* scope for catch-up. It is important to ensure that the two are not double-counted to ensure that the overall price control allows the company to finance its activities. We believe the Utility Regulator's approach to scrutinising opex and capex cost allowances alongside the proposed implementation of an efficiency target results in a significant risk of double counting.

In a large number of areas of firmus energy's cost base, the Utility Regulator has proposed "*minded*" values which are substantially below those proposed by firmus energy within our GD14 Submission, *and* which are frequently at or below historic costs levels. In aggregate, the Utility Regulator's allowances for opex and capex are both below 2011 values (in real terms) and therefore this further efficiency target is inappropriate.

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- **Impact on Customer Bills**

We have calculated that during the GD14 price control we will need to spend £36m on opex to meet our ambitious connection targets:

Additional customer connections - We are forecasting that over GD14 that we will undertake a further 19,411 connections. As set out in our GD14 Submission, the overall operating unit cost to serve a customer will reduce by 24% with the increasing number of customer connections:

Table 65: Operating Cost per Customer

Price Control	Operating Cost per Customer (£) (2006 Prices)
PCR02	1,189
GD14	903
SAVING	24%

In addition, the Utility Regulator in its Stakeholder Workshop (6th September 2013) highlighted the efficiency of the NI GDNs compared to those in Great Britain in regards to capital expenditure. Therefore, as we are clearly an efficient business and we continue to surpass the volume, connection and network targets set out in our original business plan.

J. Uncertainty Mechanisms

- **Uncertainty Mechanism**

As previously set out in this consultation response firmus energy does not agree with the Uncertainty Mechanism as set in the Consultation Document in relation to the proposed connections incentive.

- **Rolling incentive mechanism**

The Utility Regulator's GD14 consultation document sets out that:

“Our “minded to” position is to have a five year capex rolling incentive for FE as for PNGL but not at this stage to include an opex rolling incentive”.

firmus energy stated within our GD14 Submission that in regards to parameters w, g, and h that:

“Rolling incentives are turned off. We believe that these parameters should be left at 0 until the business is more mature and a stable baseline level of expenditure can be established.”

firmus energy note that this proposal by the Utility Regulator is a policy change from PCR02 and would request further information from the Utility Regulator as to why this is now being proposed, and why they are now proposing this without full and transparent consultation with firmus energy.

- **Materiality Thresholds**

firmus energy's current licence sets out the obligations in regards to increased capital and operating expenditure (Conditions 4.7.7, 4.7.8 and 4.7.9). These conditions are sensibly drafted and in line with good regulatory practice, and therefore we do not see that there is a need to set further Materiality Thresholds as the Utility Regulator is currently proposing for GD14.

K. Further Issues

- Connections incentive and connections policy

Whilst firmus energy recognises the Utility Regulators desire to reduce the value of connection incentives in 2017 and 2022, we believe that the Utility Regulator needs to be mindful of the differing levels of network maturity between Northern Ireland and GB (and indeed ROI), and between the Belfast network and the firmus energy network.

DETI's SEF, which sets out the goals for Northern Ireland's energy policy until 2020, is clear in highlighting:

“DETI...believes that extending the provision of natural gas to new areas would bring greater consumer choice and help shift dependence on coal/oil for household heating (which is currently unregulated) as well as increase the potential for businesses to use this cleaner more efficient fuel. Our (Northern Ireland's) dependence on heating oil remains a problem - economically, socially and environmentally – and the Department will continue work with the Utility Regulator and consumer organisations to address the issues this dependence raises while seeking to encourage alternative choices for consumers.”

Indeed the SEF's 7th Aim is to “*Help create conditions which more readily facilitate customer switching to Natural Gas*”. Therefore, firmus energy would question how the Utility Regulator's current proposals for future connection incentives and policy support this stated strategic policy aim.

The Utility Regulator's own Social Action Plan sets out the Utility Regulator's strategy to reduce financial insecurity in Northern Ireland by growing the gas network, and we would therefore question, how the Utility Regulator's proposals for future connection incentives and connection policies correspond to the aims of this plan.

These issues are of acute importance to firmus energy due to the economic development of our network development which has in part focused on converting NIHE properties to natural gas. Ultimately this has meant that currently around 90% of the existing properties firmus energy network has passed are “*low income*” households or have “*low disposable income*” as they are generally ex-NIHE properties where the owner has exercised their “*right to buy*”. These owner occupied properties will continue to need financial support to convert to natural gas and therefore we believe it is vital as a minimum that future connections incentives and free connections are maintained for those households which remain financially vulnerable.

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Table 66: Ownership Composition of NIHE Estates⁴⁶

Town	NIHE Properties - %	Owner Occupied (ex-NIHE) -%	Private Rented (ex-NIHE)- %	Total Households in NIHE Estates
Derry/Londonderry	62.94	34.22	2.84	7,375
Limavady	51.08	42.93	5.99	1,436
Coleraine	62.76	34.11	3.13	2,502
Ballymoney	50.38	44.97	4.65	932
Ballymena	55.25	40.39	4.36	3,138
Antrim	47.27	46.67	6.06	4,027
Craigavon	47.96	45.35	6.69	6,610
Banbridge	46.38	48.35	5.27	1,194
Armagh	42.94	49.18	7.88	1,514
Newry	38.73	53.77	7.55	2,860

Official Government statistics continually show that Northern Ireland suffers from the highest levels of fuel poverty in the United Kingdom. The Department of Climate Change and Energy's (DECC) Annual Report on Fuel Poverty 2012 explains that;

“Northern Ireland has a higher proportion of fuel poverty than the other nations due to a high percentage of off gas grid households (who therefore have to use more expensive fuels to heat their homes) and lower incomes.”

This finding is supported by Professor Christine Liddell who in her recent review⁴⁷ of fuel poverty in Northern Ireland stated gave evidence that:

“A primary reason for high levels of energy expenditure in Northern Ireland is the prominence of oil as a source of domestic heating fuel. Whilst the unit price of oil is lower in Northern Ireland (when compared with the other 3 UK territories), it is a more expensive source of heating than gas, on which the other 3 UK territories rely. The predominance of oil as a central heating source has an overwhelming impact on current heating expenditure. Put another way, at winter 2010-11 prices, the cost of 17,395 kWh of energy (the average oil consumption in Northern Ireland) supplied as kerosene cost £993, whereas in England and Wales, a similar quantity of energy supplied as gas would have cost £635.”

In addition to actual cost savings, natural gas also brings other tangible benefits to low income and fuel poor households, as customers have the option to choose from different payment methods which help to make it easier to budget for their household's energy needs. For example, pay-as-you-go prepayment meters can be topped up with as little as £5 on an

⁴⁶ Mapping Northern Ireland Housing Executive Estates Outside Belfast, NIHE, 2007. These figures take no account of gas availability and are just an indication of the ownership composition of NIHE estates in our Ten Town Network Area.

⁴⁷ Defining Fuel Poverty in Northern Ireland: A Preliminary Review, Christine Liddell et al., University of Ulster, 2011

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ongoing basis rather than requiring a significant payment at wider intervals as is generally the case with deliveries of Home Heating Oil or Coal.

Therefore, in designing any future connection incentives or connection policies, firmus energy believes that the Utility Regulator should remain aware of the different network characteristics and support Government initiatives in helping tackle fuel poverty here in Northern Ireland by making the financial benefits of natural gas available to as many homes as possible, and by providing financial support to financially vulnerable households to allow them to connect and convert to natural gas. So we would refute any suggestion by the Utility Regulator to eliminate the connection incentive and free connection to households who are in fuel poverty/low income, or those who have only recently been able to avail of natural gas; especially as by the end of GD14 households in Greater Belfast will have been able to avail of these benefits for 20 years.

- **Cost Reporting**

firmus energy has complied with the Utility Regulator's request of June 2010 to provide Annual Cost Reporting. Since then firmus energy has provided the Utility Regulator with detailed annual cost reports to help provide enhanced transparency and regulatory understanding of our business. This has been in addition to our licence condition of submitting annual regulatory accounts.

firmus energy has worked diligently to comply with the Utility Regulator request and we are disappointed that firmus energy's efforts have not been recognised within the Regulator's GD14 Consultation.

As firmus energy has now being providing the Utility Regulator with annual cost information for three years (2010 and 2011 - with 2012 being prepared) we therefore would question the accuracy and justification for the following comments within the Utility Regulator's GD14 Consultation document:

"We began to introduce a cost reporting framework last year but we had insufficient time to fully implement this."

The Regulator's GD14 consultation document goes onto say:

"in 2014 we intend to recommence our cost reporting project. The intent is to evolve robust and consistent reporting templates that will enable us to have a better insight into costs and to more effectively compare costs across the two GDN's."

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firmus energy believe this comment is disingenuous and shows a lack of recognition to the efforts we as a licence holder have put into annual cost reporting to date. We would therefore question the purpose of the Utility Regulator's document of June 2010 which was entitled, *"Regulatory Instructions and Guidance for Annual Cost Reporting"* and the accompanying excel spreadsheets that firmus energy was asked to complete. The 2010 Guidelines set out that:

"The overall objective of the Regulatory Reporting Pack (RRP) is to develop an understanding of the financial performance of the Gas Distribution and Supply Businesses in Northern Ireland and to enable comparison with other organisations, particularly GB GDNs."

We therefore request justification from the Utility Regulator as to why their 2010 Annual Cost Reporting Process is now deemed by the Regulator to be redundant – especially after firmus energy has worked hard to support and comply with the process. We would also question why the Utility Regulator is now simply ignoring and discrediting our input.

- **Price cap vs. revenue cap**

The difference between price cap and revenue cap regulation is clearly set out in the Utility Regulator's 3rd April 2013, consultation on *"Gas Network Extensions in Northern Ireland"* this document states that:

"A Revenue Cap

9.5 This form of control applies to Phoenix Natural Gas, who owns the distribution network in the Greater Belfast area. Under this form of control the licence holder receives a guaranteed level of income for a given period based on an assessment of the capital and operating costs of the licensed activity in that period. The licence holder is protected against the risk of variations in demand but not variations in the cost base. This simple model can be added to by the inclusion of various incentive mechanisms which adjust the allowed revenue according to how effective the licence holder has been in delivering the desired output. So for example Phoenix Natural Gas has an incentive to increase the number of network connections above the business as usual rate.

9.6 The revenue cap regulatory model is the typical form of control applied to network utilities in the United Kingdom and is suited to mature networks. In return for a guaranteed level of revenue consumers receive the benefits of relatively low financing costs. The main risk to the licence holder relates to variations in the cost base of the business, but as the majority of costs related to an established regulatory asset base this risk is also reasonably low.

A Price Cap

9.7 This form of control applies to firmus energy who own and operate the distribution network outside of the Greater Belfast area. Under this regulatory model the licence holder is permitted to charge up to a certain tariff based on an assessment of the capital and operating costs and projected demand. The licence holder therefore is subject to both demand and cost variation risks. In recognition of this increased risk

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the licence holder may receive a higher rate of return as compensation. In order to protect the licence holder against some of these risks there may be automatic stability mechanisms should either demand or costs deviate significantly from their projected levels e.g. provision of special reviews where forecasts deviate from actual by over 15%.

9.8 Linking of the price cap to a more stable measure of demand such as capacity rather than consumption volumes is another option that could be considered although this is not currently operated in NI and the details of how this would fit in with licence conditions would need to be considered.

9.9 The price cap model however has been used to regulate networks in the early stages of development as it places a very strong incentive on the licence holder to connect the largest supply points to the network as quickly as possible to maximise collected revenue. The more quickly large loads are connected and begin to consume gas the more stable the finances of the network become, which is of benefit to all gas consumers. In addition the more quickly connection occurs the more quickly the other benefits of natural gas get delivered such as reduced energy costs to business and reductions in greenhouse gas and other emissions.”

As has been previously stated, firmus energy is only 8 years into a 30 year recovery period. In terms of our development and comparison with other GDNs both in Northern Ireland and in Great Britain, we still remain an immature company.

Whilst we note the Utility Regulator's statement that, “*As the business matures we are minded to change this to a revenue cap*”, we do not agree that firmus energy is a mature business as we are still in our initial growth and development stage and therefore the current price cap arrangement should continue to remain in place, and any change should only occur following a process of fully transparent and accountable consultation.

- **Profiling of revenues**

As agreed in 2005, our licence provides for there to be under-recoveries or over-recoveries relative to the revenue assessed by the Utility Regulator. It also provides for under-recoveries to be recovered later in the licence period and ensures that the financing cost associated with such deferred recovery is taken into account. As previously mentioned it also explicitly provides for the return on under-recoveries to be set equal to our allowed WACC through to 2035. This was the basis on which investment by our parent company, Bord Gáis Éireann, was made.

We therefore do not believe that it is appropriate that to set an arbitrary date for the elimination or reduction of under-recoveries without associated analysis of likely market conditions and the impact of such action on volumes. To date the Utility Regulator has not produced evidence to suggest that an earlier date is appropriate and why the existing

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arrangements are inconsistent with their statutory duties. A decision around the profiling of revenues can only be made on a no-surprise basis following full consultation with firmus energy and that if a change in policy is to occur it must be correctly explained, calculated and justified.

- **Consumer and stakeholder engagement**

As part of our network development and our responsible business operations, firmus energy already actively engages with both stakeholders and consumers. As a responsible licence holder we regularly meet with the likes of; DETI, DSD, CCNI, NIHE, Energy Saving Trust, Carbon Trust, NEA, Bryson Energy, CBI, Northern Ireland Independent Retail Trade Association, Manufacturing Northern Ireland, along with Local Councillors and MLA's to take account of their views and ensure we continue to operate our business in both a commercial and consumer focused manner.

Since our licence was awarded we have undertaken customer surveys in the ten towns to ensure as a company we understand and take account of customers' views. Currently, firmus energy undertakes two consumer surveys per year, in which we ask 300 gas customers and 150 non-gas customers their views on:

1. Natural gas conversion
 - Fuel used before converting to natural gas
 - Description of boiler before converting
 - Previous experience of natural gas
 - Motivators to convert to natural gas
 - Source of good reports about natural gas
2. Perceptions of natural gas
 - Concerns prior to converting
 - Experience of conversion v expectations
3. Personal satisfaction
 - Overall satisfaction
 - Satisfaction drivers
 - Satisfaction with specific aspects

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4. Switching to natural gas

- Interest in switching to natural gas
- reasons for interest in switching to natural gas
- reasons for disinterest in switching to natural gas
- intention to switch to natural gas
- factors aiding likelihood of switching to natural gas
- attitudes towards switching to natural gas

5. Importance of home heating oil vs. attributes of natural gas

- Importance of home heating issues
- Attributes of natural gas
- Perceived performance of natural gas

6. Price comparison

- Likelihood of fuel prices increasing
- Price perception of natural gas vs. Oil

7. How customers and potential customers feel about firmus energy

The information that we gain from these surveys help us to plan our business and our various information campaigns. This targeted approach has in part helped us to double our connection numbers during the PCR02 period.

The Utility Regulator's approach to stakeholders and consumers engagement within the GD14 process is very different to that in Great Britain, where strong stakeholder engagement is central to Ofgem's RIIO Framework. Indeed the Utility Regulator, itself within its September 2011 consultation "*Network Price Controls: Proposals for a Cross-Utility approach*", states that the majority of the concepts used by Ofgem in the RIIO model are relevant to Northern Ireland. Therefore firmus energy would question why during the GD14 process the Utility Regulator has not made stakeholder engagement a central strand of the process.

- **Energy Efficiency and Shrinkage Gas**

firmus energy takes its statutory and regulatory duties in regards to energy efficiency very seriously. We carry out an energy audit and energy efficiency presentation in each customer's home before they connect to our natural gas network and this provides the

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householder with energy saving tips e.g. Insulation, heating controls etc.

In addition to this work, firmus energy has partnered with Bryson Energy to provide a free service for vulnerable customers. This firmus energy funded service provides a home visit from a professionally trained Bryson Energy representative who reviews the individual customers' energy bills with the householder and ensures that they were fully aware of how to get best use from their natural gas heating system, and refers any of those eligible to any suitable energy efficiency schemes. Participants are also offered a benefit entitlement check and the average check is estimated to result in households receiving a further £1,247 per year in benefits entitlement. Due to energy efficiency improvements which many households have undertaken themselves, or through work that firmus energy has undertaken through NISEP or via NIHE schemes – the majority of homes in our Network area already have high insulation standards and heating and hot water temperature controls, and therefore presumed annual consumptions have been lower than originally anticipated.

For the large industrial and commercial customers in our Network area, firmus energy has supported energy efficiency improvements as per our licence conditions through our joint work with the Carbon Trust. Such improvements include higher efficiency boiler installations, CHP, decentralisation schemes etc, which have contributed to lower than anticipated burn volumes for our large industrial and commercial loads.

In terms of shrinkage gas, firmus energy's network is new compared to other equivalent systems across Europe. Our network has been designed to be energy efficient which keeps shrinkage gas to a minimum.

- **Meter Reading**

firmus energy agree with the Utility Regulator's GD14 proposal to consider whether the responsibility for meter reading should be moved to GDNs. A similar arrangement currently exists with electricity distribution companies in Northern Ireland as it offers scope for economies of scale and it seems sensible that there is a consistent approach across the regulated energy industries in Northern Ireland.

However, we believe any change to the current arrangements should be fully and transparently consulted upon and the Utility Regulator should provide appropriate justification from for any change in current regulatory policy.

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- **Change in Ownership Structure**

The sale process for Bord Gáis Energy formally commenced in May 2013 and is expected to conclude by the year end. firmus energy is fully owned subsidiary of Bord Gáis Energy and will therefore be included within this sale. As part of the GD14 process, firmus energy will continue to update the Utility Regulator in regards to any changes in ownership.

L. Next Steps

- Responses

The Utility Regulator's GD14 consultation process is important in developing public confidence in Northern Ireland's gas industry. Therefore it is important that the process is transparent and accountable, and actively encourages stakeholder participation.

2012 Cabinet Office guidelines state that public bodies in undertaking consultations should place an emphasis on engagement and targeting stakeholders, and ensure that stakeholder participation begins as early as possible in the consultation process.

We do not feel the Utility Regulator has achieved this in this consultation with only providing a consultation period of 9 weeks and undertaking the stakeholder workshop only two weeks prior to the consultation end date. This is inconsistent with good practice.

Indeed the Utility Regulator's own Consultation Standard of 24th May states:

"While we recognise the quality of consultation is as important as process, we will set limits for the length of consultations:

- i. regulatory policy consultations, such as our consultation on the development of the retail energy market, will last for a minimum of 12 weeks;*
- ii. more regulatory (non-public policy) consultations, such as in respect of price control decisions, will last a minimum of 8 weeks;*
- iii. technical regulatory matters (for which prescriptive consultation times are stipulated by statute), such as those relating to the granting of a licence, will last a minimum of 4 weeks."*

The Utility Regulator's GD14 Consultation document of 16th July 2013, with a 9 week deadline seems to be a hybrid of these standards. Indeed the GD14 consultation document itself states that:

"This document sets out our initial view of the price controls that should be applied from the beginning of 2014."

Therefore, we view this consultation as very much an initial regulatory view rather than a price control decision and therefore this proposal consultation should have been afforded the correct status and the resulting time length of a "*minimum of 12 weeks*".

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The provision of feedback around the consultation process is central to accountability and transparency and that this should remain as an integral and important aspect of the consultation process. firmus energy would therefore request assurance from the Utility Regulator that our feedback is given appropriate attention and consideration, and as a licence holder we receive transparent and reasoned justification for any decisions that are made. In this regard, firmus energy trusts that the Utility Regulator will conduct the consultation process in a manner which gives proper weight to its main statutory objective to:

“Promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland”.

- **Stakeholder Engagement**

firmus energy does not feel that is appropriate for stakeholders to be invited to participate in a stakeholder event only 2 weeks (6th September 2013) before the GD14 Consultation closes. In addition, we would question whether the overall attendance at this event was reflective of Northern Ireland’s energy/consumer landscape. We recognise that this was the first of its type, and we hope that the process will develop over time.

We feel this approach is very different to that in Great Britain, where strong stakeholder engagement is central to Ofgem’s RIIO Framework. As part of this process, Ofgem has set up 2 stakeholder groups to increase consumer involvement with network companies. Firstly, a Price Control Review Forum meets at key points during the price control review process to bring together all aspects of stakeholder engagement during the process. Members of the Forum include representatives from suppliers, generators, government, environmental groups, energy users, trade unions, and consumer groups. Secondly, an expert Consumer Challenge Group has been developed. The group meets regularly to provide Ofgem with consumer insight into complex issues that cannot be addressed through market research. Members of the group include individuals from Consumer Focus, Utility Consumers Association, Environment Agency, the Centre for Sustainable Energy and several energy users groups. Ofgem in developing these Groups has recognised the interests of consumers (e.g. domestic consumers vs. generators) of a network company may not always be aligned, and therefore will look to balance the different viewpoints in its decisions. Indeed the Utility Regulator, itself within its September 2011 consultation “*Network Price Controls: Proposals for a Cross-Utility approach*”, states that the majority of the concepts used by Ofgem in the RIIO model are relevant to Northern Ireland, and therefore firmus energy would question why during the GD14 process has the Utility Regulator not made stakeholder engagement a

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key strand of the process.

- **Implementation of Price Control**

firmus energy would wish to highlight that any amendments that are proposed to our licence must be dealt with in accordance with the modification process as provided for in the licence or in the current legislation.