



**Price Control for Northern Ireland's Gas
Distribution Networks**

**Phoenix Natural Gas Limited response to the
Utility Regulator
Consultation Paper (July 2013)**

20 September 2013

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INTRODUCTION

Phoenix Natural Gas Limited ("**PNGL**") welcomes the opportunity to respond to the Utility Regulator's ("**UR**") consultation on its price control for Northern Ireland's Gas Distribution Networks ("**the consultation**"). Following the referral of the previous PNGL12 price control¹ to the Competition Commission ("**the Commission**"), PNGL believes that this GD14 price control² will be vital in reinforcing the recommendations of the Commission, and restoring stability, transparency and predictability to the regulatory process.

The GD14 price control is somewhat unique, since the review process commenced before PNGL's previous price control had been determined by UR. This is understandable in the context of the Commission's PNGL12 Inquiry, which involved extremely challenging timescales and required substantial resources of both PNGL and UR. PNGL remains disappointed by the manner in which PNGL has been portrayed by UR in regard to the timeliness of its submissions to the current review process. PNGL has responded quickly, efficiently and co-operatively to UR's requests, and has met all of its legal obligations through this regulatory process.

PNGL has already informed UR of its concern at the lack of engagement from UR prior to UR publishing its proposed allowances in July 2013. Despite providing comprehensive written responses to UR's detailed information requests, PNGL had limited opportunity to discuss or debate any of UR's initial views or rationale prior to publication of the initial proposals. In addition PNGL has not been provided with a copy of the report from UR's engineering consultants, Rune, as part of this consultation process, nor has PNGL been attributed the opportunity of meeting with Rune for further engagement over detailed issues and specific proposals during this consultation process, even though it requested such a meeting on numerous occasions. Therefore we make the following response without having had the opportunity to properly engage with UR to discuss the rationale for some of its proposals.

PNGL believes this lack of proper engagement has led to a number of inappropriate and flawed positions and proposals being adopted by UR. This has resulted in a proposed price control package which cannot be justified since it loads significant downside risk onto PNGL. In particular:

- UR has proposed significant reductions in allowed opex (23%) and capex (8%) relative to PNGL's forecast. On a like-for-like basis (i.e. if PNGL's submission and UR's proposed allowances were based on the same levels of activity), the variance between PNGL's submission and UR's proposed allowances would be even greater e.g. PNGL estimates that the variance between PNGL's capex submission and UR's proposed capex allowances is, on a like-for-like basis, c.17%. These reductions have been proposed without apparent recognition of evidence provided to UR that PNGL runs an extremely efficient operation, and

¹ The PNGL12 price control runs for two years from 2012 to 2013.

² The GD14 price control is proposed to run for three years from 2014 to 2016.

that these costs are necessary to deliver outputs and benefits that are highly valued by natural gas consumers in Greater Belfast. PNGL understands that UR's unit cost analysis demonstrates that PNGL was c.30% more efficient than Gas Distribution Networks ("GDNs") in Great Britain in 2011, and that PNGL is also by some distance the most efficient operator in Northern Ireland. The additional proposed 1% efficiency factor serves to magnify this issue by double counting the potential efficiency gains PNGL can achieve over and above lower allowed baseline costs.

- UR's target for owner occupied connection numbers is more than 50% higher than the target set in the last price control despite strong evidence submitted by PNGL that the recent high level of connections is not sustainable. At the same time UR is proposing to reduce allowances to make these connections by 36%, including significant reductions to marketing allowances which are a necessary and cost effective way to generate more connections. These cost disallowances therefore reduce the prospect of PNGL being able to meet the higher connections target still further.
- UR has justified some cost reductions on the basis of a flawed application of the appropriate economic test. PNGL's requested allowances are within the economic level. UR therefore has no economic grounds for reducing these allowances. If UR wishes to reduce PNGL's costs, it must recognise the impact this will have on vulnerable customers in Northern Ireland, and on the overall objective of expanding the natural gas market.
- UR's proposed connections and infill incentive mechanisms are asymmetric, with substantially bigger downside penalties than upside rewards. A well-established principle of incentive regulation models in Great Britain is that the overall package of incentives provides a reasonably balanced opportunity for upside and downside, as evidenced by Ofgem's Return on Regulatory Equity analysis. The connections incentives overall do not further the common objective of UR and PNGL to efficiently expand the natural gas market in Northern Ireland.
- UR's modelling assumption to apply an unrealistically low WACC from 2017 onwards in PNGL's financial model will only result in additional revenue deferral. This is despite UR's stated intention to re-consider whether revenue deferral remains appropriate in the Phoenix model. While we agree with UR that the long-term WACC assumption does not represent a precedent for future decisions, it is nevertheless important that this assumption is set at a reasonable level so as to retain the appropriate revenue deferral properties of the model.

There does not appear to be any logical justification for these proposals, and in many instances no information of any substance or detail has been provided by UR to support its position.

Proper engagement prior to publication of the initial proposals would have allowed PNGL the opportunity to address these issues earlier. We consider that early, detailed engagement on specific issues and proposals will be essential at future price controls. In particular, we agree with UR that

establishing the appropriate WACC at the GD17³ review will be an important issue. As we explain in this consultation, we do not agree with a number of the aspects of UR's initial thinking. Timely engagement ahead of GD17 will allow these concerns to be discussed and debated properly.

Finally, there are a range of issues where the consultation document lacks the clarity and transparency necessary to facilitate a constructive consultation. For example, UR has not provided the necessary information on how it intends to implement a change to the modelling assumption on the timing of cash flows, or provided information that would allow PNGL to replicate and verify UR's benchmarking analysis. This undermines PNGL's ability to respond fully to UR's proposals.

PNGL has already taken the opportunity to inform UR of a number of these concerns in detail, and the remainder of this consultation response expands further. Given that UR intends to publish its final determination in December, PNGL would welcome further close engagement and discussion with UR so as to reach an appropriate price control settlement. We consider that UR will be able to successfully determine an overall price control package which benefits consumers and allows PNGL to continue to operate effectively and efficiently.

The remainder of our response is structured as follows:

- First, we set out our detailed comments on UR's proposed incentive mechanisms for connections and infill.
- Second, we provide detailed comment on UR's proposals for opex and capex.
- Finally we discuss a number of other aspects of the price control proposals, including:
 - adjusting from PNGL's previous price control, PNGL12;
 - recommendations of the Competition Commission determination on PNGL12;
 - financial issues;
 - draft GD14 outputs;
 - GD14 uncertainty mechanisms;
 - further issues; and
 - next steps.

³ The GD17 price control will follow the GD14 price control and is expected to run for five years from 2017 to 2021.

1. CONNECTIONS INCENTIVE

Both UR⁴ and the Northern Ireland Executive⁵ have recognised that the economic, social, health and environmental benefits emanating from the growth of Northern Ireland's natural gas industry are significant. The Northern Ireland Executive remains committed to making natural gas available to c.70% of properties in Northern Ireland. This will need to be achieved both by extending the natural gas network to new areas, and by maximising potential further development within existing Licensed Areas. In most cases, the latter will be significantly more cost effective than extending the natural gas network to new areas.

UR states in paragraph 5.9 that the *"...connections incentive was introduced in 2012 to ensure PNGL had a strong incentive to encourage owner occupiers to switch to gas and provided a high level of flexibility for PNGL to target the incentive however it considered appropriate – e.g. advertising, discounts, etc. This mechanism has been very successful and has seen large increases in connections..."* However c.120,000 owner occupied properties with access to PNGL's network have not yet made the switch and the need for a similarly strong incentive remains.

PNGL is committed to the growth of Northern Ireland's natural gas industry, and UR and PNGL should have aligned objectives to achieve this. We would therefore welcome a strong incentive to connect customers, providing the incentive mechanism is well-designed and calibrated to achieve an appropriate risk and reward balance, based on an appropriate target level of connection growth. Unfortunately, UR's current proposals fail to deliver this.

PNGL was not given the opportunity to engage with UR on its current proposals prior to publication. To determine an appropriate incentive regime, it is necessary to consider both the specific connections incentive that UR has proposed (including the mechanism referred to as "A+M+PR" in PNGL12) together with the treatment of infill. It is the combination of these mechanisms that determine PNGL's incentive to grow connections. We therefore cover both in this section⁶.

We expressed our concerns with UR's approach to allowing A+M+PR costs when the mechanism was introduced at PNGL12. We remain concerned with UR's approach to determining a number of the cost items that are included within the A+M+PR mechanism. PNGL addresses each of these concerns in Chapter 2.

⁴ See, for example, http://www.uregni.gov.uk/uploads/publications/Guide_for_Applicants_-_Business_Analyst_Gas_Supply.pdf (at page 4).

⁵ See, for example, http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/phoenix-natural-gas-limited/deti_response_to_pd.pdf.

⁶ To avoid confusion, the connection incentive mechanism proposed by UR in GD14 is referred to as A+M+PR throughout the remainder of this chapter.

The remainder of this chapter provides PNGL's detailed comment on UR's economic test for new connections and the incentive properties of UR's proposals.

ECONOMIC TEST FOR NEW CONNECTIONS

In determining the economics of new connections, there is a value to connecting a new customer to the gas network if there is a reasonable expectation that the cost of connecting that customer will be recovered over the economic life of that connection. This provides a cap to the level it is worth spending to attract new customers. This spend may be on investment in infill or it may be through attracting customers through advertising or incentives, or both.

It is therefore necessary to answer two questions.

- What is the total level of benefit that may be derived from a connection?
- How should this be allocated between infill and A+M+PR to ensure that such a connection becomes a reality?

To answer these questions, UR undertakes two separate, and different, calculations: one to determine the level of allowance it deems to be appropriate for A+M+PR and another to determine the value of infill. We can see no justification for making such a distinction.

We broadly support the methodology UR undertakes in section 7 of the consultation as the correct methodology to determine the maximum amount it is worth spending to attract new customers. UR uses this methodology to determine the value of infill assuming a cost of A+M+PR per connection. It would be equally valid for UR to assume a cost per property passed for infill, and reveal the remaining benefit per-connection which would represent an economically justified cap for A+M+PR costs. Either way, this single calculation methodology determines the total level of benefit that may be derived from a connection.

UR has therefore incorrectly undertaken two separate calculations which it claims determine a level of economic cost for A+M+PR costs and infill costs. There is no logical justification for undertaking two separate calculations – the only correct methodology is the one UR has adopted for infill. Any costs incurred below this aggregate level on either A+M+PR or infill should rightly be considered economic⁷.

⁷ If UR chooses to continue with its inappropriate methodology for determining the A+M+PR allowance, we would note that in this calculation UR overstates the infill cost per owner occupied connection in paragraph 5.27. c.90% of properties within our Licensed Area already have access to natural gas. The infill cost has therefore already been incurred for the vast majority of consumers who will ultimately connect to our network. If UR wished to understand the historic cost of passing each owner occupied property for different means, then it must recognise that the unit cost should be commensurate with the actual cost PNGL incurred in passing these properties and not the future determined infill cost for GD14, which applies to a very small proportion of future connections. For reference, PNGL's analysis suggests the average cost of infill per owner occupied connection between 1997 and 2011 was c.£310 (excluding any cost of managing construction

To determine a maximum economic allowance for infill, UR must determine an appropriate A+M+PR cost as an input to the current calculation methodology. This input assumption determines how the overall economic value is split between infill and A+M+PR. The appropriate balance between spend on A+M+PR and infill costs should be determined by assessing the value each provide in terms of growing connections and any other potential benefits to customers. UR's proposals demonstrate that it considers spend on A+M+PR to be somehow inferior as a way to grow connections, without explaining why this should be the case.

In particular, it is not clear how UR can claim that the goal of incentive payments "*has largely been achieved*"⁸ when only around 38% of owner occupied homes are connected to the natural gas network. UR has seemingly ignored the evidence PNGL has provided about the value derived from its A+M+PR spend in terms of securing connections growth. Similarly, the proposal to reduce the A+M+PR allowance by 50% from 2017 onwards (see box below) is arbitrary, and has no justification on either economic grounds or in terms of the benefits or efficiency associated with A+M+PR expenditure. UR has also ignored the substantial impact that reducing A+M+PR allowances is likely to have on vulnerable customers (see Chapter 2 for overview of the benefits of PNGL's business development activity).

Reducing the full per connection allowance by 50% from 2017

UR's proposal to reduce the per-connection allowance by 50% from 2017 is entirely arbitrary and unjustifiable. As with its approach to A+M+PR allowances in GD14, UR has failed to provide any evaluation of the effect of such a significant reduction in allowances on the growth of the market, or on vulnerable customers. UR has suggested that this reduction is justified on the grounds of moving to a "*more standard approach consistent with a mature network*". As detailed elsewhere in this submission, it is clear that neither PNGL nor the Northern Ireland market for natural gas can yet be considered mature.

Furthermore, there is no reason to try to estimate now what the appropriate allowance for A+M+PR will be from 2017 when, as noted by UR, this can only properly be addressed – and with greater accuracy – as part of the GD17 review. Contrary to establishing more predictability and certainty over the regulatory approach to these cost allowances, UR's proposals only serve to increase uncertainty, since PNGL believes that these costs will remain economic and essential to continue the growth of the Northern Ireland natural gas market.

The fact that UR has attempted to establish this proposal some three years in advance of its implementation is therefore concerning. We strongly consider that it will not be in customers interests for PNGL to effectively "switch off" a further 50% of the relevant operations on 31st December 2016, nor do we believe that UR's proposal is helpful in terms

activity).

⁸ Paragraph 5.14 of the consultation.

of enabling PNGL any advance warning of future cost reductions.

We would welcome a commitment from UR that the merits of A+M+PR expenditure will be assessed at the proper time (i.e. at the next review), and without any pre-existing bias or expectation as to the change in these allowances, in line with the UR's approach for all other cost categories.

UR has also made a number of other important errors in the input data and assumptions that have been used to calculate the overall economic value of a connection⁹. PNGL addresses each of these errors in Chapter 3. Once these errors are corrected, the total value associated with a new connection increases significantly.

PNGL's calculations demonstrate that the economic value, once the inputs are corrected, is in excess of the allowances PNGL has requested to cover both A+M+PR and infill costs. There is therefore no justification for disallowing PNGL's requested allowances on the basis that the spend is not economic.¹⁰

If UR wishes to disallow some of these costs, it must demonstrate that they are either inefficient or do not deliver benefits. As we explain in detail in Chapters 2 and 3, our A+M+PR and infill expenditure proposals are efficient, and deliver substantial benefits, both in terms of accelerating the growth of the Northern Ireland gas market, and supporting vulnerable customers.

THE INCENTIVE PROPERTIES OF UR'S PROPOSALS

Given the shared objective to expand the industry, the design of the regulatory framework should provide PNGL with appropriate incentives to connect customers. Those incentives must be strong enough to encourage the expansion of gas in an economic and co-ordinated manner while ensuring risk is shared appropriately between the company and customers.

The Commission recommended that UR re-visit the connections' incentives faced by PNGL, noting that these incentives did not appear to be of the same magnitude as previous volume incentives

⁹ We notified these to UR in "*Infill UR Analysis - Infill Cost Allowance sent to PNGL Aug 13_PNG correction*".

¹⁰ We recognise that there may be a case, from a distributional point of view, for new customers to make a contribution to recovering shared network costs. However, average infill costs PNGL has incurred to connect customers to date are lower than they would be expected to be in future, reflecting that the more economic extensions to the network have already been undertaken. In fact, the estimate of forward-looking infill costs is approximately equal to the historic estimate of total network costs per connection. It should also be recognised that the question of equity between existing and future customers is complicated by the revenue deferral associated with the PA, which pushes costs on to future customers.

which had applied up to 2006¹¹. The Commission considered that changes should be made to the regulatory framework where UR found that such changes would be in the public interest¹².

In light of these recommendations, UR has proposed a number of changes to the incentives on PNGL to continue the growth of the natural gas industry. We do not consider that the incentive properties of the regulatory mechanisms UR has proposed are consistent with the common objective to expand the natural gas industry. We therefore consider that these incentive mechanisms will need refining for GD14.

We set out our concerns for the proposed A+M+PR incentive and infill incentive in more detail below.

A+M+PR allowances

Despite the fact that the Northern Ireland gas market cannot yet be considered mature, UR has proposed to reduce the allowance per connection for advertising, marketing and PR to £480 at GD14, from c.£750 at PNGL12¹³ i.e. a 36% reduction, while also expanding the scope of the allowance. This expanded scope serves to increase the downside risk of the proposed allowances still further, since a new lower allowance is now deemed sufficient to cover a higher level of cost. We expressed our concerns with this approach to allowing A+M+PR costs when the mechanism was introduced at PNGL12. We remain concerned with the detailed cost allocation approaches UR has taken for subsuming costs under the A+M+PR mechanism. PNGL provides specific comments on this cost allocation in Chapter 2.

In addition, PNGL would like to emphasise the following points regarding the incentive properties of UR's proposed A+M+PR mechanism for GD14.

The A+M+PR expenditures we proposed for GD14 are economic, efficient, and are associated with substantial benefits including the furtherance of the expansion of the natural gas industry. By reducing the allowance relative to PNGL's forecast, and by assuming that more costs must be covered by this allowance, it will not be economic for PNGL to incur these costs on an ongoing basis: PNGL would be better off not incurring the costs as the allowance would be less than the expected costs associated with connecting a new customer.

In addition to the base A+M+PR cost allowance mechanism, UR has proposed to introduce an additional risk-reward mechanism. We welcome the introduction of such a mechanism since it has the potential, if designed appropriately, to mitigate some of the incentive effects described above.

¹¹ Paragraph 10.48 of the Commission's Final Determination.

¹² Paragraph 10.50 of the Commission's Final Determination.

¹³ c.£750 in 2012 prices (£690 in 2010 prices).

As with any regulatory incentive mechanism, however, the connections target and the penalty/reward parameters have to be carefully calibrated in order to achieve the desired effect. We do not consider that UR's proposal is appropriate.

As we explain in more detail below:

- the proposed target for owner occupied connection numbers is too high;
- there is no basis for the proposal that no allowance be given for the first 1,625 owner occupied connections; and
- the risk-reward mechanism is asymmetric and is not capped.

Overall, these design issues result in an incentive mechanism that inappropriately loads downside risk onto PNGL, and does not deliver an appropriate framework in which to continue expanding the natural gas market in Northern Ireland.

First, the proposed target for owner occupied connection numbers is too high. UR has increased the target to over 50% higher than the target set in PNGL12. At the same time UR has reduced the level of allowance available to achieve this higher connections target, both relative PNGL12 and relative to the level of costs currently being incurred. To achieve an appropriate balance of risk and reward, UR must base its connections target on a reasonable assessment of the evidence available to it to understand how many connections PNGL is likely to be able to achieve given the allowances that have been set. No information of any substance has been provided by UR to support its position on the connections target.

In contrast, in May 2013, PNGL provided UR with a detailed supplementary submission¹⁴ exploring the key drivers that have contributed to the higher than average levels of interest and numbers of homeowners connecting to the natural gas network in PNGL's Licensed Area during 2011 and 2012. This paper also explained in detail why PNGL expects performance in this sector to return to a normal and predictable level across GD14¹⁵. UR has not demonstrated that it has engaged with this evidence at all, or provided any reason to suggest that PNGL's analysis can be dismissed. An update on current connection levels is provided in the box below.

PNGL would ask UR to set realistic targets which take into consideration the significant detailed information submitted by PNGL and provide PNGL with the market data which justifies its position.

Current Connection Levels

PNGL ran a pilot boiler scrappage scheme in 2011 which was hugely successful and consequently oversubscribed. More recently the Department of Social Development ("DSD") has introduced a boiler replacement allowance to assist vulnerable consumers who typically

¹⁴ "Owner Occupied Connections 2011-2012 for UR May 13".

¹⁵ PNGL notes that UR has misquoted PNGL's GD14 submission for domestic connections in Table 8.

do not meet the criteria of existing schemes. PNGL's business development department, alongside the Northern Ireland Housing Executive ("NIHE") who administer the scheme, have been instrumental in identifying homeowners who may qualify for this grant. Consumers who were unable to avail of PNGL's pilot boiler scrappage scheme were signposted to the DSD's boiler replacement scheme.

Despite PNGL being able to signpost customers effectively, third parties experienced administration issues in getting the boiler replacement scheme off the ground which resulted in a backlog of registrations in 2012. The level of connections in the owner occupied sector has therefore been driven higher than forecast in 2013 as the backlog of registrations is cleared.

The most recent report for 2013 indicates that this backlog created demand for an additional c.1,200 gas connections. To put this number within the PNGL Licensed Area into context, c.20 new gas installations have been achieved in Northern Ireland's other distribution Licensed Area in the same timescale.

PNGL believes that the backlog of registrations has now been addressed and those who qualified for the scheme progressed through to connection. Any new referrals are expected to be at a significantly reduced run rate.

Furthermore PNGL highlighted in its paper of May 2013 the compelling arguments as to why the current hiatus in the housing market has positively contributed to owner occupied connections in recent years. Northern Ireland is already starting to see a rise in house prices in 2013 and whilst PNGL would expect this to manifest itself in higher new build connections going forward, PNGL will be disproportionately impacted by the corresponding downturn in owner occupied connections.

Second, there is no basis for the proposal that no allowance be given for the first 1,625 owner occupied connections.

As noted above, any costs incurred below the economic level on A+M+PR should rightly be considered economic. Given this, it is far from clear why UR should propose that no allowance be given for the first 1,625 owner occupied connections.

The cost of market development varies by consumer. The historical allowances for sales-related costs reflected the required average cost per customer across all of the customers that switched to natural gas (i.e. those who required a higher stimulus and those who would still have switched with a lower incentive). If UR proposes to disallow costs for customers who need less incentive to switch, it must recognise that the average cost required to attract the remaining customers is higher.

Third, there is no evidence that UR has based its calibration of the reward and penalty parameters on any reasonable assessment of the appropriate level of risk to place on the company or on

customers. Ofgem undertakes analysis of the return on regulated equity (“RoRE”) in order to calibrate its incentive mechanisms in the context of the overall price control package. This type of analysis can also be used to test whether the mechanism should be symmetric, or should have caps and collars.

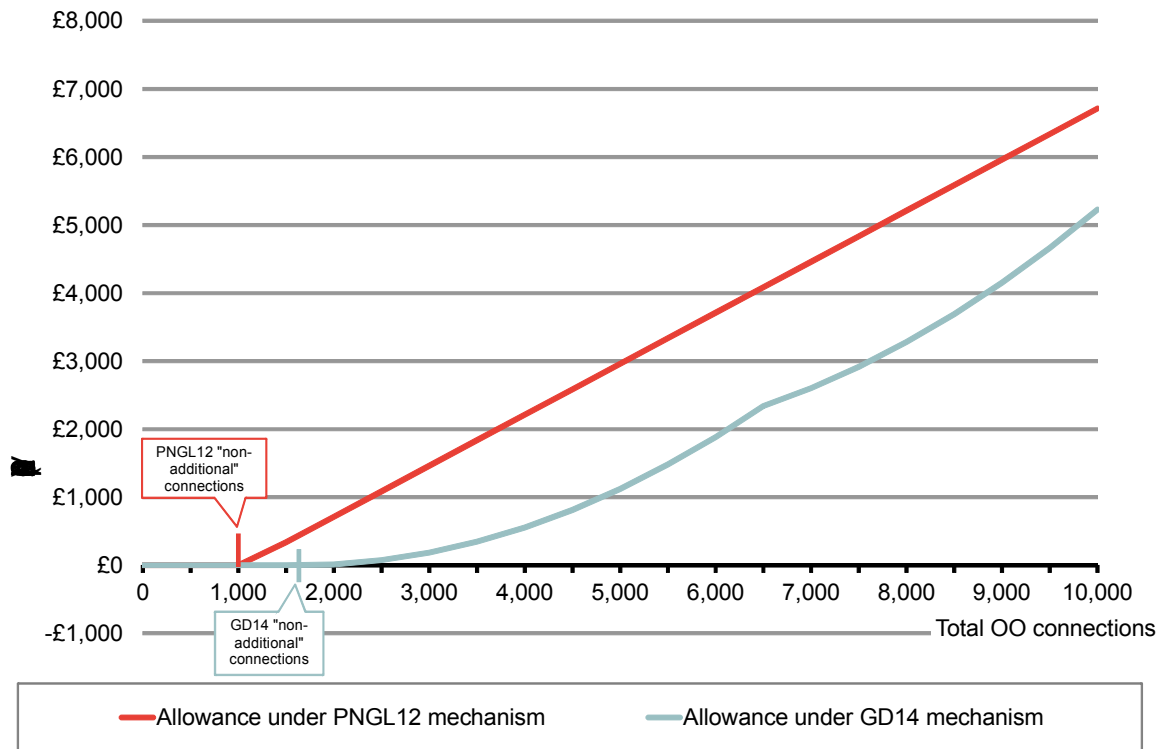
- **Symmetry of the mechanism:** The proposed mechanism is asymmetric in that if PNGL exceeds the target, the connections allowance is only increased for incremental connections, whereas if PNGL underperforms the target, the connections allowance is reduced for all connections. It is not obvious that an asymmetric incentive results in an appropriate balance of risk and reward.
- **Caps and collars:** UR had previously indicated to PNGL that it was minded to collar the unit connections allowance payable if PNGL underperforms connections targets at 50% of the connection allowance. This would appear an appropriate addition. PNGL would welcome clarification from UR that its current proposal includes this incentive collar.

We note that we have not been able to verify the figures quoted in paragraph 5.9 and 5.40 of the draft determination. For example, it is unclear why the additional costs PNGL has recovered in PNGL12 should be described as “outperformance” in paragraph 5.9 given that this is the cost allowance PNGL has received for achieving connections above the PNGL12 target. This allowance therefore simply reflects the costs UR determined PNGL needed to incur to make the connections it made – it does not translate into additional equity returns for PNGL. By the same token we would not describe other costs allowed through the retrospective mechanism on the basis of outturn outputs as outperformance.

Similarly, we cannot verify that the £10m value UR has calculated as the loss to PNGL under the price cap regime prior to 2006 reflects the magnitude of the incentive to connect customers at that time. The volume variation prior to 2006 would have in part reflected variance in connections from target, but more significantly it would have reflected variance in consumption relative to forecast for customers already connected. Volume fluctuations could have occurred as a result of, for example, installing more Pay As You Go (“PAYG”) meters than had been forecast at the price control review, or unusual weather events. To the extent that these drivers are incorporated in UR’s calculation of £10m, UR’s calculation bears no relevance for understanding the strength of PNGL’s incentive to connect new customers prior to 2006, and has no use for comparing this with the strength of the current connections incentive.

We therefore do not consider that UR has provided any robust comparative analysis of the strength of the incentive on PNGL to connect customers over time. UR has therefore not demonstrated whether the new risk-reward mechanism for GD14 leaves PNGL facing a stronger or weaker connections incentive than its previous connections incentive.

In the absence of any RoRE-type analysis, it is also clear that UR has not considered the overall downside and upside risk associated with its overall connections incentive proposal. However, the overall loss of value and increased downside risk associated with the new A+M+PR mechanism relative to the PNGL12 mechanism is shown in the figure below.



The chart demonstrates that relative to PNGL12, UR's GD14 proposal provides a lower cost allowance at any level of connections. As submitted to UR in PNGL's GD14 submission, PNGL expects to achieve 4,700 connections at GD14 given the cost allowances PNGL submitted. Under the PNGL12 mechanism PNGL would have received cost allowances of £2.6m (2012 prices) for achieving 4,700 connections, whereas under the proposed GD14 mechanism the allowed costs would be £930k (2012 prices). Overall, the high target, low cost allowance, and asymmetric incentive result in an incentive which is heavily weighted towards the downside in GD14.

Overall, we believe that UR should consider re-visiting its overall A+M+PR framework. It is important to recognise the difference between allowing costs through a mechanism like A+M+PR, and incentivising outcomes through the introduction of risk and reward opportunities.

- The A+M+PR cost allowance is more like an 'uncertainty mechanism', since in principle it allows PNGL to recover its costs where the extent of those costs varies with the number of connections (although the current proposals are not sufficient to allow PNGL to cover its costs).
- The new risk-reward mechanism is more like a conventional regulatory 'incentive' based on a target level of connections, and parameters determining the reward/penalty for the outturn level of connections relative to the target. This mechanism is therefore a more standard way to incentivise PNGL to meet a connections target.

The interplay between the A+M+PR cost allowance and the risk-reward incentive complicates the signals PNGL faces. Based on UR's current proposal, particularly given the greater downside risk,

PNGL appears to be encouraged to consider whether or not it would be in its interest to spend any advertising or incentive costs. We do not believe this to be an intended feature of UR's incentive design.

Simplifying incentive mechanisms such as these can be beneficial – it gives clearer signals to the company about what the regulator is trying to achieve, simplifies trade-offs, and is more likely to avoid unintended consequences. A simpler model would involve setting a reasonable level of connections commensurate with a reasonable assessment of the efficient level of cost allowances, where those allowances were not subject to a connections volume driver. A suitably designed risk-reward mechanism around an appropriate target level of connections would encourage PNGL to make trade-offs associated with increasing its expenditure if it considered this would attract more connections than the target.

We would therefore urge UR to consider adopting a more simple and clear incentive and cost allowance framework for GD14.

Infill incentive

The infill incentive mechanism comprises of the following features:

- an allowance of £70 per meter of infill and a cap of 7.2 meters of infill per property passed; and
- a target of 3,000 properties to pass per annum with a penalty of £50 for every property below the target and a reward of £20 for each additional property above the target.

PNGL understands that the allowance for infill mains will be retrospectively adjusted so that PNGL receives:

$$\begin{array}{c} \text{Actual number of properties passed} \\ \\ \text{X} \\ \\ \text{Actual average number of meters per property passed (capped at 7.2m)} \\ \\ \text{X} \\ \\ \text{GD14 cost per meter determined by UR} \end{array}$$

If this is the case, PNGL has a number of concerns with the incentive properties of the infill mechanism.

- UR's proposal to update for actual length of infill as part of the retrospective mechanism is an example of micromanagement as it removes any incentive for PNGL to identify those projects that are best value in terms of infill costs or to minimise the length of infill below

the level of the cap. Ultimately there should be some incentive to do infill where the cost is lower, so the incentive properties of UR's current proposals are not necessarily aligned with objectives that would be in customers' interest.

- The 3,000 target for properties passed is high given the £507 allowance for passing a property. UR's proposed allowance of £507 per property passed reduces to c.£450 if the management fee element is excluded. PNGL calculates that c.7,500 of the c.12,600 properties that it has completed desktop analysis and designs for, could be passed with an allowance of c.£450. The misalignment of the overall allowance and target number of properties passed loads unreasonable downside risk onto PNGL.
- Similarly the c.£1.5m allowance for infill for passing 3,000 properties is substantially below the c.£2.5m allowance requested by PNGL for passing the same number of properties. UR used the economic test described above to justify its allowance. Since UR's calculation used an incorrect set of input data to calculate this allowance, UR should revisit this allowance in its final determination.

Finally, UR has proposed an asymmetric incentive mechanism for the risk-reward mechanism. There does not appear to be any logical justification for this. PNGL would suggest that, if UR feels it necessary and appropriate to introduce an incentive mechanism for passing properties, the risk and reward of PNGL meeting UR's targets is symmetric.

- To address the current imbalance PNGL would propose that the magnitude of the penalty matches the magnitude of the reward at £20. For example if UR sets a target of passing 3,000 properties and PNGL passes 2,500 properties, the penalty would be £10k i.e. 500 x £20 penalty; if PNGL exceeds the target and passes 3,500 properties, the reward would be £10k i.e. 500 x £20 reward.

Overall, UR must determine a more appropriate and balanced incentive mechanism for properties passed in which the level of the target and the cost allowances to pass properties are aligned, and in which the incentives PNGL faces to pass properties do not impose asymmetric downside risk.

2. OPERATING EXPENDITURE, PNGL

Overall UR has proposed opex allowances which are 23% lower than PNGL's submitted cost forecasts for GD14. We consider that cuts of this scale are unjustified, and result in significant downside risk being placed on PNGL.

In this section we discuss in turn UR's allowances for:

- A+M+PR and business development expenditure;
- Emergency and call centre costs;
- Network maintenance;
- Insurance;
- Manpower;
- Rates;
- Licence Fee;
- Office Costs;
- Information technology (IT);
- Professional and legal fees; and
- Smaller opex items.

A+M+PR AND BUSINESS DEVELOPMENT COST ALLOWANCES

As explained in Chapter 1, the allowances requested by PNGL are well within the economic level. This section therefore discusses:

- first, why PNGL's A+M+PR and business development expenditure is efficient, and necessary to further the expansion of the natural gas industry, and also provides substantial benefit to vulnerable customers; and
- second, how UR has inappropriately incorporated fixed costs in the A+M+PR mechanism, as well as a number of cost items which cannot be said to be related to domestic owner occupied connections.

Overview of the activities of PNGL's Business Development Department

UR states that the connections incentive was introduced in 2012 to ensure PNGL has a strong incentive to encourage owner occupiers to switch to natural gas. PNGL would be interested to read the consumer research which supports UR's assertion that given the high ongoing level of connections, it appears that the reputation of natural gas such that it is considered the fuel of choice in Greater Belfast has largely been achieved. As UR is aware the Greater Belfast area accounts for more than half of the potential for gas sales in Northern Ireland. Currently about half of the customers who could switch to natural gas have chosen to do so. Despite PNGL's marketing activities, there still remain around 135,000 customers in PNGL's Licensed Area who could switch to natural gas but have chosen not to. With over 60% of the owner occupied sector not yet connected to the natural gas network, the objective of enhancing the reputation of natural gas such that it is considered the fuel of choice in Greater Belfast has, contrary to UR's claims in paragraph 5.14, not yet been achieved. Based on PNGL's experience to date, it will get progressively harder to persuade the remaining potential customers to switch rather than easier. PNGL would further contend that the apparent strength of natural gas in the mind of potential customers will not in itself be sufficient to achieve a connection; other factors such as age and reliability of existing equipment will be also be relevant. Marketing is therefore as much about retaining the natural gas brand and reputation at the forefront of the mind of potential customers both now and into the future for when the appropriate time comes for them to reconsider their heating needs. This concept is fundamental to the continued growth of the natural gas industry and requires sustained levels of marketing activity.

The Northern Ireland Executive remains committed to making natural gas available to c.70% of properties in Northern Ireland. The economic, social, health and environmental benefits emanating from the growth of Northern Ireland's natural gas industry are significant. Benefits will only be realised by maximising uptake in areas where natural gas is currently available. UR's proposals run contrary to this and may indeed damage the overall development of the natural gas industry. Notably, they do not take into account the impact on consumers and in particular the impact on vulnerable consumers e.g. those in fuel poverty.

Vulnerable consumers – the Warm Homes Scheme and the Northern Ireland Sustainable Energy Program

PNGL plays a pro-active role in identifying, signposting, and providing assistance to vulnerable consumer groups. This has not been considered by UR. PNGL's business development team currently visit c.15,000 homes each year and telephone c.100,000 homeowners each year. PNGL's Energy Advisors are fully trained in areas such as energy efficiency and offer advice on a range of measures that homeowners can undertake to improve the thermal comfort and energy efficiency of their homes.

We believe this level of contact and in particular the visits to consumers' homes, are unique to PNGL. These visits allow PNGL to establish a relationship with homeowners and, in many instances, homeowners are willing to provide PNGL with more targeted information so that PNGL may identify whether the homeowner might qualify for financial assistance towards installing a range of

measures including insulation and replacement heating systems. A number of schemes are available e.g. the Warm Homes Scheme funded by the DSD and a variety of programmes are also available under UR's Northern Ireland Sustainable Energy Program ("NISEP"). Moreover it provides an opportunity for PNGL to address any concerns that potential consumers may have about converting to natural gas and is therefore an integral part of PNGL's marketing activity.

We estimate that c.1,000 vulnerable consumers are identified and signposted to the various schemes by our business development team each year. In PNGL's experience, homeowners who qualify for these schemes are typically vulnerable on the basis of age and in many cases do not want any disruption in their home. These potential natural gas consumers are best served by one-to-one contact in their homes where a clear explanation of the steps to connect and the benefits they will enjoy thereafter can be explained. These visits often provide PNGL with additional referrals e.g. the homeowner may signpost a family member, neighbour or friend to one of the schemes.

Any reduction in PNGL's overall marketing allowance will restrict visits to consumers' homes. This will have a negative impact on the c.1,000 vulnerable consumers PNGL typically identifies and signposts to the various schemes each year. UR's proposals may therefore restrict take up of these schemes and will restrict PNGL's ability to tackle the growing problem of fuel poverty in Northern Ireland.

Vulnerable consumers – the boiler replacement allowance

PNGL welcomes DSD's recent announcement that an additional £6m has been allocated to the boiler replacement scheme having secured funding from the European Regional Development Fund. We also understand that the Northern Ireland Executive may allocate additional resources should the scheme continue to be successful.

Whilst DSD's boiler replacement scheme provides a grant to replace old boilers, it also permits direct replacement with an oil boiler. The cost of installing a natural gas heating system vs. replacing an existing oil boiler is considerable. The current economic climate makes this more of a challenge. Furthermore we understand, from working alongside NIHE and the wider natural industry, that the typical timescale from interest to connection is c.5 months; consumers therefore need to be continually persuaded that natural gas, whilst more expensive to install, will provide them with greater benefits in the medium to long term. We also understand that c.25% of consumers that could install natural gas choose to replace their existing oil boiler. In that case it is likely that the opportunity to persuade these homeowners to convert to natural gas is lost for the next 15 years until that oil boiler breaks down or a scheme for replacement is introduced. This is further demonstration that the objective of enhancing the reputation of natural gas such that it is considered the fuel of choice in Greater Belfast has not yet been achieved.

The ultimate success of DSD's boiler replacement scheme will depend not only on sustaining resources to help identify and signpost homeowners who may qualify for the scheme, but also on enhancing the reputation of natural gas. Any reduction in PNGL's overall marketing allowance will only delay this day further.

PNGL's incentives cost line

PNGL provides a range of incentives to encourage consumers to connect to the natural gas network using the allowances granted by UR and additional funding leveraged from third parties. At the time of the GD14 submission PNGL estimated that the incentives provided to consumers having converted to natural gas over PNGL12 was c.£1.8m.

The largest beneficiaries are vulnerable consumers e.g. PNGL's Saver 65 scheme provided a grant of £800 to over 65s who typically did not meet the criteria for the Warm Homes Scheme or any of the NISEP programmes.

Any reduction in the current level of support will have a direct impact on the range of incentives PNGL may offer and ultimately on the number of homeowners who are able to fund the cost of installing a natural gas heating system. It may also inhibit PNGL's ability to attract other funding if PNGL is unable to provide support itself.

Furthermore any installer who wishes to offer any of PNGL's incentives must complete a registration process with PNGL. In addition to being adequately qualified, installers must sign PNGL's charter developed to help protect consumers. This charter includes obligations such as providing written quotations and dealing with complaints. If PNGL is unable to offer incentives to consumers, installers will have no incentive to take part in the registration process. This will have further negative impact on consumers who will lose this additional level of protection and may experience a decline in customer service.

PNGL's advertising, marketing and PR cost line

PNGL's March 2013 supplementary submission¹⁶ describes how an active installer base has helped keep installation costs in Northern Ireland below the rest of the UK. The natural gas industry is dependent on PNGL stimulating the market and facilitating incentives that persuade consumers to connect. To some extent, the reduction in the level of incentives or promotion by PNGL may result in this activity having to be borne to a greater extent by installers. With so many individual installers, this would not be cost effective; installation costs would rise creating an even greater upfront financial burden for those yet to connect. However the bigger issue is that the lack of stimuli will result in future potential customers choosing not to switch to gas; there is no onus on installers to promote natural gas and, to some extent, they may choose to promote other fuels alongside natural gas if PNGL is not actively encouraging them to retain their pro-gas approach.

PNGL would urge UR to reconsider its proposed overall allowance on this basis.

¹⁶ "IR1 - Q12 - Market Development for UR Mar 13".

Inappropriate allocation of fixed and non-owner occupied costs to the A+M+PR mechanism

We expressed our concerns with UR's approach to allowing A+M+PR costs when the mechanism was introduced at PNGL12. We remain concerned with some of the approaches UR has taken to identifying the costs that should be allowed through the A+M+PR mechanism, now referred to as the connections incentive mechanism.

The level of cost attributed to the owner occupied sector as part of UR's analysis is unjustified and indeed significantly higher than the level assessed less than two years ago. UR's proposal that no allowance be given for the first 1,625 owner occupied connections serves only to magnify the downside risk loaded onto PNGL.

The implication of UR's proposals is that PNGL will have an allowance for GD14 which is 36% below the PNGL12 allowance at a time when the opportunity to connect consumers from new areas where natural gas has just been made available, is falling. This makes it all the more challenging for PNGL to continue to increase its customer base as PNGL will have to encourage more consumers within existing areas to convert. As each of these areas becomes more mature, the early adopters who were persuaded to convert to natural gas have already connected. In many cases those who are still to convert have not yet been convinced of the benefits and require significantly more time and effort to be educated and persuaded to make the switch. PNGL would urge UR to reconsider its proposals in light of its primary objective to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland. Appropriate levels of investment in advertising, marketing and PR are fundamental to PNGL's ability to deliver further growth in the Northern Ireland gas market.

PNGL's specific comments on the calculations proposed by UR are detailed below:

Corporate Overheads

A high proportion of the costs included within the corporate overheads cost line are neither marginal in nature nor are they attributable to market development. PNGL will incur these fixed corporate overheads irrespective of whether owner occupied connections arise. This reduces the marginal element of the allowance for market development. Setting allowances for these cost items on the basis of the volume of connections cannot therefore be justified and unnecessarily increases the risk faced by the business as cost recovery of fixed corporate overheads is not certain. Further, as noted in Chapter 1, UR expects to reduce PNGL's overall marketing allowance by 50% from 2017 onwards which would serve only to magnify the flaw in UR's marginal treatment of corporate overheads.

UR states in paragraph 5.36:

"The Corporate Overheads (apportioned) cost line above refers to a share of overhead costs we consider appropriate to apportion to the Business Development Department. The costs are:

- Fleet costs;

- Human Resources;
- Insurance (buildings and car insurance);
- IT;
- Office Costs;
- Rates (excluding network rates);
- Stationery;
- Telephone and postage;
- Travel and subsistence; and
- Corporate support personnel AND their apportioned share of the above costs (by this we are referring to staff in the Finance department including the Finance Director and the Regulatory Affairs section of the Commercial Department, and to the Chief Executive Officer)."

PNGL is concerned that the level of corporate overheads attributed by UR to owner occupied connections is inappropriate and furthermore that the allocation of some of these cost lines is fundamentally flawed.

PNGL accepts that some opex cost lines may be attributable to owner occupied connections and to an extent could be seen at the very least to be 'step' marginal in nature e.g. it is reasonable to identify the element of fleet costs, travel and subsistence and car insurance directly attributable to the business development team involved with the owner occupied sector - these costs are a function of manpower levels and will therefore vary with owner occupied connections.

However the following seven opex cost lines which UR considers are required to manage such connections, are not variable in line with owner occupied connections:

- Human Resources;
- Insurance (buildings insurance);
- IT;
- Office Costs;
- Rates (excluding network rates);
- Stationery;

- Telephone and postage;

Firstly it is inappropriate to include office costs (including rates and buildings insurance) within the proposed connections incentive mechanism. The costs of managing and maintaining PNGL's office space at Airport Road West are largely fixed i.e. a marginal change in manpower levels does not reduce the rental on Airport Road West.

Secondly it should be noted that many of the staff directly involved with owner occupied connections are field-based and do not have a defined office space. Their demand on the facilities of Airport Road West is significantly less than office-based staff e.g. they will not require the same level of access to IT, stationery, postage and other related facilities.

Finally a significant proportion of the Human Resources cost line relates to training and skill accreditation. It should be noted that a disproportionate element of these costs is devoted to engineering related activities (due to Health and Safety requirements and need to develop natural gas specific skills) as opposed to sales and customer services. Virtually all training for staff involved with owner occupied connections is on-the-job and does not require external service providers.

These seven cost lines are not marginal and are required almost irrespective of the level of new connections to allow PNGL to operate and maintain the network and serve its existing customer base. These seven cost lines should therefore be removed from the connections incentive mechanism.

This leaves corporate support personnel. The level of corporate support identified for the owner occupied sales function is excessive and out of proportion with the time devoted to this area of activity. By way of example, PNGL cannot support UR's proposal to allocate 16% of the CEO's and Financial Director's time to owner occupied connections. To suggest that they each devote almost one day a week to owner occupied connections grossly underestimates the time they devote to other business activities. Indeed to suggest 16% of time associated to the finance department as a whole in a business as complex as Phoenix is devoted to managing incentive payments is incorrect and out of step with the work arising there from.

The level of support from other corporate staff to the owner occupied sales function is equally disproportionate i.e. a marginal change in manpower levels does not mean that PNGL does not need to pay for the cost of say its Revenue Protection Manager or Regulatory and Business Planning team etc. Again such costs are not marginal and are required almost irrespective of the levels of connections being undertaken.

Rather than undertaking an in-depth (and arguably subjective) review of the role of each individual, PNGL has identified a simple mechanism for weighting such costs across corporate activities¹⁷. The

¹⁷ £4.8m income generated from new owner occupied connections across GD14 (assumes mid-year connection): Year 1 connections: 40 pence per therm x 3,250 connections x 410 therms = £0.5m; Year 2 connections: 40 pence per therm x 9,750 connections x 410 therms = £1.6m; Year 3 connections: 40 pence per therm x 16,250 connections x 410 therms = £2.7m.

additional 6,500 owner occupied customers proposed by UR each year will generate c.£5m revenue across GD14. This equates to c.3.5% of UR's proposed total allowed revenue for PNGL across GD14. We would suggest that 3.5% is a more appropriate allocation than the 16% proposed by UR.

PNGL would therefore urge UR to reconsider the level of corporate overheads within the connections incentive mechanism.

Fixed Allowances

Business Development Department

PNGL notes UR's review of PNGL's Business Development Department and notes that the allocation of each individual to owner occupied activities is largely in line with UR's PNGL12 determination with the exception of the allocation of the Business Development Manager now exclusively to owner occupied activities and the inclusion of corporate affairs personnel within the scope of the connections incentive mechanism in GD14.

PNGL sees no rationale for UR's proposal to change the allocation of the Business Development Manager to owner occupied activities across GD14. There has been no change in the role; PNGL continues to operate with a dedicated Private Residential Sales Manager. The Business Development Manager is a much broader role being responsible for all aspects of private residential sales not just that associated with the owner occupied market plus the activity associated with development of third party trade (installers, equipment manufacturers, merchants, distributors and retailers). In addition to supporting owner occupied growth, this third party trade activity serves the existing connections base as well as key growth areas associated to the new build and NIHE sectors. **PNGL would therefore suggest that UR uses a maximum allocation of 50% to owner occupied activities in line with the allocation of the Business Development Director to owner occupied activities across GD14.** This would be more reflective of the time dedicated by the Business Development Manager to owner occupied activities rather than the 100% allocation proposed by UR. This would also be reflective of the approach as adopted for PNGL12 as fundamentally the situation remains unchanged in GD14.

PNGL notes the inclusion of corporate affairs personnel within the scope of the connections incentive mechanism in GD14. However the allocations of the PR/Comms Manager (50%), Marketing Manager (50%) and Marketing Assistant (65%) to owner occupied activities across GD14 are overstated.

The PR/Comms Manager is primarily responsible for external and internal communications. We estimate that 80% of this activity is dedicated to protecting and enhancing the natural gas brand and reputation with PNGL's existing connections base and key stakeholders within the Northern Ireland natural gas industry including MLAs and wider Government. Our Corporate Social Responsibility ("CSR") programme provides an overarching framework for the range of ongoing initiatives carried

Total Allowed Revenue across GD14 = £136.1m.

% of Total Allowed Revenue attributable to new owner occupied connections =3.5%.

out by the Group that positively impact our marketplace, environment and community. This year we were delighted to have received, for the ninth year running, national recognition for our efforts by collecting a Business in the Community 'Big Tick' award for CSR excellence. CSR plans are both time and resource intensive. The PR/Comms Manager is responsible for the overall CSR strategy for the Group and its implementation. This involves engagement with staff, third parties and, whilst there is some engagement with the domestic sector, this is predominately with consumers already connected to the network. **PNGL would therefore suggest that UR uses a 20% allocation to owner occupied activities for the PR/Comms Manager to more accurately reflect the activities undertaken.**

The Marketing Manager is responsible for the overall marketing strategy for the natural gas industry through the PNGL brand. We estimate that 70% of this resource is dedicated to the design and production of materials that would be required regardless of the level of new connections. Their role includes managing our website and supporting the wider natural gas industry. Both these activities are essential to ensure the education of consumers and the smooth running of the business. **PNGL would therefore suggest that UR uses a 30% allocation to owner occupied activities for the Marketing Manager to more accurately reflect the activities undertaken.**

The Marketing Assistant is responsible for marketing administration and supporting the PR/Comms Manager in coordinating the many activities that make up our CSR programme. Their role extends to providing cover to the PR/Comms Manager for holidays, peak levels of calls etc, and responding to general enquiries from third parties. We estimate that 65% of this role is dedicated to such activities that would be required regardless of the level of new connections. **PNGL would therefore suggest that UR uses a 35% allocation to owner occupied activities for the Marketing Assistant to more accurately reflect the activities undertaken.**

Corporate Affairs

UR is not proposing a fixed allowance for corporate affairs and is therefore attributing the cost of corporate affairs to forecast connections each year. This is a change in stance from the opinions expressed in its PC03 and PNGL12 determinations when UR accepted that corporate affairs costs are incurred to support the existing customer base and development of the natural gas industry as a whole and are not linked to achieving new connections.

UR has not provided any justification for this is a change in stance in GD14. **UR should therefore grant PNGL a fixed allowance for corporate affairs in line with the opinions expressed in its "Market Development and Incentives 2007-2011 Determination Paper" in April 2009:**

... our understanding is that the Ofgem benchmark is in fact 0.96% of total opex. This latter benchmark is considered to be the appropriate one to apply to PNG...

We are satisfied that the benchmarking approach with GB companies is reasonable although we note that some of elements included in PNG's submission appear to overlap with other cost allowances in the Determination e.g. professional subscriptions, attending conferences,

publication and journals and internet costs. Other costs may not be classified as corporate affairs e.g. Dial before you Dig. We have therefore decided to include an additional allowance of £18,500 (1996 prices) to cover these activities.

This would also ensure that the treatment of corporate affairs in GD14 is in line with the treatment of corporate affairs in PNGL12 where UR granted PNGL a fixed allowance of c.£175k (£2010) per annum as part of its PNGL12 determination.

EMERGENCIES

PNGL has not been provided with a copy of the report from UR's engineering consultants, Rune Associates Limited ("**Rune**") and has not been attributed the opportunity of meeting with Rune for further engagement during this consultation process, even though it requested such a meeting on numerous occasions. Therefore we make the following comments without having had the opportunity to properly engage with UR to discuss the rationale for some of its proposals.

PNGL notes that the call volumes quoted in Tables 17 and 18 of the consultation do not match those submitted by PNGL. We believe the discrepancy has arisen as a result of UR's modelling of repair activities. PNGL would advise that a PES engineer is required to attend all call outs including those that ultimately require a repair team to undertake the necessary repairs to the network. The numbers quoted by PNGL below reflect the call outs attended by PES as submitted by PNGL.

Call Centre Costs

Enquiry Calls

PNGL notes that UR has formed the opinion that PNGL should be targeted for 2014-2016 to reduce the number of calls received by its emergency call centre, *"as the number of general enquiry calls received historically has been around 50% of the total calls, which is particularly high compared with counterparts in GB."*

In response, PNGL would advise that in addition to owning and operating the gas distribution network, PNGL is required under its Licence to carry out certain associated activities, including establishing and maintaining a 24-hour emergency service, attending to gas leaks as soon as is reasonably practicable, and taking all necessary steps to prevent an escape of gas within 12 hours of receiving a report. PES currently provides the initial 24/7 emergency response to PNGL's network, under agreement with PNGL. PNGL's Licence also requires it to secure adequate publicity for this emergency service and its telephone number. In the 17 years since natural gas was introduced to Northern Ireland PNGL has established the 0800 002 001 emergency number ("**the emergency number**") and developed a brand that is proven to be highly safety orientated, customer focused

and recognisable in its own Licensed Area and indeed across Northern Ireland as other licensees have adopted the same emergency service provisions.

The safe operation and maintenance of the system was the highest priority of PNGL under the mandatory development plan detailed in its Licence. To achieve this PNGL was required to educate the general public and gas consumers on the primary emergency number for Northern Ireland through years of literature, door drops, media and vehicle livery. While PNGL has successfully established the emergency number, there is no general 24-hour contact number for enquiries or other issues faced by consumers. The lack of alternative contact facilities undoubtedly results in the emergency number becoming a default contact number for consumers looking to resolve more general issues that should be addressed by third parties e.g. natural gas suppliers. Unless this matter is addressed by UR and by third parties, any initiatives undertaken by PNGL are unlikely to have any significant effect on the level of enquiry calls made to the emergency number.

The relative immaturity of Northern Ireland's natural gas market places PNGL in a different position to its counterparts in Great Britain. UR's proposals do not take into consideration that unless there is an alternative 24-hour contact number for enquiries, or industry undertakes further PR to educate consumers and third party call centre operatives, the 24-hour emergency number will remain the default number used by consumers looking to resolve more general issues. The number of calls made to the emergency number is proof that consumers need this service and, for safety reasons, PNGL must continue to promote the emergency number.

The most recognisable emergency number in the UK is "999" which was introduced over 75 years ago. However c.70% of "999" calls continue to have nothing to do with an emergency. More recently police forces across Great Britain introduced a "101" non-emergency number to try and reduce the level of "999" calls. Despite spending millions of pounds promoting the service, the number of non-emergency calls made to the "999" number only reduced by c.10% in the twelve months since its introduction in England and Wales.

In contrast, PNGL established the Northern Ireland emergency number for natural gas only 17 years ago and there is no alternative 24-hour contact number for enquiries. Even if UR introduces an incentive on suppliers to manage the level of enquiry calls their customers generate to the emergency number downwards, suppliers may well incur significant costs promoting the service. Based on the evidence from the introduction of the "101" non-emergency number in Great Britain, this may only result in a marginal decrease in calls to the emergency number.

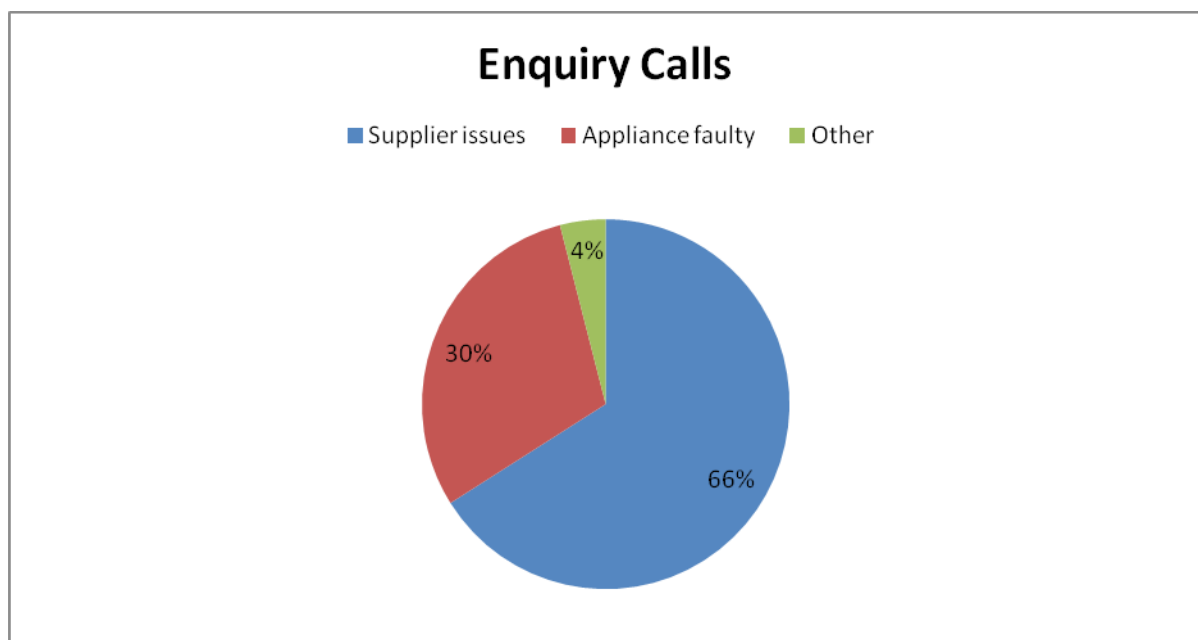
The safe operation and maintenance of the network is PNGL's highest priority. PNGL must be granted an appropriate allowance to operate the emergency number to ensure that consumers continue to use the number to report emergency issues. UR is proposing that PNGL effectively discourages calls to the emergency number. There may be a potential safety risk unless alternative 24-hour contact facilities are provided to address consumers' concerns; PNGL will not initiate any change which encourages customers to fail to report concerns and which is likely to result in a reduced level of service. It would not be in the interest of safety to dissuade consumers from contacting the number when there is no other customer orientated 24-hour contact number

available in Northern Ireland. It is therefore more appropriate for UR to understand the changes PNGL has already made to educate consumers and manage the level of enquiry calls made to the emergency number downwards, and the initiatives PNGL has introduced to mitigate the number of call outs from enquiry calls received.

PNGL, as part of its interaction with gas users, undertakes a customer satisfaction survey; c.95% of callers rate the service as either excellent or very good. Furthermore the cost of providing responses to enquiry calls is cost effective in the absence of an alternative 24-hour contact number for enquiries by third parties e.g. natural gas suppliers. As previously indicated, the number of calls received by the emergency call centre is proof that customers need this service and, for safety reasons, PNGL must continue to promote the emergency number. Unless this matter is addressed by UR and by third parties, any initiatives undertaken by PNGL are unlikely to have any significant effect on the level of enquiry calls made to the emergency number.

Enquiry Call Analysis

The breakdown of enquiry calls varies slightly over the year dependant on prevailing issues e.g. weather conditions, but the last quarterly review in February 2013 indicates that the enquires fell into two main categories, namely supplier issues (66%) and appliance faulty (30%):



Supplier issues

The largest number of enquiry calls fall into the 'Supplier issues' category; two thirds of enquiry calls are supplier issues that neither the emergency call centre at Hinckley nor PES can resolve other than to give general advice and redirect to other agencies. 20% of enquiry calls relate to the card start up procedure; 12% relate to a faulty card following a change of supplier; 9% relate to a change of tenant with the remaining 25% relate to more general PAYG issues. These are mostly problems that

leave the consumer without a gas supply which may cause concern and distress and are, of course, a particular concern if they affect vulnerable consumers.

PNGL is aware that consumer education is the best practice to mitigate the number of enquiry calls the emergency number receives. PNGL has already successfully implemented the following initiatives:

- Reviewed and updated the stickers on meter boxes to include the meter operation/credit transfer process
- Reviewed and updated the leaflets supplied with exchanged meters to include the meter operation/credit transfer process
- Provided training for all Hinckley, PNGL, firmus, Airtricity, NIHE and other social housing organisation operatives on the meter operation/credit transfer process
- Introduced a strict no “Wind-on” process for Quantum meters
- Made blank Quantum cards available at PNGL reception for pick-up by customers of Airtricity (Quantum cards are unique to the customer and come from England. Blank cards can be paired with their meter and allow them to continue to use gas if they lose/damage their card)
- Developed web-based “You Tube” videos e.g.
 - <http://www.youtube.com/watch?v=wle6X4ZXvUk>
 - <http://www.youtube.com/watch?v=Cfds2AuRoIk>

which can also be accessed from PNGL’s website providing consumers with advice on:

- (a) Defrosting a meter
- (b) Defrosting condensate pipes
- (c) Credit transfer and opening valve on a meter (various meter types)
- (d) How to turn on/off meter control valve

The emergency call centre at Hinckley provides PNGL with information on the range, type and number of such calls. Where they can and within their levels of competency, Hinckley will take the time to deal with these distressed customers in a professional and helpful manner and, as appropriate, they refer the consumer back to the supplier, other straightforward meter credit issues can, under PNGL’s guidance, be resolved over the phone. PNGL would suggest that, in order to alleviate the problem and provide their customers with a better standard of service, suppliers should provide a similar level of guidance.

These initiatives are reviewed on a regular basis and despite regular training and low staff turnover, with four main variations of PAYG meter currently in operation in Northern Ireland and the complexity of meter faults (23 main fault codes), call centre operatives in third party organisations are unable to resolve all issues over the phone and often refer them to the emergency number. This “call dumping” is particularly prevalent where call centre operatives are targeted/rewarded by the number of calls they answer and tight standards of service. In our experience, resolving a meter call over the phone may take 5-10 minutes, particularly where consumers are remote from their meter and seek reassurance that their appliances are operational before finishing the call.

All calls received by the emergency number that cannot be resolved over the phone or eliminated as enquiries are tasked to PES engineers. Although PAYG metering may be a challenge for the average call centre operative, PES engineers have the knowledge and experience to resolve the problem. PNGL have implemented a Customer Contact and Resolve (“CCR”) process to reduce site attendance at a job; the standard procedure is for the PES engineer to contact the customer by phone. This also acts as a security feature which allows the PES engineer to confirm the caller, location and ascertain the nature of the job. The PES engineer may then be able to offer further safety advice, if required, on gas emergencies. However, if the PES engineer is able to confirm that there are no safety issues, the PES engineer will attempt to resolve the issue (usually card/meter credit transfer issues) on the phone. This process normally takes 5-10 minutes and will be documented as CCR. This innovation, to the best of our knowledge, is unique to the PNGL network and prevents c.450 call outs per annum.

PES has undertaken a manual review of job sheets for January 2013. The table below shows the final resolution for a range of meter call outs:

Cause of meter call out	Number of jobs in category	% of total meter jobs in month
Exchange non-operational meter	380	55.5%
Cleared slot of debris/water	125	18.5%
Showed customer operation	54	8%
Advised to buy new card	49	7.0%
Transferred credit	32	4.5%
Wrong supplier card	23	3.5%
Other various issues	20	3.0%

Examples of call outs include:

- **Exchange non-operational meter** e.g. where a non-operational code has caused the meter to cease functioning and cannot be reset so must be exchanged or debris in slot cannot be removed. Consumer operating meter incorrectly contributes significantly to this situation.
- **Clear slot of debris/water** e.g. clearing the PAYG slot of water, a broken PAYG card or other debris to return it to functional use.

- **Show consumer operation** e.g. a consumer moves in to the premises on a weekend and after several unsuccessful attempts to transfer credit, causes the meter to fault. The PES engineer clears the fault on the meter and shows the consumer its correct operation.
- **Advises consumer to buy new card** e.g. consumer purchases credit from Supplier A. The PES engineer discovers that the credit cannot be transferred on to the meter as it is set up for Supplier B.
- **Transfer credit** e.g. a vulnerable consumer is unable to transfer credit on to the meter and has no heat or cooking facilities
- **Wrong supplier card** e.g. the supplier advises their customer to purchase credit via a PAYG card when their customer requires a Quantum card

Appliance faulty

The second largest number of enquiry calls fall into the 'Appliance faulty' category. In excess of 80% of these calls are from social housing tenants and are referred back to their landlord unless a potential safety issue is identified where PES would dispatch an engineer. However, anecdotally tenants demand a quicker service than that provided by the landlord and try all avenues to speed up the process. The remaining 20% of these calls are owner occupied consumers who demand a quicker service than that provided by their installer and are looking for more immediate support, particularly during cold weather conditions.

PNGL has successfully implemented the following initiatives to mitigate the number of such calls to the emergency number:

- PES attaches a 'contact details' sticker to every boiler it services or repairs. This provides PES's customer services number.
- The PES web site gives all contact details and availability for both contracted and non-contracted customers e.g. www.phoenixenergyservices.com/boiler-repair and <http://www.phoenixenergyservices.com/servicecare-boiler-cover/>.
- PES provides a 24-hour helpline for its customers.
- PES leaves customer satisfaction survey forms with each emergency job it attends. This gives contact details of gas safe register installers for repair/inspection work.
- PES liaises with the Health and Safety Executive for Northern Ireland ("HSENI") and the Northern Ireland Housing Executive to ensure that their literature provides relevant contact numbers as well as the emergency number.
- All Northern Ireland Natural Gas Association registered installers are provided with "top tips for winter" to ensure their customers are not increasing unnecessary call traffic to the emergency number.

- PES display adverts in yellow pages, yell.com and local media for boiler service/repair services and provides PES's customer services number.

PNGL remains committed to finding further initiatives to mitigate the level of enquiry calls made to the emergency number however this will only be achieved by implementing phased initiatives over a period of time.

Call centre activity

The actual driver for call centre activity is complex and has been studied extensively by National Grid and other emergency service providers to balance resource against expected workload. Some of the factors to be considered are:

- Weather conditions (cold/wet/windy/hot all bring different variety and numbers of calls)
- Numbers of new consumers (this includes new connections to the network and new natural gas consumers e.g. consumers moving house to a property where natural gas is installed may have no previous experience of using natural gas)
- Type of equipment in use and pressure regimes (External/Internal; Low, medium or high pressure)
- Type and variety of meters (the more complex the meter the more calls. **It is important to note that there is a significantly higher percentage of PAYG meters in Northern Ireland than in Great Britain**)
- Location of electronic meters (external meters are more influenced by climatic conditions. It is important to note that there are more external meters on a 4bar network)
- Proximity of natural gas network to other sources of smells (tidal estuary, LPG and other industrial plant, biogas production and landfill sites)
- Tariff changes by suppliers (more top ups and shorter intervals between top up)
- Footprint of gas release related to high volume third party damages
- Support offered to gas customers by third parties i.e. suppliers, housing associations, landlords etc, including the levels of support both during and after hours
- Percentage change of tenancy in the social housing customer base (it is important to note that Northern Ireland has a high level of social housing)
- Changes in economic conditions and increasing energy costs
- Level of gas safety awareness by the general public and safety promotions by agencies such as HSENI

In addition there are a number of factors, unique to Northern Ireland; in particular the higher number of PAYG meters in Northern Ireland and consumers moving into a property where natural gas is installed who may have no previous experience of using natural gas (arguably a new natural gas customer), unlike in Great Britain.

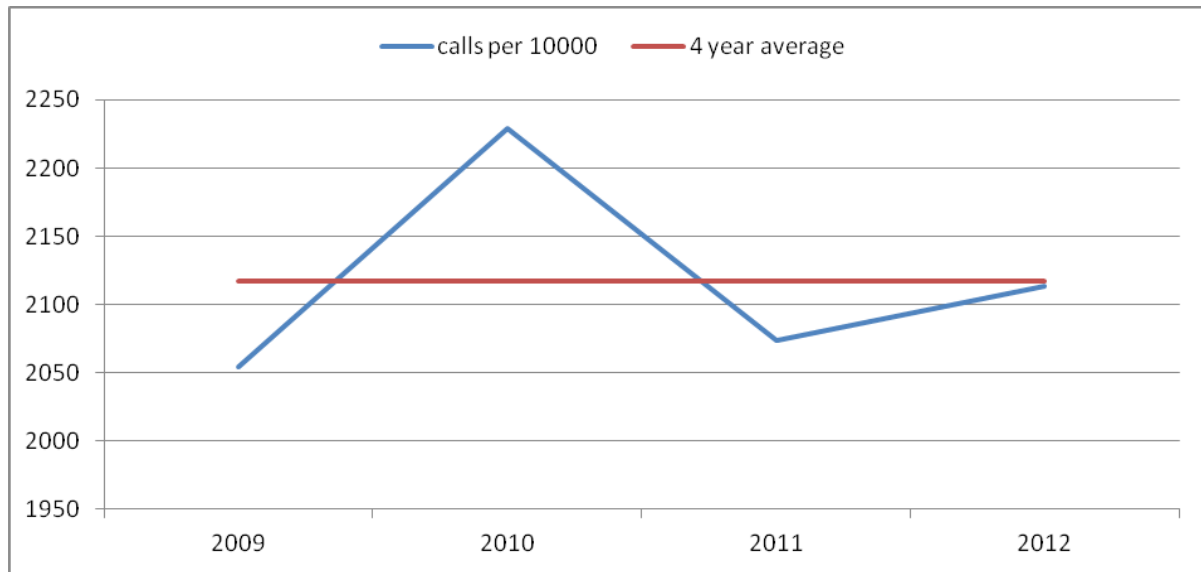
UR has suggested that better collaboration may, over time, facilitate a reduction in costs. The HSENI led Gas Safety Forum is attended by PNGL, firmus and the wider gas industry. Here safety initiatives are promoted such as the Carbon Monoxide poisoning awareness initiative (leaflets, media advertising, presentations to other agencies etc.) and the recent initiative on installing Carbon Monoxide detectors by social housing landlords. However such initiatives, fully and actively supported by PNGL, promote gas safety but, undoubtedly generate additional emergency calls and call outs. This is contrary to UR's belief that call numbers/costs will reduce. PNGL unreservedly supports gas safety initiatives and accepts that long-term benefits are likely to be achieved following additional emergency calls/responses in the short-term. However without a robust and safety focused emergency response process, these initiatives and general gas safety will be compromised.

UR has used actual call volumes for 2010 and 2011 as the basis for its model. PNGL notes that UR's forecast does not consider high levels of calls resulting from the cold winter conditions in 2010 and 2011, as the calculations are based on mid-point estimates and exclude exceptional peaks in activity. PNGL would therefore ask UR to confirm how exceptional peaks in activity resulting from circumstances outside PNGL's control are to be accounted for in GD14?

A more appropriate basis would be to use actual call volumes for 2009 to 2012 (an average of 2,116 calls per 10,000 customers).

The following table shows actual call volumes for 2009 to 2012, and the following graph the four-year average:

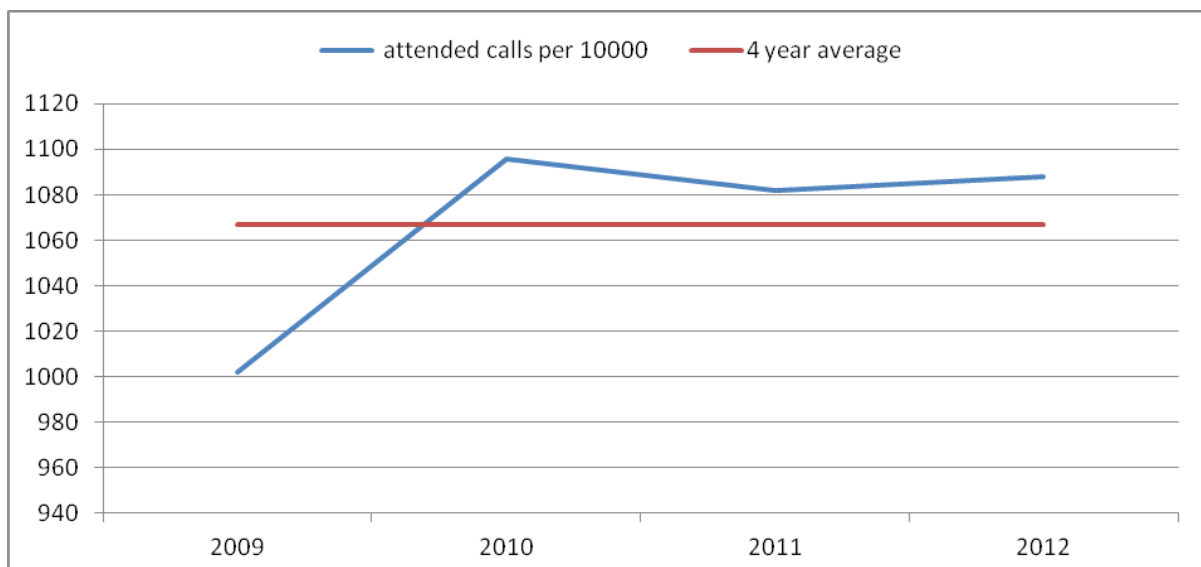
YEAR	Enquiry calls	Call outs attended	Total calls	Average Customers connected	Total calls per 10,000
2009	13,222	12,694	25,916	126,615	2,047
2010	15,271	14,769	30,040	134,715	2,230
2011	14,245	15,542	29,787	143,615	2,074
2012	15,753	16,734	32,487	153,736	2,113



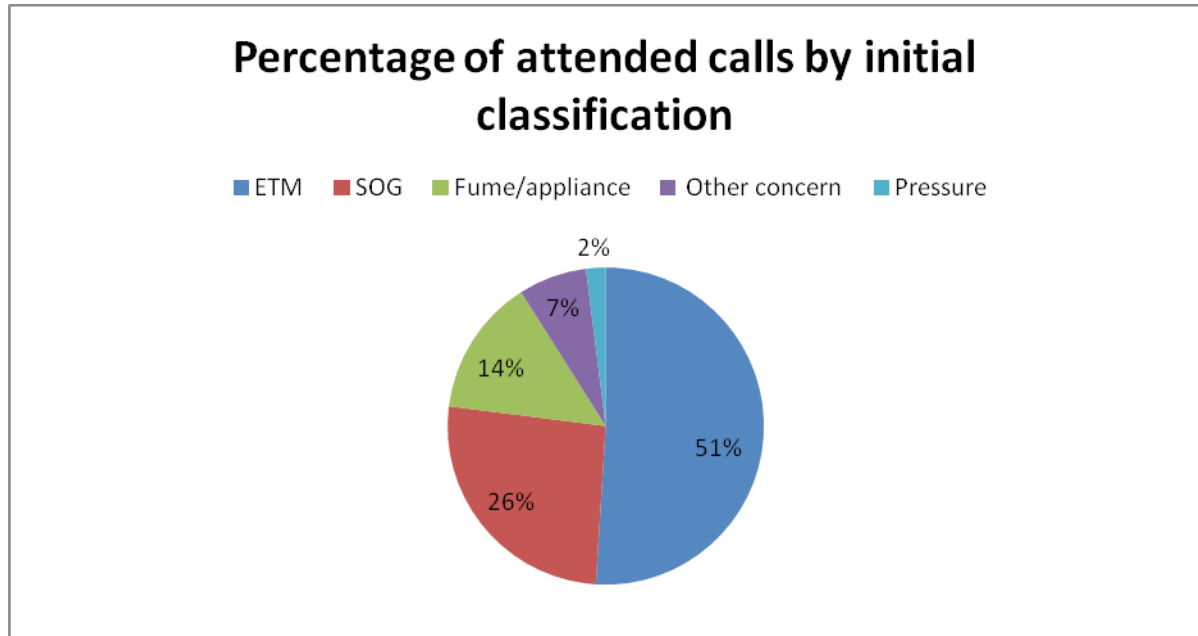
Emergencies (First Call costs)

PNGL records the actual number of attended jobs by first response engineers; these records are supported by job specific records. The following table focuses on the actual call outs for 2009 to 2012, and the following graph illustrates the four-year average:

Year	Call outs attended	Average Customers connected	Call outs attended per 10,000	Year-on-year growth
2009	12,694	126,615	1,003	n/a
2010	14,769	134,715	1,096	+16.3%
2011	15,542	143,615	1,082	+5.2%
2012	16,734	153,736	1,088	+7.7%



The table below indicates that 40% of the jobs attended (Smell of Gas “SOG” and Fumes/appliance) are safety related:



If safety is to be promoted and safe processes maintained, there should be no cap on these calls. UR should be supporting gas safety and helping to promote PNGL’s emergency service. The general public would find it unacceptable if the Northern Ireland Fire Service was capped on the number of calls it could attend; in the same way it is not acceptable that genuine gas emergency calls should be capped. If there is to be a cap on the number of emergency calls, the matter should be debated by public representatives and their conclusions made publicly available.

Actual call outs for 2009 to 2012 average 1,067 calls per 10,000 customers. The average annual increase in the number of jobs attended over the period 2009 to 2012 is 9.7%. This figure is a fair and appropriate reflection of growth and is supported by the year-to-date data (January 2013 –June 2013) which shows comparative growth against the same period in 2012 of 10.9%.

Using the 2009 to 2012 average actual call outs of 1,067 calls per 10,000 customers would imply the following growth for GD14:

Year	Average Customers connected (per GD14 submission)	Projected call outs (based on four-year average)	Forecast call outs (per GD14 submission)	PNGL’s proposed reduction (four-year average vs. GD14 submission)	Forecast call outs (per UR’s proposals)	UR’s proposed reduction (four-year average vs. UR proposals)
2014	172,469	18,402	18,200	1.1%	17,542	4.7%
2015	181,172	19,331	19,048	1.5%	17,844	7.7%
2016	189,700	20,241	19,918	1.6%	18,128	10.4%

Note – the “projected call outs” reflect UR’s methodology using a four-year average rather than the two-year average proposed by UR

UR has retrospectively applied its target reduction in calls from 2011. In doing so, UR’s proposal imposes an immediate reduction between c.5% and c.10% against the 2009 to 2012 average actual call outs. UR’s proposal to impose an immediate reduction of between 1% and 3% is therefore unrealistic; a more appropriate basis would be to phase any reduction across the GD14 period given that PNGL, mid-way through 2013, has no influence on the level of calls in 2012.

PNGL’s price control submission incorporates a reduction in call outs compared to the 2009 to 2012 average of c.1.4% and is therefore a reasonably determined and prudent request.

Emergencies Summary

PNGL supports the principle of reducing the number of calls made to the emergency number and reducing the number of jobs attended. However the safe operation and maintenance of the network is PNGL’s highest priority. PNGL must be allowed an appropriate allowance to operate the emergency number to ensure that consumers continue to use the number to report emergency issues. It would not be in the interest of safety to dissuade consumers from contacting the emergency number.

PNGL has provided evidence of the changes it has made to educate consumers which manages the level of enquiry calls made to the emergency number downwards and the initiatives PNGL has introduced to mitigate the number of jobs it has to attend. PNGL remains committed to identifying further such initiatives. However unless there is an alternative 24-hour contact number for enquiries or industry undertakes further PR to educate consumers and third party call centre operatives, the 24-hour emergency number will remain the default number used by consumers looking to resolve more general issues.

Contrary to UR’s proposals, reducing the level of enquiry calls made to the emergency number is not PNGL’s (or indeed Distribution Operators’) sole responsibility, nor is it appropriate to initiate any change which encourages customers to fail to report concerns. PNGL would suggest that, if UR wishes to manage the level of enquiry calls downwards, suppliers are tasked with developing similar guidance and initiatives as introduced by PNGL in the absence of providing their customers with a 24-hour contact number for enquiries. In fact it could be argued that UR will, under its proposals, reward suppliers for not providing their customers with a 24-hour contact number for enquiries; if UR does not allow PNGL the cost of these calls, UR will give suppliers a free 24-hour contact number for enquiries. UR will therefore have removed any incentive on suppliers to manage the level of enquiry calls their customers generate to the emergency number downwards. UR could mitigate this by requiring suppliers to meet the cost associated with enquiry calls.

PNGL has serious reservations with UR’s proposals and, if these remain, will require PNGL to update its Safety Case and enter into discussions with HSENI. The arbitrary reductions proposed by UR will have an impact on gas safety initiatives. UR must make HSENI and other parties involved in gas

safety in Northern Ireland aware of the consequences of its proposals and seek their unequivocal agreement before implementation.

PNGL does not believe UR has adequately accounted for the cost PNGL will incur during GD14 of providing the emergency service and would urge UR to reconsider its proposal on this basis.

Emergency Call Centre – “better collaboration”

UR notes that Rune has formed the opinion that whilst PNGL and firmus use the same provider for the call centre, each places its own contract for the provision of emergency call handling and dispatch. Rune believes that savings could be made in the fixed provision costs of this service by PNGL and firmus working more closely together. UR comments that it wishes *“to discuss further with the GDNs how they can achieve better collaboration in this area and we have incorporated a 50% saving of the fixed modelled call centre costs to calculate the proposed allowances. Over the three years of the control, this would be a reduction of £127,500.”*

In response, it would appear that there may have been a misinterpretation of exactly what basis the tender for an emergency call centre provider is issued. Although PNGL and firmus, as separate legal entities, are required to enter into individual contracts with the emergency call centre provider, the tender is issued for the provision of a service for Northern Ireland i.e. the total number of calls received for both PNGL and firmus. The service is therefore already tendered on a joint basis and a saving in the fixed provision cost of the emergency call centre has already been delivered as a result of PNGL and firmus using the same provider.

The cost of providing the emergency call centre in 2006 was c.£550k¹⁸ (2012 prices) for 12 months when PNGL was the sole user; PNGL’s cost in 2007 was £468k¹⁹ (2012 prices) when PNGL and firmus began using the same provider. This represents a c.15% saving of c.£82k (2012 prices).

PNGL does not believe UR has considered the saving already delivered as a result of PNGL and firmus using the same provider in reaching its proposals and would urge UR to reverse its arbitrarily proposed 50% saving.

NETWORK MAINTENANCE

PNGL has not been provided with a copy of the report from UR’s engineering consultants, Rune and has not been attributed the opportunity of meeting with Rune for further engagement during this consultation process, even though it requested such a meeting on numerous occasions. Therefore

¹⁸ See “Emergency Call Centre evidence, 2006” submitted with this response.

¹⁹ See “Emergencies analysis by cost and call volume for UR.xls” submitted to UR on 30th March 2011 as part of its PNGL12 review.

we make the following comments without having had the opportunity to properly engage with UR to discuss the rationale for some of its proposals.

The section examines the following areas:

- PNGL Submitted Costs
- UR Analysis Model
- Efficiency Factor
 - Pressure System Safety Regulations (NI) 2004 Inspections
 - District and Customer Maintenance
- Asset Management
- Meter Batteries
- Reliability Centred Maintenance (RCM)
- RCM Upgrades

PNGL Submitted Costs

PNGL notes that UR has misquoted PNGL's GD14 submission for network maintenance in Table 20 and throughout the consultation. It appears that the costs associated with "Valve Chamber Covers - Remedial Maintenance" have been excluded. As there is no mention of this within UR's consultation, PNGL assumes that these costs have been excluded in error.

Costs (£'000)	2014	2015	2016
PNGL GD14 Submission	£ 2,438	£ 2,668	£ 2,374
PNGL GD14 Submission as per Table 20	£ 2,401	£ 2,631	£ 2,336
Difference	£ 37	£ 37	£ 38

PNGL would ask UR to review its proposal for network maintenance on this basis.

UR Analysis Model

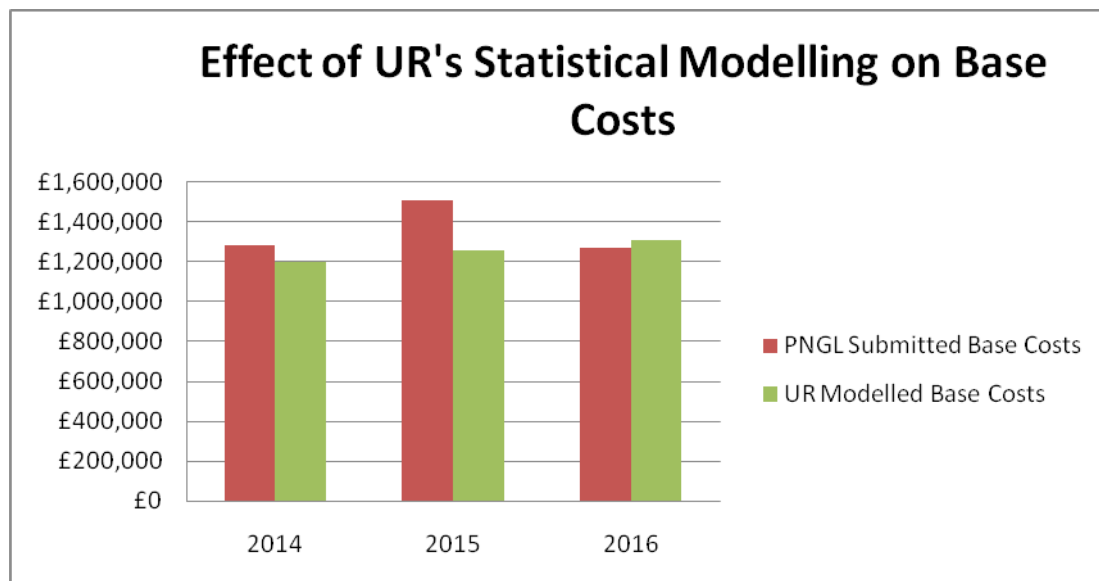
PNGL notes that UR has taken the PNGL submitted base costs and has carried out a modelling exercise based on customer numbers. This has resulted in an immediate reduction in costs.

PNGL's submitted base costs are derived from first principles and primarily consist of units of equipment (how many items of a given piece of equipment), unit costs (the costs for the maintenance activity, usually parts) and maintenance intervals (based on manufacturers' instructions).

The modelling carried out by UR is an attempt to apply a statistical model, informed by PNGL's actual costs in 2010 and 2011. This is a valid strategy for activities where a detailed build-up of rates is not available or impractical to derive. However as stated, PNGL's submitted base costs are derived from first principles and there is no need for UR to resort to statistical modelling.

The table and figure below show the impact of UR's modelling on PNGL's submitted base costs year-on-year, ranging from a reduction in allowance of 17% to an increase in allowance of 3%, equating to an overall reduction of 7% over the three years of GD14.

Item (Costs)	2014	2015	2016	Total Base Costs
PNGL Submitted Base Costs	£1,278,683	£1,500,996	£1,267,050	£4,046,729
UR Modelled Base Costs	£1,194,000	£1,250,667	£1,306,083	£3,750,750
Difference in Base Costs	£84,683	£250,329	£-39,033	£295,979
% Difference	7%	17%	-3%	7%

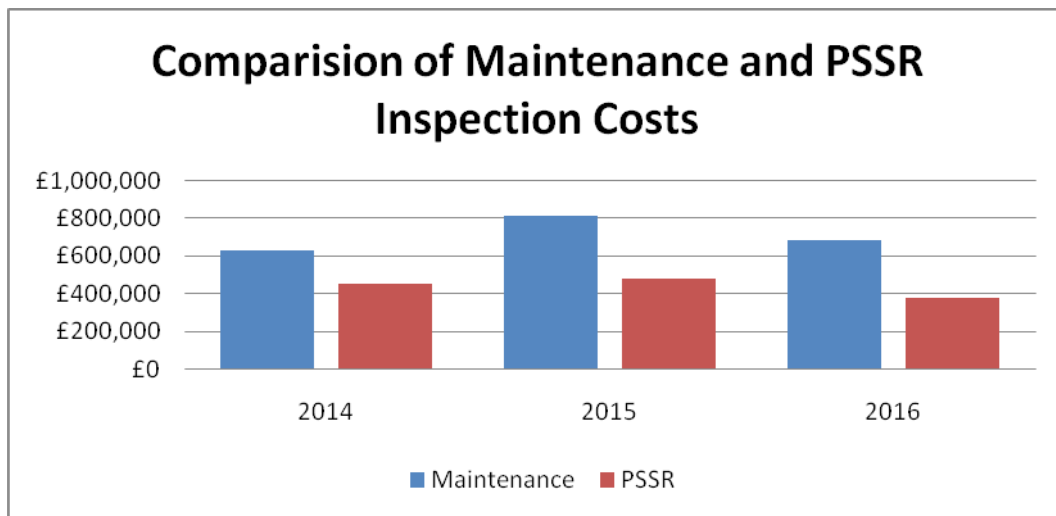


Efficiency Factor

UR has applied a 10% efficiency factor to PNGL's baseline maintenance costs *"to reflect the efficiencies which we consider PNGL should be achieving if it had fully implemented an asset maintenance system"*. It is further stated that the efficiency factor be applied *"in recognition that PNGL is in all likelihood still not operating to the most efficient maintenance schedule"*.

PNGL has not been provided with the gap analysis undertaken by UR to determine the quantum of efficiencies it believes PNGL would have achieved if PNGL had fully implemented an asset maintenance system, even though PNGL requested such. In the absence of any supporting analysis, PNGL can only assume that the 10% efficiency factor applied by UR is an arbitrary figure.

The PNGL submitted base costs referred to by UR are primarily made up of Pressure System Safety Regulations (NI) 2004 (PSSR) inspections (**"PSSR"**) and costs associated with the maintenance of district and customer pressure reduction equipment and customer meters (collectively **"Maintenance"**). The figure below illustrates the breakdown of PNGL's submitted base costs into the two categories:



PSSR

Under PSSR, PNGL is required to carry out periodic inspections of pressure reduction equipment operating at above 2 barg. The intervals of these inspections are dictated by legislation and PNGL has no discretion to change these. The work is carried out on PNGL's behalf by PES. Implementation of PAS55 (or another asset management system) will have no bearing on the costs associated with this work.

PNGL urges UR to grant its requested allowance for PSSR inspections so that PNGL can carry out this work and remain in compliance with legislation.

Maintenance

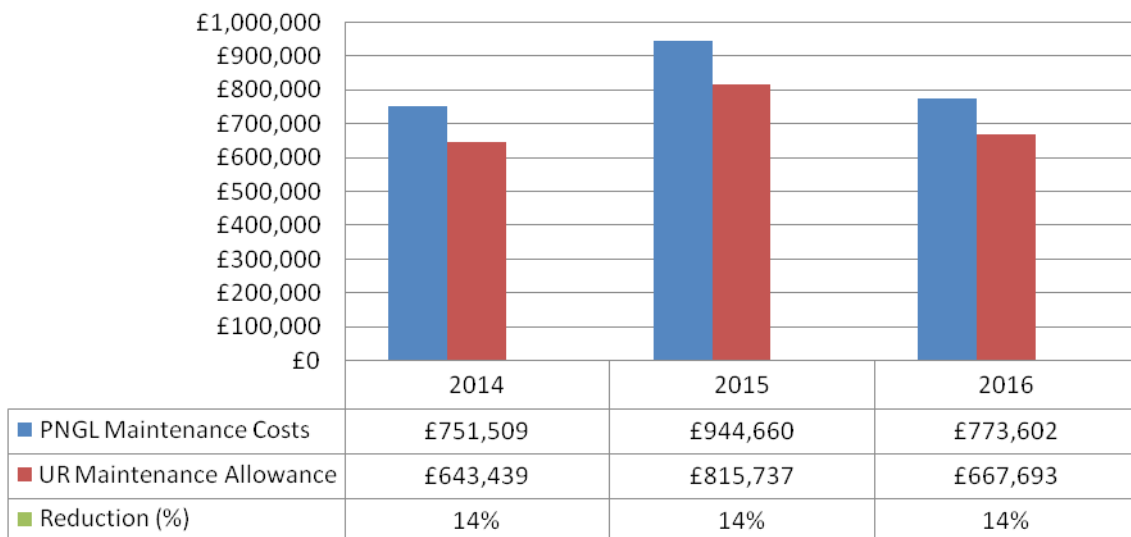
As stated, PNGL's submitted base costs for the maintenance of district and customer pressure reduction equipment and customer meters are derived from first principles:

- *Number of Units* – this is a count of all the units that PNGL operate and maintain
- *Materials / parts used* – these are procured from the manufacturers of the equipment
- *Maintenance intervals* – fixed for each activity (based on manufacturers' instructions)

PNGL's maintenance intervals are based on manufacturers' instructions. This strategy is incorporated into our Safety Case, as accepted by HSENI. Any changes **must** be agreed with HSENI.

As it stands, UR's 10% arbitrary efficiency factor applied to the PNGL submitted base costs will result in a **c.14% reduction** in PNGL's maintenance of district and customer pressure reduction equipment and customer meters given that there is no scope for reduction in the areas subject to PSSR:

Reduction in Maintenance Costs as proposed by UR



However the introduction of an asset management system such as PAS55 or ISO55000 will have no impact on either the number of units or the procurement of materials / parts. Furthermore any modification to PNGL's current maintenance intervals is subject to the completion of the Reliability Centred Maintenance project (see below), PNGL updating its Safety Case **and** acceptance of this by HSENI. As none of these projects can be fully completed during GD14, there is no opportunity for PNGL to modify its current maintenance regime during GD14. It is therefore unreasonable for UR to apply an arbitrary cost reduction in the knowledge that PNGL cannot take any action to attempt to deliver that reduction during GD14. Safety must remain PNGL's highest priority.

UR should provide detailed justification of where UR believes its proposed 10% efficiency reduction can be achieved without compromising the safety of the network.

Asset Management

As stated in our paper, "Asset Management Review for UR Dec 12" submitted as part of our GD14 price control submission, PNGL embrace the principles of asset management. We are working in line with the main tenets of PAS55 and aim to implement the new ISO55000 when it is launched.

PNGL has extensively researched the use of PAS55 by other GDNs and can find no one who can demonstrate a directly related saving. Indeed work undertaken by Rune Consulting for PNGL concludes:

We support UR's direction to develop a suitable asset risk management system and consider that PNGL's approach will enable current asset management practices to be formally recognised as best practice and for these to be complemented by other appropriate asset

management arrangements. We have not examined whether 10% efficiency imposed by the UR can be achieved and we are not aware of any analysis in the public domain that translates the benefits of formal asset risk management into quantitative efficiency improvements. We also caution against unquestioning compliance with a particular standard, since we consider that, in some ways, PASS55 lags behind current leading edge thinking about asset management.

If UR is aware of any analysis, or has undertaken its own analysis, translating the benefits of formal asset management into quantitative efficiency improvements, PNGL would appreciate being advised of details in order to assist us in our implementation of an asset management system.

Meter Battery Replacement

UR has suggested that PNGL should assess, through experience of the operation of the batteries, the feasibility of extending the battery life. The quoted life of the meter batteries from the manufacturer is 8 years.

Through operational experience PNGL has extended the battery replacement interval from 8 years to 10 years. This means that PNGL now only replaces meter batteries once during the normal 20-year operational life of the meter instead of twice. PNGL has therefore delivered the optimum battery replacement cycle. The resultant saving has already been incorporated into PNGL's maintenance submission and the benefits passed on to consumers.

UR's proposed 15% arbitrary reduction in meter battery replacements is therefore fundamentally flawed. PNGL cannot achieve any further efficiency savings by extending the battery replacement interval beyond 10 years; even if it were determined that the battery replacement interval could be increased, e.g. to 12 years, PNGL would still be required to replace the meter batteries once during the normal 20-year operational life of the meter.

UR's proposal to extend the battery replacement interval would not deliver savings in practice²⁰ and can only increase risks:

- It is PNGL's view that extending the replacement interval beyond 10 years would be unwise: has UR fully considered the consequences of a meter battery failing in operation?
- Are UR and gas suppliers willing to allow customers to obtain free gas as this may be a likely outcome of extending the battery exchange interval beyond 10 years?
- Is UR suggesting that PNGL does not respond to notifications provided by suppliers regarding battery replacement?

²⁰ The small time value benefit would not outweigh the increased safety and reliability risks.

PNGL urges UR to reverse this arbitrary and unachievable reduction in meter battery replacements.

Reliability Centred Maintenance (RCM)

This section addresses three points regarding the costs submitted under “RCM Upgrades” before reviewing each item in more detail.

The first point is that while a number of cost items classified under “RCM Upgrades” were identified during the RCM review process, the issues were not in fact RCM-related; the work is required to achieve compliance with other legislation e.g. PSSR; or due to the items no longer being fit-for-purpose e.g. ladders. Contrary to UR’s statement, none of the items identified under “RCM Upgrades” have arisen due to equipment not being built to appropriate standards.

The second point relates to the principle of RCM. RCM is a comprehensive maintenance philosophy that has been adopted in many industries, including the gas industry, around the world. Implementing RCM requires a structured methodology to ensure that the correct maintenance is being carried out on equipment and at the correct intervals.

In an ideal world all manufacturers would carry out an RCM analysis on their own equipment for a range of operating contexts in advance of the product being brought to market. This would allow clients, in this case PNGL, to make fully informed choices regarding equipment. All failure modes and effects would be pre-identified and all that would remain for PNGL would be to ensure that the operating contexts of the reviews matched the operating contexts of PNGL. **This is an idealised scenario. It does not apply in the gas industry.**

In the absence of industry provided RCM analysis, when PNGL carries out an RCM review it is highly likely that previously unknown or unsuspected failure modes may be identified, such as those identified in our paper, “*Asset Management Review for UR Dec 12*”, that required upgrade work e.g. ventilation.

In these instances RCM has been successful in highlighting safety issues that need to be addressed. The items identified via RCM regarding safety are not issues that have arisen due to equipment not being built to appropriate standards; the equipment complies with current standards. Instead RCM has identified design issues that need to be addressed to ensure that a previously unidentified failure mode will not have safety consequences.

The third, and possibly most important, point is that RCM is **not** necessarily focussed on saving money. It **is** about carrying out the correct maintenance at the correct time. There is no guarantee that costs will reduce as a result. As has been outlined in our paper, “*Asset Management Review for UR Dec 12*”, savings should not be expected in the short term, and rather costs may indeed rise in the short term with a view to a reduction in costs in the longer term.

This is a key point in the RCM process. UR cannot cherry pick the benefits of RCM (potential, though non-specified, savings) and ignore the increased workload (costs for redesigns, changes in work practices, etc.). RCM can only be implemented in the whole i.e. balancing costs and savings, or not at all.

UR's rejection of PNGL's investment in enhancing our system through RCM Upgrades is a positive and clear disincentive to innovate. PNGL has statutory obligations to ensure continual improvement in the management of our assets. UR's proposal is entirely inconsistent with our obligations and is clearly not in the best interest of gas consumers in Northern Ireland.

PNGL urges UR to grant an allowance for RCM Upgrades so that PNGL can carry out this necessary work.

RCM Upgrades

As noted above, a number of cost items classified under "RCM Upgrades" were identified during the RCM review process which were not RCM-related. These cost items have arisen through natural wear and tear or through guidance from PNGL's Competent Person (GL Noble Denton) as part of PSSR examinations. The remaining cost items are the redesigns required following the RCM review process.

Natural Wear and Tear / PSSR

Ladders

While carrying out the RCM review, the ladders in the district sites were examined. These were not deemed fit-for-purpose and therefore require replacement to ensure the safety of operatives working on site. PNGL is requesting an allowance of c.£20k across GD14 for ladders.

Pipe Supports

As part of ongoing PSSR site inspections, the Competent Person raised concerns about the condition of the pipe supports for the main streams and the auxiliary pipe work and requested that they be replaced. As this request coincided with the RCM review of the auxiliary pipe work and pipe supports in general, the costs for the work were included under the "RCM Upgrades" heading. PNGL is requesting an allowance of c.£82k across GD14 for pipe supports.

RCM Redesigns

Ventilation

The larger district sites operated by PNGL have ventilation grids at each end to ensure adequate ventilation. The design of this complies with the relevant standards. The RCM review identified a problem with the current ventilation grills as, due to the way that the grids are fitted to the installation kiosks, there is no way for a technician to visually inspect the ventilation duct to ensure

that it has not become blocked. PNGL is requesting an allowance of c.£9k across GD14 for modifying the ventilation grills.

Water Level Gauges

The RCM reviews, as detailed in our paper, *“Asset Management Review for UR Dec 12”*, identified potential safety issues with water ingress into the district below ground (Asoflex and PDIM models) kiosks freezing and preventing the operation of safety devices. PNGL propose fitting remote telemetry and water gauges to provide warning when water has reached specified levels. PNGL is requesting an allowance of c.£4k across GD14 to complete this work.

Lock Upgrades

The RCM reviews identified an issue with the type of locks being used on the district PRSs and recommended a move to a simpler system using padlocks. This would reduce the risk of technicians being unable to access the sites in the event of an emergency and reduce future repair costs associated with maintaining the current, more complex locks. PNGL is requesting an allowance of c. £4k across GD14 for lock upgrades.

Regal 2 / H40 Ventilation Upgrades

Again, as detailed in our paper, *“Asset Management Review for UR Dec 12”*, the RCM review highlighted issues with water ingress into the below ground regulators freezing and preventing the operation of safety devices. PNGL has designed, and borne the cost of testing, a number of solutions to the problem of water ingress into the regulators. The proposed upgrades can be carried out by the existing governor technicians as part of their day-to-day work and will be completed by end of 2014. PNGL is requesting an allowance of c.£40k across GD14 for Regal 2 / H40 ventilation upgrades.

Domestic Site Works

PNGL notes UR’s proposal for a change of policy to domestic site works to align PNGL’s current arrangement in relation to meter exchanges with the policy currently in place with firmus. We note UR’s proposal that meter exchanges from:

- credit to prepayment will continue to be free of direct charge (up to a maximum of one exchange per year)
- prepayment to credit will no longer be free of direct charge (with an exception for vulnerable consumers)

PNGL notes UR’s proposal that PNGL would charge the cost of the prepayment to credit meter exchange directly to the appropriate supplier or consumer and would therefore be neutral to UR’s proposed change of policy.

PNGL would request that UR engages with suppliers and consumer bodies as part of the GD14 consultation process to discuss the implementation of UR's proposed change of policy so that any issues arising are fully understood and accepted. In addition if there is to be a lead time prior to implementation of UR's proposals, PNGL would request UR to adjust PNGL's allowances appropriately.

INSURANCE

In response to UR's *GD14 – Information Request – IR1*, PNGL provided justification for its insurance request. Business insurance accounts for c.88% of total insurance costs. The main business insurance policies relate to Business Interruption and Public Liability, and to a lesser extent Employers Liability Insurance. These are assumed to be driven by company turnover and therefore would need to be calculated on the basis of the final allowable income derived. PNGL provided UR with justification and the methodology used in deriving the allowances in response to UR's *GD14 – Information Request – IR3*.

UR is proposing to grant PNGL an average, based on the three-year timeframe (2009 to 2011). This is not appropriate given that business insurance is driven by company turnover and PNGL's turnover profile is rising. PNGL does not believe UR has adequately accounted for the business insurance PNGL will incur during GD14 and would urge UR to reconsider its proposal in light of the methodology submitted by PNGL in response to UR's *GD14 – Information Request – IR3*.

PNGL has highlighted to UR as part of the 2012 actualisation process that its "insurance" cost line from 2010 onwards is overstated and its "fleet costs" cost line understated by the corresponding amount. PNGL advised UR that the credit associated to cars used by PES had not been appropriately allocated between its "fleet costs" cost line and car insurance within PNGL's 2010 and 2011 actualisation submission and PNGL's GD14 submission forecasts. The decrease in car insurance is therefore offset by a corresponding increase in fleet costs. This adjustment reduces PNGL's requested car insurance allowance of £1,905 per annum per car to c.£1,200 per annum per car.

PNGL notes that UR has researched car insurance costs and is minded to allow £750 per car in line with the AA's average premium for comprehensive car insurance in 2013. PNGL has sought to validate UR's researched car insurance costs and understands that £746.75 reflects the average quoted premium for an annual comprehensive car insurance policy for Quarter 1 of 2013²¹ in the UK, as tracked by the AA Shoparound index²². Furthermore PNGL understands that the AA's market

²¹ <http://www.theaa.com/newsroom/bipi/201304-bipi.pdf>.

²² The AA Index is based on a nationwide basket of risks that is representative of the UK insurance market. Quotes are obtained from a range of direct providers (brokers, insurers and schemes) and from companies quoted on price comparison sites. Market average is the average of all premiums returned for each risk. The Shoparound average is from the five cheapest quotes returned for each risk.

average²³ quoted premium for an annual comprehensive car insurance policy for Quarter 1 of 2013²⁴ in the UK is £1,132.46.

PNGL also notes a campaign launched in 2011 by the Consumer Council which quotes the average yearly car insurance premium in Northern Ireland of c.£950²⁵. The campaign also comments:

Historically, NI consumers pay on average £300 more for car insurance than GB (Source: "Quote... Unquote: The Cost of Car Insurance in Northern Ireland. A research report from the Consumer Council" (March 2009) – the Consumer Council has been pressing the NI Assembly for an investigation into the cost of insurance here since we launched our research report "Quote, Unquote" in March 2009

Furthermore, it is accepted practice when acquiring an insurance policy, for premiums to increase when there is a business travel requirement. It should therefore be accepted that policies such as PNGL's, where there is a significant level of business use, will be abnormally affected.

UR's proposal ignores the fact that Northern Ireland consumers pay on average more for car insurance than in the rest of the UK and ignores the AA's market average premium which may be more reflective of the basket of risks representative of a fleet of business cars. PNGL does not believe UR has adequately accounted for the car insurance PNGL will incur during GD14 and would urge UR to reconsider its proposal on the basis of the above and on the specific evidence for Northern Ireland highlighted by the Consumer Council.

PNGL's response to UR's *GD14 – Information Request – IR3* notes that the PNGL's car insurance cost line includes accidental damage costs up to excess level in the insurance policy. It would appear that these costs have not been considered by UR in its proposal. **PNGL would also request UR to reconsider its proposal on this basis.**

MANPOWER

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

²³ *Ibid.*

²⁴ <http://www.theaa.com/newsroom/bipi/201304-bipi.pdf>.

²⁵ <http://www.consumerCouncil.org.uk/newsroom/734/>.

[REDACTED]

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[REDACTED]

[REDACTED]

[REDACTED]

PNGL would therefore urge UR to radically reconsider its current manpower proposal as it is entirely inconsistent with actual costs incurred as dictated by market conditions.

Additional Resources

PNGL collects call volumes statistics, including those that relate to its existing customer base of c.160,000 connections at the end of 2012 and those that relate to new connections or potential connections. PNGL's submission forecasts 25,834 new connections across GD14.

PNGL believes that the continued growth in connections and the continued expansion of the PNGL network will have some form of proportional affect on call volumes beyond those that relate to new connections e.g. increased competition, increased emergency activities.

Furthermore although PNGL has assumed that the percentage of customers switching will remain flat across the price control period, this will result in a proportional increase in the level of transportation service activities associated with an increasing customer base.

Therefore PNGL's forecasts incorporate a growth of 0.5 FTE per annum across the period 2012 to 2016 in both the customer services and the transportation services departments to meet the requirements of these areas of increased activity. If UR does not allow PNGL the costs of the additional FTEs, UR is assuming that inherently PNGL can deliver efficiency to offset the growth in activity. This is inconsistent with UR's application of an overall efficiency factor for GD14 and by its application will result in double counting of efficiencies.

Other Matters



RATES

Northern Ireland and Great Britain precedent is to treat network rates as pass-through:

1. Ofgem's three price control reviews under the RIIO model²⁶ classify business rates as non-controllable opex and therefore treat rates as pass-through;
2. Ofgem's 2010-2015 electricity distribution price control review classifies business rates as non-controllable opex and therefore treats rates as pass-through;

²⁶ i.e. gas and electricity transmission, gas distribution and electricity distribution.

3. UR's 2012-2017 NIE transmission and distribution price control classifies business rates as uncontrollable opex and therefore treats rates as pass-through;
4. Ofgem's 2008-2013 gas distribution price control review classifies rates as a non-controllable cost and therefore allows rates on a pass-through basis; and
5. UR's 2011/12, 2012/13 and 2013/14 opex review for PTL and BGT considers rates as an uncontrollable cost and therefore treats rates as pass-through

The effect of the Commission's decision in relation to PNGL's rates is essentially to make rates subject to a "retrospective mechanism" for the period 1996-2006.

Furthermore it would be unreasonable for UR to align the price controls of Northern Ireland's GDNs while treating this uncontrollable cost differently for PNGL and for firmus.

For firmus, UR is minded to continue using the formula approach to set allowances for network rates. Rates will be treated as a cost pass-through, subject to firmus demonstrating that it has taken appropriate actions to minimise the valuations. The allowances will therefore be modified to reflect actual costs incurred via the retrospective mechanism.

It is impossible, against this background, to discern a legitimate reason to treat rates for PNGL as anything other than a pass-through cost and subject to the same conditions as firmus.

PNGL would ask UR to provide full justification for its proposal and for treating rates differently for PNGL and for firmus.

LICENCE FEES

PNGL welcomes UR's proposal to treat licence fees as pass-through and therefore retrospectively adjust them to reflect the actual fees levied on PNGL by UR.

OFFICE COSTS

UR has not provided any justification for its proposed allowance for office costs over the GD14 price control period.

PNGL's office costs primarily reflect the costs of the premises at PNGL HQ, Airport Road West ("ARW") and the PNGL stores at Heron Road. ARW is broadly sublet one sixth to Tenant A and one sixth to Tenant B. Tenant B's sublet will end June 2014. PNGL's submission assumes that beyond the terms of the current leases the sublets are, on average over time, only let 20% of the time. However PNGL notes that UR has not granted any allowance for empty sublets. PNGL would ask UR to reconsider whether it is reasonable to expect there not to be a period of non-occupancy or there not

to be a rent-free period offered to a new tenant between periods of occupancy, as previously accepted by UR²⁷. Under UR's proposals, PNGL is fully exposed to any period of non-occupancy.

Rent at ARW is based upon a 'repair all' lease. This was last reviewed in 2011 with the next review due in 2016: the increase assumed by PNGL in its GD14 submission in 2016 is 15%. **PNGL would ask UR to reconsider whether it is reasonable to expect PNGL's rent to remain unchanged after five years.**

PNGL stores costs increase in 2015 as the current facilities are not expected to be sufficient going forward due to (i) the scale of network, (ii) the temporary nature of the facilities used for meter storage within McNicolas' depot and (iii) the need to consolidate operations at one site from both a control and an organisational basis going forward. UR has not provided any justification for its proposed allowance for office costs over the GD14 price control period and it is unclear whether a specific allowance has been granted to cover this cost line.

INFORMATION TECHNOLOGY (IT)

PNGL has not been provided with a copy of the report from UR's consultants, Gemserv.

UR notes that Gemserv's report cites that while the size and complexity of the Concerto system has increased with the introduction of supply competition, the development costs associated with this system have been separately reimbursed and therefore the level of allowances that seem to be associated solely with the maintenance and general support of the expanded systems are excessive, notwithstanding the added complexity of the Concerto system.

In response, PNGL notes UR's proposal to maintain a materiality threshold for requests for additional costs at £100k (see Chapter 8 below). The application of such a materiality threshold over a cost category such as IT, where UR's proposed allowance is on average only c.£239k per annum, demonstrates the inappropriateness of this threshold and the inappropriateness of the proposed IT allowance. Given the complexity of the Concerto system and the replacement cost of PNGL's current IT infrastructure, PNGL's IT allowance is already fully committed and is already subject to substantial efficiencies under UR's IT proposals and therefore there would be no margin for absorbing any such "de minimus" expenditure.

UR notes that Gemserv's report cites that PNGL has sought to recover costs that were previously recharged to PSL – Gemserv's view is that it may be inappropriate to allocate these costs to the regulated business and therefore NI gas customers.

PNGL would highlight that costs recharged to PSL, including IT, were allocated to PSL on an absorption basis rather than a marginal basis. This ensured that PSL was not advantaged over other suppliers and meant that PNGL benefited from the synergies of having a supply business within the

²⁷ Section 5.9 of UR's Final Determination for PC03 states: "In order to incentivise PNG to fill the vacant space we have factored a 50% occupancy rate for sub let for 2008 onwards."

Group. Gemserv's view is not therefore correct. Northern Ireland consumers have benefitted to a disproportionate affect whilst PSL was within the Phoenix Group. Following the sale of PSL, PNGL has lost these synergies and, under UR's proposals, will never be allowed such legitimate costs of operating its IT systems into the future.

PNGL appreciates that it may be appropriate to charge gas suppliers for the cost of developing systems which benefit suppliers and consumers for the Greater Belfast area, but which are of no direct benefit to PNGL. However, given that supply competition in the domestic market is relatively new compared to the rest of the UK, PNGL would recommend full consultation with industry prior to any such fundamental change to the current regulatory regime; GMOG would provide an appropriate forum for discussion to gauge the opinion of industry. UR would also need to review the price controls of regulated suppliers and increase their IT allowance to cover the associated costs of system development. UR will note that Northern Ireland gas consumers ultimately pay for the cost of IT whether this is undertaken by the Distribution Operator or gas suppliers. PNGL is happy to consider Gemserv's proposals, and would suggest that UR undertakes this review with a view to implementing any proposed change as part of GD17 dependent on the outcome of consultation.

UR notes that Gemserv's report cites that the cost of accessing Ordnance Survey of Northern Ireland information appears to be disproportionate when compared to the overall costs, particularly as PNGL only requires access to information relating to the Greater Belfast area. The report suggests that there may, therefore, be grounds for PNGL renegotiating this cost.

In response, PNGL would advise that it only obtains large scale vector information (tiles) for areas within the PNGL Licensed Area and only where there is a likelihood of extending the gas network. This approach ensures that PNGL only pays for tiles it requires access to. The rates that PNGL pay are those charged by Land and Property Services.

PNGL does not believe UR has adequately accounted for the cost of IT PNGL will incur during GD14 and would urge UR to reconsider its proposal.

PROFESSIONAL AND LEGAL FEES

UR asked for a rationale of the justification for increased allowances, over and above those set in PNGL12 in *GD14 – Information Request – IR3*. PNGL provided detailed justification for its request in response.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

The application by UR of an allowance using a roll forward of the PNGL12 allowances without taking account of the factors as noted is selective and is not appropriate. UR should provide detailed justification of why disregarding the historical average for the last three years is unsound given that PNGL has provided a comprehensive breakdown of all costs incurred in relation to the Commission's Inquiry of PNGL12 and these have been excluded from the three-year timeframe.

One-off costs

PNGL has also requested specific allowances for additional one-off costs during 2014. These costs were not incurred historically and are not therefore incorporated within the historical averages.

PNGL notes that UR has rejected PNGL's request for a c.£20k allowance in 2014 in relation to advice and support in connection with the revisions/redesign of the company's pension scheme to deal with the implications of the new automatic enrolment requirements.

PNGL would ask UR to provide full justification for its proposal to disallow PNGL's requested allowance given that automatic enrolment into a workplace pension is a new legal requirement and costs are not therefore reflected in PNGL's historic cost base.

PNGL notes that UR is proposing a one-off allowance in relation to IFRS reporting requirements of c. £16k in 2014, as requested by PNGL. This is a reasonable and prudent allowance for the work associated with the implications of reporting under IFRS.

PNGL does not believe UR has adequately accounted for the professional and legal fees PNGL will incur during GD14 and would urge UR to reconsider its proposal.

SMALLER ITEMS

PNGL notes UR's proposal to treat the smaller item cost lines collectively, with the exception of entertainment, using an average, based on the five-year timeframe (2007 to 2011). PNGL has commented on the proposed allowance for each of the smaller items below. However at a summary level, PNGL would ask UR to consider adopting a new basis for the collective treatment of these smaller items.

UR's proposed allowance is not only 33% lower than that forecast by PNGL for the smaller item cost lines in GD14 but c.7% lower than the actual costs incurred by PNGL in 2012.

PNGL has undertaken analysis of the smaller item cost lines on the basis of the number of cumulative connections to its network, which have grown by over 40% since 2007. PNGL believes this basis is more reflective of the costs PNGL would expect to incur. This analysis highlights that the average actual cost per connection across PC03 was c.£4.65. This is in line with PNGL's requested allowance for GD14 of c.£4.75 per connection. UR's proposed average allowance for GD14 on the basis of the number of cumulative connections to PNGL's network is only c.£2. This represents reduction of over 50% relative to PNGL's actual costs for PC03.

An average, based on the five-year timeframe (2007 to 2011) is not an appropriate methodology for determining the allowance for the smaller item cost lines. PNGL does not believe UR has adequately accounted for the costs PNGL will incur during GD14 and would urge UR to reconsider its proposed methodology.

Our specific comments on each of the individual smaller items cost lines are as follows:

BILLING

UR's determined allowance averaged c.£159k per annum across 2012 and 2013 prior to allocation of costs through the A+M+PR mechanism. UR is proposing an allowance of c.£103k per annum across

GD14 using an average, based on the five-year timeframe (2007 to 2011). This represents a reduction of over 30% relative to UR's determined allowance for PNGL12.

In response to UR's *GD14 – Information Request – IR1*, PNGL provided justification for its request for an increased allowance for billing relative to that granted for PNGL12. PNGL explained that the increase is largely driven by the costs of meter reading following the introduction of supply competition in the domestic market:

“Meter reading costs are driven by the need for PNGL to undertake special visits on the basis of the following activities; re-visits following meter removals or return of a meter point where the property is vacant, meter queries or disputes, potential fraud situations, regular transportation service reads to facilitate balancing/allocation algorithms, and implication of notional reads. It has been assumed that these reads rise in real terms in proportion to total number of connections to the network. These activities have increased significantly relative to the previous price control following the introduction of a fully competitive environment and operation of the network code associated thereto. These activities will increase significantly in the coming years as the full implication of tariff competition is imbedded and transportation service activities increase in line with obligations of network code and in reaction to supplier behaviour.”

PNGL would ask UR to provide full justification for its proposal to disallow PNGL's requested increase which supports supply competition in the domestic market. An average, based on the five-year timeframe (2007 to 2011) is not appropriate given the introduction of a fully competitive environment is only reflected mid-way through this period.

ENTERTAINMENT

Phoenix's integrated Corporate Social Responsibility programme is called LIFE, which stands for “Leadership in the marketplace”, “Investing in our people”, “Fostering our community” and “Environmental responsibility”. LIFE was developed when Phoenix was first established to provide an overarching framework for the range of ongoing initiatives we undertake that positively impact our marketplace, environment and community. In 2013 we were delighted to have, for the ninth year running, received national recognition for our efforts in this area by collecting a Business in the Community ‘Big Tick’ award for CSR excellence.

Phoenix has recognised the value in developing a structure for its CSR programme. An example of this is demonstrated under the ‘LIFE’ heading of “Investing in our people”. Phoenix has established a range of activities that are designed to enhance Phoenix as an employer in the eyes of its staff and also to potential employees. The initiatives are designed to attract job candidates, raise morale, motivate staff to perform more effectively, improve levels of customer service and thereby provide positive impacts in output and reduce business costs associated with absenteeism and staff turnover.

An important element of this range of activities is to hold regular briefings to recognise performance and encourage staff to achieve their own personal targets. Phoenix's 'LIFE' programme also includes a regular internal communications programme "Phoenix Fifteen", which are interactive sessions targeted at updates on the various parts of the business and encouraging staff to participate in volunteering in the range of initiatives outside normal working hours. A structured "Health and Wellbeing" programme has been developed to highlight the importance of a work/life balance and improve the general quality of life of both our staff and the wider community e.g. all staff are given a free annual health check and also benefit from exposure to regular visits from external speakers to offer general advice and guidance on health and wellbeing. Some of the costs associated with this activity have to by definition be classified as entertainment.

UR is proposing allowances for entertainment, as with its PNGL12 decision, consistent with HMRC guidance on non-taxable employee benefits. More specifically, UR is proposing an allowance of £20k per annum, based on offering around £150 per employee. This is a reasonable and prudent allowance for staff entertainment and associated CSR functions based on the range of activities incorporated within this PNGL cost-line.

UR's proposed allowance compares with PNGL's request for £43k per annum.

In relation to the other 'LIFE' headings of "Leadership in the marketplace", "Fostering our community" and "Environmental responsibility", Phoenix has developed a further range of initiatives.

Phoenix has developed a strong community engagement programme which is designed to engage fully with the communities where we operate daily and whom we serve. This engagement extends from giving talks and presentations to marginalised people to help them into gainful employment to the establishment of the Energy for Children Charitable Trust e.g.

- Our staff continue to work closely with schools, colleges and universities e.g. Business in the Community's *Time to Read* and *Time to Count* schools initiatives and partnering with Queen's University Belfast, helping to support the establishment of Riddell Hall - a £15 million purpose built postgraduate and executive education centre. Phoenix are one of fifty founders of the establishment, all of whom have the opportunity to work with the Centre's management experts from across the world in order to shape the content of what is delivered. Phoenix now has access to relevant business tutorials, programmes and training in a number of different areas.
- Although Phoenix's CSR programme, LIFE, is wide-ranging in its approach, it is the children's Charitable Trust that is perhaps having the biggest impact on those children other charities or support agencies can't reach and for whom even limited support makes a huge difference to their quality of life and well being. Set up as a formally constituted charity to facilitate the charitable interests of the local natural gas industry, the Energy for Children Charitable Trust was formed by Phoenix in 2005. Since then it has continued to break new ground and reach deeper into the heart of local communities throughout Northern Ireland in order to really

make a difference to disadvantaged children's lives. The Trust is governed by trustees made up of representatives from Phoenix and local people linked to the communities that our industry serves. It focuses on supporting those needy causes that are slipping through the net of the more established charity network, and is founded on the principle that 'all monies raised go directly to local children and young people'. Behind the scenes Phoenix provides all administrative support and funding for the work of the front-line staff that facilitate the funding bids. Although the Trust was founded initially by the natural gas industry, it is now supported by a variety of different sectors and organisations locally as it continues to grow.

Phoenix has a key role to play in getting its message across to the political world, business community and community groups. It is essential for Phoenix's operation that strong community support exists and whilst we operate a range of initiatives to support this, there tends to be no substitute for engaging with people and have them attend some of these to see firsthand our active involvement. Phoenix's ongoing engagement programme with a wide range of stakeholders on LIFE continues on a daily basis. This includes pro-actively briefing local politicians and other key stakeholders specifically on the importance of CSR in Northern Ireland and using LIFE as a case study of how it can be done to great benefit. Many of these initiatives transcend the political divide and introductions can be made that may lever additional support from other organisations. Maintaining a good image requires commitment over a sustained period of time and it is essential that the benefits of this work are communicated widely not only within the community, but also with the wider business and political sector.

New channels through which to communicate Phoenix LIFE initiatives have also been established, including a Phoenix Twitter account and a bespoke Phoenix You Tube channel. These social media channels are a promotional tool; they give advice, highlight grants and most importantly showcase Phoenix LIFE. 2012 saw sustained levels of growth in terms of engagement and the popularity of these CSR platforms. Their popularity and increased impact are evaluated in terms of interactions, followers and views.

Further to this Phoenix employs significant resources to continue to grow its customer base with key customer contacts in the Industrial and Commercial sector, new build and public sector housing sectors and other key customer representatives in support of its customer and load growth initiatives.

Finally trade development continues to be a key part of the orderly development of the industry with PNGL providing a key role with installers, distributors, retailers, specifiers, architects etc.

All this activity necessitates a significant level of time and energy and at times will involve a level of expenditure which due to its nature needs to be classified as entertainment.

Finally LIFE's "Environmental responsibility" banner:

- The strong Health, Safety and Environmental culture throughout Phoenix has been recognised by two British Safety Council Swords of Honour; the processes that underpin this

recognition were tested again in 2012 by a detailed ARENA Network survey which saw Phoenix accredited by ARENA Network as being of 'Quintile One' standard – amongst the best in Northern Ireland.

- Environmentally around 3 million tonnes of carbon dioxide ("CO₂") have already been prevented from entering the local atmosphere as a result of the conversion to natural gas from other fuels, with continued savings of around 250,000 tonnes of CO₂ per annum (or the equivalent of removing approximately 60,000 cars off Northern Ireland's roads every year). Phoenix have also promoted the installation of the latest high efficiency technologies and through its teams of highly trained Energy Advisors have established natural gas as the energy source to replace more polluting fuels like oil and coal. In the last year PNGL has connected an additional 10,523 properties to its natural gas network.

In addition PNGL has spoken to over 100,000 customers in 2012, including visits from our Energy Advisors to homes and businesses to provide essential energy awareness and saving advice tailored to each individual property. Over this time Phoenix's energy efficiency focused marketing campaigns were communicated to around 320,000 homes in Northern Ireland. Phoenix estimates that its staff has helped around 5,000 homes out of fuel poverty in the last year alone.

Phoenix's investment in CSR is a long-term one put in place strategically to benefit both the organisation and the local communities that we serve. The financial resources attributed to Phoenix LIFE are far outweighed by the voluntary effort, commitment and time given by staff to maximise the impact of all initiatives pursued. We see such expenditure as beneficial to our business and therefore we would propose that an allowance of £23k (in addition to the £20k allowance for staff entertainment) to cover business entertainment and related CSR functions to be reasonable and consistent with its past experience. This is a reasonable and prudent allowance based on activities incorporated within this PNGL cost-line.

FLEET COSTS

In response to UR's *GD14 – Information Request – IR1*, PNGL provided justification for its request for fleet costs. The main driver is manpower numbers and more specifically the number of employees with a company car. Mileage unit rates have also risen in line with the cost allowances as determined by HMRC.

UR is proposing an allowance of c.£238k per annum across GD14 using an average, based on the five-year timeframe (2007 to 2011). As already noted in our response to UR's proposals for insurance, PNGL has highlighted to UR that PNGL's submitted "fleet costs" cost line is understated from 2010 onwards. The corrected figures provided to UR during the consultation process increases UR's proposed allowance to c.£257k per annum.

PNGL has benefited across the three-year timeframe (2007 to 2009) due to a rebate of c.£130k from a previous provider on disputed costs of a historic lease contract. An average, based on the five-year timeframe (2007 to 2011) therefore cannot be regarded as representative and is not an appropriate allowance for fleet costs.

PNGL does not believe UR has adequately accounted for the fleet costs PNGL will incur during GD14 and would urge UR to reconsider its proposal.

HUMAN RESOURCES (HR)

UR's determined allowance averaged c.£79k per annum across 2012 and 2013 prior to allocation of costs through the A+M+PR mechanism. UR is proposing an allowance of c.£68k per annum across GD14 using an average, based on the five-year timeframe (2007 to 2011). This represents a reduction of over 10% relative to UR's determined allowance for PNGL12.

PNGL has indicated in response to UR's *GD14 – Information Request – IR1* that forecast costs tend to be driven by manpower numbers. Whilst recruitment costs are assumed to be flat in real terms across the period, the changes are largely as a result of changes in the number of employees and the need to suitably develop and train both new and existing staff to meet the ongoing requirements of the business and facilitate CPD requirements. A disproportionate amount of training and development relates to engineering and commercial operations in support of ensuring that we attract and retain suitably qualified staff to support the construction, operation and maintenance of the network. As staff numbers change in these areas over time, training costs will rise in proportion. Further the company has benefitted from a relatively stable workforce over the last few years, in part due to the difficult market conditions with respect to alternative employments options. On the basis that the economic situation is likely to improve somewhat over the next three years, this can only increase the cost of recruitment and additional staff training associated thereto.

PNGL does not believe UR has adequately accounted for the costs PNGL will incur during GD14 in relation to its HR functions and would urge UR to reconsider its proposal.

OWN USE GAS

An average, based on the five-year timeframe (2007 to 2011) is a reasonable and prudent allowance for own use gas.

TELEPHONE AND POSTAGE / STATIONERY

UR is proposing an allowance using an average, based on the five-year timeframe (2007 to 2011). As indicated during the PNG12 price control review, PNGL benefitted in 2008 due to a credit negotiated with our telephone provider on historic and current year costs of using a local call platform for incoming calls. An average, based on this five-year timeframe therefore cannot be regarded as representative and is not an appropriate allowance for telephone costs.

More recently, call costs appear to have reached a plateau with providers now seeking cost increases in order to deliver the same service going forward. PNGL has indicated in response to UR's *GD14 – Information Request – IR1* that telephone costs in 2013 will increase by c.£5k per annum as the previous arrangement re the lo-call number no is longer available.

In general call and postage volumes are increasing in line with the combination of a rise in the number of cumulative connections/new connections/properties passed and mobile phone costs which are increasing in line with PNGL's overall manpower numbers and in particular the number of staff requiring mobile phones.

The application by UR of an allowance using an average, based on the five-year timeframe (2007 to 2011) without taking account of the factors noted is not appropriate and we would ask UR to review this matter further.

TRAVEL AND SUBSISTENCE

In response to UR's *GD14 – Information Request – IR1*, PNGL provided justification for its request for travel and subsistence. PNGL explained that forecast costs have increased largely as a result of an increase in activity associated to the regulatory (e.g. ring-fencing requirements) and the rating processes, attendance at industry and supply chain meetings and forums as the complexity of the industry develops. In addition travel associated with specialist training events in Great Britain is also impacting on these costs.

Furthermore, the unit cost of travel is rising driven by increased fuel costs, transport taxes and landing costs.

An average, based on the five-year timeframe (2007 to 2011) is not an appropriate allowance for travel and subsistence. PNGL does not believe UR has adequately accounted for the additional costs PNGL will incur during GD14 and would urge UR to reconsider its proposal.

3. CAPITAL EXPENDITURE, PNGL

PNGL has not been provided with a copy of the report from UR's engineering consultants, Rune and has not been attributed the opportunity of meeting with Rune for further engagement during this consultation process, even though it requested such a meeting on numerous occasions. Therefore we make the following comments without having had the opportunity to properly engage with UR to discuss the rationale for some of its proposals.

The analysis provided by UR²⁸ to inform PNGL's capex review has enabled PNGL to undertake a high level review of the overall capex allowance proposed by UR for 2014, 2015 and 2016.

UR states that PNGL's performance in 2011 is used as a benchmark for its GD14 capex assessment for both Northern Ireland GDNs as PNGL demonstrate performing with lower unit costs than the other Northern Ireland GDN. PNGL notes that the other Northern Ireland GDN is in the order of 25% more expensive than PNGL.

In order to facilitate comparability UR has normalised the unit rates of this benchmark using a set of synthetic costs, claiming that this approach has been used by Ofgem for both GDPRC1 and RIIO-GD1. PNGL understands that UR's analysis demonstrates that PNGL was, on a like-for-like basis, c.30% more efficient than GDNs in Great Britain in 2011 i.e. GDNs in Great Britain in 2011 were, on a like-for-like basis, c.40% more expensive than PNGL. PNGL therefore has difficulty understanding UR's rationale for targeting this area of cost.

PNGL understands that UR has "back-solved" the synthetic unit rates used by Ofgem for GDNs in Great Britain to match PNGL's performance in 2011. Given that PNGL is considerably more efficient than GDNs in Great Britain, these "back-solved" unit rates are considerably lower than the synthetic unit rates used by Ofgem for GDNs in Great Britain. However despite PNGL's demonstrable efficiency, UR judges these lower unit rates to be the efficient levels to be applied to PNGL for future years. PNGL find this approach somewhat illogical.

If done properly, benchmarking comparisons may be useful: PNGL believes it runs a lean and efficient business in line with industry-leading standards. Consideration must however be given to relevant specific factors which drive uncontrollable differences between comparators, both for comparing PNGL to firmus, and when comparing the Northern Ireland GDNs to those in Great Britain or other relevant regimes. Allocating costs and normalising cost drivers is essential to ensure that benchmarking is done on a proper and comparable basis. However, this is likely to be challenging, particularly between companies under different regulatory jurisdictions. Given this, PNGL would

²⁸ "Capex Basket of Works Sent to PNGL Aug 2013.xlsx" and "Capex Basket of Works Sent to PNGL Aug 2013.docx" were provided to PNGL on 9th August 2013. PNGL notes a transposition error in Cell B31 of worksheet "PNGL Submitted Numbers Extract". This should link to Cell AB45 of worksheet "P1;Capex" in spreadsheet "PNGL Template v2 1 20130429_for UR RUNE Amended.xlsx", not Cell Y45.

have welcomed the opportunity to engage with UR on its benchmarking proposals so as to ensure that meaningful comparisons could have been made.

UR's use of synthetic unit rates restricts PNGL's ability to comment on UR's capex proposals other than at an overall level; it is impossible to compare PNGL's submission of unit rates informed by PNGL's historic performance with UR's proposed unit rates based on an arbitrary allocation of costs. PNGL does not recognise the basis of UR's unit rates.

The modelling applied by UR is an attempt to apply benchmarking for its GD14 capex assessment. However the synthetic unit rates proposed by UR result in an allocation of costs across the individual capex cost lines which are not comparable to PNGL's submission nor to PNGL's historic cost base and are not the basis upon which PNGL records its actual costs. UR's benchmarking does not therefore allow for any meaningful comparison across the individual capex cost lines. UR's proposals would only serve to lose any comparability with actual costs incurred by PNGL over the last 17 years.

UR has identified that PNGL is more efficient than the established mature GDNs in Great Britain and is the most efficient GDN in Northern Ireland. However UR has proposed a significant reduction in allowed capex relative to PNGL's forecast. On a like-for-like basis (i.e. if PNGL's submission and UR's proposed allowances were based on the same levels of activity), PNGL estimates that the variance between PNGL's capex submission and UR's proposed capex allowances is c.17%. PNGL would therefore ask UR to provide full justification for its proposal to reduce PNGL's overall capex allowance requested across GD14.

In addition UR is proposing a further 1% efficiency target for GD14 capex allowances. The application of a blanket efficiency target is inappropriate; applying a blanket efficiency target across all of PNGL's cost allowances effectively amounts to 'double counting' of efficiency and is completely unjust given PNGL's performance against GDNs in the rest of the United Kingdom.

PNGL would also ask UR to provide justification for its proposal to base the 5% fixed allowance on the average of the two Northern Ireland GDNs costs in 2011. For benchmarking purposes it would appear more appropriate that any proposed fixed allowance would be based on the costs of each individual GDN each year so that this is linked to the level of activity undertaken by that GDN.

UR's use of arbitrary methodology has restricted PNGL's ability to provide detailed commentary on UR's proposals to a handful of individual capex cost lines:

- Street works legislation (TMA)
- Management Fee
- Infill Mains
- Meters
- Services

- Other Capex Items

STREET WORKS LEGISLATION (TMA)

PNGL welcomes UR's proposal that TMA costs will be subject to retrospective adjustment at the time of the next price control review given the uncertainty in terms of the timing of implementation of TMA in Northern Ireland and the impact on costs. PNGL notes UR's analysis retains TMA forecasts as a separate capex cost line to better facilitate the retrospective adjustment.

MANAGEMENT FEE

PNGL has concerns about UR's approach in apportioning the management fee across the various capex activities undertaken by PNGL. UR believes that this facilitates a more direct comparison of PNGL's unit costs with other GDNs.

As stated at the time of UR's PNGL12 price control review, PNGL remains of the view that this approach should only be adopted for the purpose of benchmarking as, in practical terms, PNGL's management fee is predominantly fixed. Hence this proposal increases the risk faced by the business as cost recovery of fixed overhead is not certain, i.e. PNGL incurs upfront costs for stores, supply chain, manpower, etc., whereas the allowance proposed by UR is only available if PNGL delivers the numbers of connections.

INFILL MAINS

Existing Housing Domestic and I&C²⁹

PNGL's properties passed submission is based on desktop designs for passing c.12,600 of the remaining properties to be passed within its Licensed Area. UR has on many occasions in the past, including in PNGL12, reviewed PNGL's cost forecasts for infill on a project-by-project basis and found those forecasts to be accurate and efficient.

UR has not yet fully audited PNGL's proposed properties passed submission and proposes to carry out an economic test in determining the proposed infill allowance for GD14.

As detailed in Chapter 1, we broadly support the methodology UR undertakes in section 7 of the consultation as the correct methodology to determine the maximum amount it is worth spending to attract new customers. UR uses this methodology to determine the value of infill assuming a cost of A+M+PR per connection. However UR has made a number of other important errors in the input data and assumptions that have been used to calculate the overall economic value of a connection.

²⁹ PNGL notes that UR has misquoted PNGL's GD14 submission for properties passed in Table 50.

These have been highlighted to UR in a supplementary spreadsheet *"Infill UR Analysis - Infill Cost Allowance sent to PNGL Aug 13_PNG correction"* and could have been averted had UR properly engaged with PNGL prior to publication of its initial proposals. In summary:

- the weighted average annual consumption for small I&C consumers is 2,500 therms. UR's 'rough' average of 2,000 therms should be amended accordingly
- UR's properties passed split (91% : 9%) within its calculations should be amended to reflect its assumptions in paragraph 7.32 of the consultation i.e. 90% existing domestic properties and 10% small I&C properties
- UR's proposed initial connection rates are understated. PNGL has provided a more appropriate view based on historic penetration in the supplementary spreadsheet

These changes may also impact upon the hard-coded opex cost included within UR's supplementary spreadsheet. This should be adjusted accordingly.

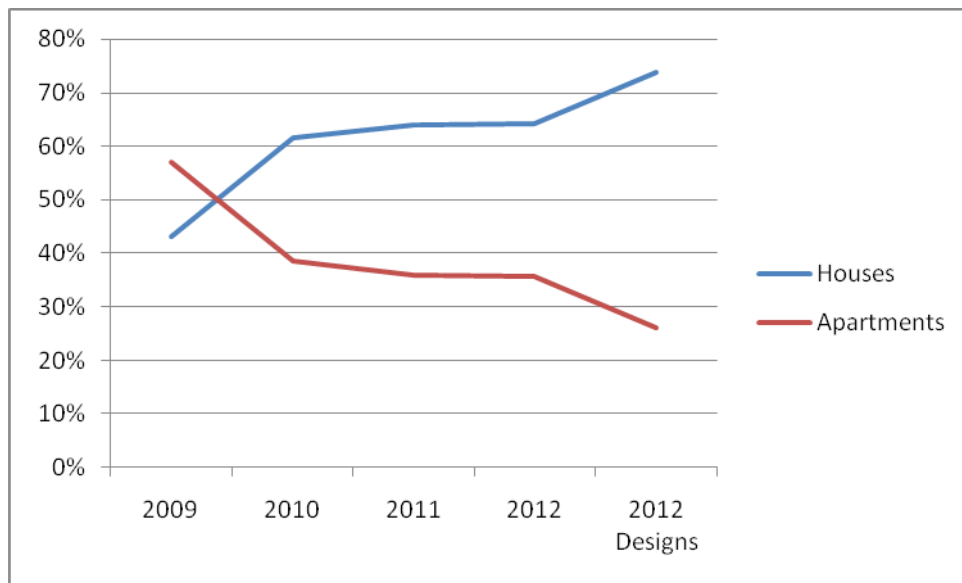
Once these errors are corrected, the total value associated with a new connection increases significantly.

PNGL would urge UR to reconsider its proposal upon correction of these errors.

New Build Domestic

UR proposes to base its approach for new build domestic housing upon the historical level of metres per property passed during 2009 to 2011 i.e. 5.9m. PNGL has requested an allowance of 11m per property passed on the basis that future new build is more likely to be houses compared to apartments.

The following figure shows the increasing trend in houses over the last 5 years:



Note: 2012 designs are reflective of construction that will take place in 2013 and 2014

This evidence supports PNGL’s proposal that the mix of construction in new build areas has over recent years and will continue, to move more towards houses than apartments.

PNGL does not believe UR has adequately accounted for the infill mains allowance for new build housing during GD14 and would urge UR to reconsider its proposal on the basis of the evidence provided above.

DOMESTIC METERS

UR has advised that PNGL’s submission included an amount for replacement domestic meters for the period 2012-2016 without volumes of meters. UR’s proposals therefore estimate the number of replacement domestic meters associated with that amount for each year.

As part of the GD14 price control review process, PNGL noted this anomaly. PNGL advised UR of this on 9th April 2013:³⁰

“There is an anomaly in PNGL’s GD14 submission at line 35 of the “CAPEX_domestic” worksheet, hence the calculation error therein. The costs in line 37 of the “CAPEX_domestic” worksheet should be incorporated in line 31. “PNGL Template v1.0 20130222.xls” includes the costs in the correct category.”

In short, the amount included for replacement domestic meters in PNGL’s original submission was incorrectly transposed. The amount should have been incorporated within the overall “installed” cost line, resulting in a marginal increase in the unit rate in PNGL’s original submission.

³⁰ “IR1 - Q1 - PNGL comments on population of PNGL Template v1 0 20130222 for UR Apr 13.pdf”.

To clarify, PNGL's replacement domestic meters cost line reflects the costs of replacing meters at the end of their normal operational life. PNGL forecasts that these costs will commence in 2017 i.e. 20 years after the first meters were installed. PNGL is not therefore requesting any allowance for replacement domestic meters during GD14. Having noted the anomaly in its original submission, PNGL provided UR with the costs in the correct category as part of UR's benchmarking review.

Some meters do however fail before they reach the end of their normal operational life. In this regard UR's proposed estimate, if it reflects domestic meter failures and not replacement domestic meters at the end of their operational life, indicates a change in stance from previous price control determinations. UR's PNGL12 final decisions paper allows for a 1.38% failure rate on domestic meters which is to be retrospectively adjusted (based on outturn cumulative domestic connections and determined unit rates) in accordance with the retrospective mechanism in place since PC03.

PNGL advised UR on 20th May 2013³¹ that these domestic meter failures were not included in its GD14 submission (i.e. for either years 2012-2013 or 2014-2016). Although PNGL anticipated that these would ultimately be taken account of via the GD14 retrospective mechanism, we advised UR that it may be more appropriate for UR to increase the activity levels for domestic meters (i.e. add an additional 1.38% of cumulative domestic meter connections) to ensure that the PC03, PNGL12 and GD14 determinations are issued on the same basis. Furthermore, for clarity PNGL provided UR with the amended domestic meters figures within the "CAPEX_Domestic" worksheet of its original submission to reflect this adjustment.

It would appear that there has been a misinterpretation of exactly what was included in the GD14 submission/resubmission. UR should reconsider its proposal on the basis of the additional clarifications provided above.

DOMESTIC SERVICES

UR has provided PNGL with background for its statement that *"...we believe the cost split between meters and services has not previously been on a consistent basis. Also, we see no case to differentiate between the unit rates for new and replacement meters"* (paragraph 7.49)

PNGL accepts that, in the context of carrying out a comparative review of Northern Ireland GDNs, UR needs to consider the methods used for each company for allocating costs e.g. between services and meters. PNGL understands that UR's assessment is based upon meter boxes being included as part of the services cost line. PNGL accepts that this will result in a lower allowance for meters than requested by PNGL given PNGL allocates the cost of the meter box to its meter cost line. However in this context, PNGL would have expected a correspondingly higher allowance for its services cost line than requested by PNGL given that the cost of the meter box was not included in PNGL's services cost line submission. This is not the case.

³¹ E-mail from Abigail McCarter to Paul Harland.

UR has not provided justification for disallowing PNGL its requested domestic service allowance.

On a like-for-like basis (i.e. if UR’s proposed allowances were based on the same level of connections as in PNGL’s submission), the variance between PNGL’s submission and UR’s proposed allowances is c.£2m. PNGL would therefore ask UR to provide full justification for its proposal to reduce PNGL’s overall cost of installing a domestic service and meter requested across GD14.

UR has not adequately accounted for the overall cost of installing a domestic service and meter and PNGL would urge UR to reconsider its proposal.

I&C METERS

PNGL notes UR’s statement that *“Although I&C meter costs are dependent on load size, the difference between the allowance requested by PNGL for new and replacement meters is substantial, casting doubt over the robustness of cost allocation”* (paragraph 7.55)

In response PNGL would advise that PNGL’s replacement meters cost line reflects the costs of replacing meters at the end of their normal operational life. PNGL’s requested allowance for replacement I&C meters is based on PNGL’s existing asset base which includes a higher mix between large loads and small loads. The meters reaching the end of their normal economic life during GD14 are typically those large loads that connected to PNGL’s network in the early days. As an illustration, PNGL’s meter population at the end of the PC01, PC02 and PC03 price control periods shows that there is a larger proportion of large meters installed in the early years which are now needing replaced:

	2001	2006	2011
Small I&C	93%	94%	96%
Large I&C	7%	6%	4%

PNGL’s requested allowance for new I&C meters is based on PNGL’s future asset base which will largely consist of small loads, given that the large loads are typically already connected to the natural gas network. There is therefore a need to differentiate between the average unit rates for new and replacement meters given that the cost of large I&C meter is significantly more expensive than the cost of a small I&C meter.

UR should reconsider its proposal on the basis of the clarifications provided above.

OTHER CAPEX ITEMS

UR has not provided any detailed justification for its treatment of the individual cost items under “other capex” i.e. network code, fixtures and fittings, leasehold improvements and capex-related IT.

These residual cost lines amount to c.2% of total claimed capex allowances. UR should therefore adopt a similar approach to that established for the smaller opex items and set the allowance for these “other capex” cost lines using an average, selecting the most recent five-year timeframe for which it has audited numbers (i.e. 2007 to 2011).

This provides a total allowance of £147k per annum for “other capex” which is consistent with the average actual spend over the 2007 to 2011 timeframe.

4. ADJUSTING FROM PNGL's PREVIOUS PRICE CONTROL, PNGL12

TOTAL REGULATORY VALUE (TRV)

We do not agree with the composition of the PNGL TRV in Table 79 of the consultation, since it is not consistent with our licence or with the Commission's conclusions at the Inquiry of PNGL12.

At no time did the Commission seek to prepare or consider any breakdown of the opening PNGL12 TRV as a whole into component parts that included "Net investment", "Historical Under-recoveries of Revenue", or "Unspent Allowances", or otherwise: nor did it need to do this in order to reach its conclusions on the public interest or to specify its recommendations.

The true 'building blocks' of TRV are clear: these are set out in PNGL's licence under condition 2.3.18, which states that $TRV = DAV + Q + CC + PA$. This is the only breakdown that is relevant to rolling forward TRV at successive price controls.

The Commission's Final Determination and UR's Replacement Determination Notice for PNGL12 also recognise this breakdown of TRV when calculating the best available value for closing 2011 TRV:³²

£2010 (£'000s)	2011
DAV ³³	362,864
Q	-3,611
CC	-4,626
PA	85,236
Retro Adj into TRV ³⁴	-2,720
TRV	437,143

Since our previous submissions to the Commission and to UR on this matter provide full justification for PNGL's view, we do not comment further on it here.

³² See UR's spreadsheet model entitled, "*UR 15 PNGL12 model FINAL-remedies*" dated 11 July 2013. See also the Commission's Final Determination, at paragraph 10.9, footnote 1.

³³ This includes the value of the Commission's one-off £13.6 million (2010 prices) adjustment to deal with historic issues.

³⁴ The addition of the retrospective adjustment to TRV reflects the operation of the capex roller, which the Commission recognised operates outside of the licence formulae but agreed should be taken into account in determining the TRV in 2011.

DEFERRED CAPEX

Contrary to UR's statement:

*"PNGL has requested that a number of the excluded deferred projects be included within the capex allowances in future years. It is not clear from the CC decision how this should be dealt with."*³⁵

the Commission confirmed in its Final Determination that PNGL can now apply for funding for these deferred projects at future price control reviews, should they become relevant to PNGL's investment strategy again in the future:

*"We also think that removing the original allowances reduces the risk to PNGL, as PNGL can now apply for funding for the remaining 1999/2000 capex deferral projects on the basis of actual efficient costs at the time. We therefore decided to remove the original allowances for the 1999/2000 capex deferrals that have not been completed by the end of PC03 from the TRV."*³⁶ (emphasis added)

CURRENT TOTAL REGULATORY VALUE

PNGL welcomes UR's acceptance of PNGL's "Best Available" opening TRV in relation to 2014 of £503.9m (2012 prices)³⁷. This reflects outturn data up to 2011. The actualisation of data for 2012 and 2013 will be completed as part of the GD17 price control review.

³⁵ Paragraph 10.31 of the consultation.

³⁶ Paragraph 6.36 of the Commission's Final Determination.

³⁷ Paragraph 10.33 of the consultation.

5. RECOMMENDATIONS OF THE COMPETITION COMMISSION

DETERMINATION ON PNGL12

TIMING OF CASH FLOWS

PNGL's regulatory model, which determines allowed revenues, is currently based on assuming cashflows occur at the end of the calendar year. The Commission suggested that UR consider whether this modelling assumption should be switched to mid-year cashflows to reflect how cashflows are received in reality.

The Commission did not consider the methodological and practical implications of implementing such a switch in any detail. It decided not to implement the change at PNGL12 so that UR could consult on the proposal and determine an appropriate methodology at the current review. In its GD14 consultation, UR has not elaborated on how it would implement the modelling change, but has invited views on how it could be implemented in the final determination.

If a change is to be made to the timing of cashflows, it is important to recognise that the opening TRV for GD14 represents a stock of value which is owed to PNGL, and which flows from past cashflows. The opening TRV is therefore dependent on assumptions about the timing of cashflows in the past and the recovery of these in the future.

PNGL's revenue allowances since 1996; the opening asset value calculated under the 2006 Agreement; and the opening TRV for GD14 have all been calculated on the basis of an end-year cashflow assumption. Had a mid-year assumption been used for these calculations, the opening TRV for GD14 would be greater than it is in the current financial model. This is because the cumulative present value of negative historic cashflows is greater if those cashflows are assumed to have occurred mid-year rather than end-year.

The current opening TRV calculation therefore embeds an implicit loss to PNGL, which can be interpreted as the financing cost PNGL incurred for making investments earlier than is assumed in the TRV calculation. However, calculating the opening TRV in this way is still consistent with the full recovery of the value of past investment *so long as the forward-looking cashflow assumption remains end-year until costs are recovered*.

In general, over the recovery period of an up-front investment, neither the company nor customers suffer an overall loss, or receive an overall benefit, if the cashflow timing assumption remains constant: instead, the company exactly recovers its allowed investment, regardless of when cashflows occur in reality. In PNGL's case, therefore, continuing to assume end-year cashflows would mean that the loss embedded in the TRV calculation would be recovered over future periods when cashflows are positive. In other words, based on the current TRV calculation, the determined revenues are set at the level that allows PNGL to recover its investment so long as an end-year cashflow assumption continues to be used.

If UR wishes to switch to mid-year cashflows on a forward-looking basis from GD14, it must also therefore make an adjustment to the opening TRV so as to ensure PNGL recovers the full allowed value of costs it has incurred. This adjustment reflects the principles the Commission applied to other aspects of the PNGL12 determination, in which the Commission established the importance of avoiding changes that retrospectively alter the value PNGL recovers. Failure to make a compensating adjustment would amount to opportunistically and retrospectively disallowing value to PNGL.

We calculate that the required adjustment at GD14 is approximately an £18m uplift in the opening TRV. This estimate is only approximate given the complexity involved in making such a change at this time. To undertake the calculation of the necessary TRV adjustment accurately, we believe UR would need to re-calculate the opening asset value agreed in 2006, and re-calculate each subsequent price control based on a mid-year cashflow assumption.

Given the importance of this issue, and the complexity of making a change in cashflow timing at GD14, we note our concern that UR's standards of consultation and engagement on this issue fall somewhat short of what would be required to comply with the Commission's recommendation to consult on the proposal. Further, the necessary licence re-drafting³⁸ and spreadsheet modelling adjustments are likely to be complex. While we accept that UR may wish to consider implementing a change in the modelling assumption in light of the Commission's recommendations, UR has not set out either in public or in its bilateral engagement with us exactly how it would propose to implement the required changes.

If UR intends to implement the adjustment at GD14, we would therefore welcome the opportunity to engage further with UR on the appropriate methodological approach.

CAPEX 2007 TO 2011

The treatment of capex retrospective adjustments and capex over and underspends is consistent with UR's July 2010 PC03 supplemental determination from 2007 onwards.

CAPEX OVERSPEND

PNGL agrees with UR that the treatment of 2009 capex overspend is now consistent with the rolling incentive mechanism. For clarification, paragraph 10.33 confirms UR's acceptance of PNGL's "Best Available" closing TRV in relation to 2013 of £503.9m (2012 prices). The 2009 capex overspend has

³⁸ During the Commission's Inquiry into PNGL12 UR noted that *"the timing assumption for cash flow was set out in PNGL's licence (condition 2.3.15(b)) and any change to the assumptions would require a change to the licence."* (Commission's Final Determination, at paragraph 10.43). We do not consider that the licence modification is likely to be trivial to draft or implement. UR has not published a draft of the licence modification required to implement this change, and we cannot comment on the validity of the proposals until the proposed licence modification is published.

been correctly added to PNGL's opening DAV in relation to 2014 in PNGL's "Pis" model in accordance with UR's July 2010 PC03 supplemental determination. This is simply a timing technicality and no further adjustments are required.

TRV ADJUSTMENT FOR PREPAYMENT METERS

PNGL provided an overview of the treatment of installation costs for prepayment metering in its submissions to the Commission in respect of the Inquiry of PNGL12. PNGL considers that no mistake has been made, and no further adjustments are required.

Even if UR is correct that a mistake had been made, which PNGL has stated above was not the case, as was noted by the Commission in its final determination, the impact is very small:

"We have not assessed this potential error, but we have noted that its impact is very small at less than 0.1 per cent of PNGL's TRV (around £0.2 million out of a total TRV of around £0.4 billion). We recommend that UR consider whether it would be appropriate to make the associated adjustments as part of its next determination."

6. FINANCIAL ISSUES

The consultation sets out UR's proposals for WACC for GD14; its proposals to align the depreciation profiles of PNGL and firmus; and the associated financeability analysis it proposed to undertake. The consultation also provides UR's view of the issues it expects to have to deal with when setting WACC at GD17. We address each of these in turn below.

GD14 WACC

UR has confirmed that PNGL will continue to earn an allowed rate of return of 7.5% (pre-tax) throughout GD14. This is consistent with PNGL's licence and with the Commission's conclusions at the PNGL12 Inquiry. This proposal maintains the integrity, credibility and time-consistency of previous decisions and we welcome the transparency and predictability this brings for investors.

Since our previous submissions to the Commission and to UR on this matter provide full justification for the continuation of the 7.5% WACC through to 2017, we do not comment further on it here.

DEPRECIATION

PNGL notes the differences between the PNGL and firmus asset life assumptions.

PNGL's Licence Condition 2.3.23 states that "*Annual Depreciation*" is "*the annual depreciation of those assets included within the Depreciated Asset Value, allocated on a systematic basis over the useful lives of such assets, using policies and asset life assumptions approved by the Authority. The Depreciated Asset Value for 2006 shall be depreciated on a straight-line basis using a 40 year asset life*".

The licence thus requires that the depreciation assumption in the Pis model is:

- a) as approved by UR, and
- b) set so as to recover costs over the expected useful economic lives of the assets concerned.

Depreciation assumptions in PNGL's model vary across asset categories.

- a) Mains are depreciated over 40 years, and services over 35 years. Although the regulatory asset life assumption is 40 years, the technical life of the assets may be longer.³⁹ It is not

³⁹ The technical life of polyethylene pipes is not actually known as they have been in service for less than 40 years, but advanced ageing tests suggest that the technical lives may exceed 40 years.

unusual that regulatory asset lives do not match technical asset lives. As Ofgem noted in its first consultation for the RIIO GD-1 price control review:

“There are a number of different ways of defining the life of a network asset. Each asset will have a design life, a technical life (the expected life of an asset from commission until it falls below minimum technical and/or safety performance levels); and an economic life (the life it is expected to be active on the network). Through good maintenance and management of an asset, its technical life will often exceed its design life. The economic life of an asset will be no longer than its technical life but may be shorter”⁴⁰

Under the RIIO model, Ofgem decided that regulatory asset lives should reflect the average expected economic life of the related network assets, since this *“balances the interests of existing and future customers as it spreads the cost of network assets over the time they are in use”*.⁴¹ Economic asset lives are determined on the basis of expectations about the long-term demand for use of the network, including taking account of, among other things, the possibility that gas consumption falls in the long-term as a result of decarbonisation efforts.⁴²

PNGL’s approach - given the possibility that the technical life of mains may be longer than 40 years - has been to be prudent in its GD14 planning and submission.

- b) Meters are depreciated over 15 years. This is consistent with the technical asset life for these assets as their accuracy cannot, within statutory limits, be guaranteed beyond 20 years.

Based on the above, PNGL sees no reason why UR should not apply the PNGL depreciation approach for firmus as part of the GD14 review.

It is also important to note that the assumptions that are made about asset lives for depreciation purposes should not be taken in isolation of consideration of the Profile Adjustment, since both impact on the speed and profile of investment recovery.

⁴⁰ Ofgem, *“Consultation on strategy for the next transmission and gas distribution price controls”*, December 2010, available at:
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIOT1/ConRes/Documents1/T1%20and%20GD1%20finance.pdf>.

⁴¹ *Ibid.*

⁴² In GB, Ofgem derived scenarios for the move towards renewables to assess the scope for future use of the gas network. Ofgem concluded that, at present, it would be premature to reduce regulatory asset lives, and retained its assumption of 45 years for post-2002 gas distribution assets.

INITIAL GD14 FINANCEABILITY ANALYSIS

UR has not undertaken a detailed financeability review to accompany its draft determination. While we welcome the commitment to provide a more detailed analysis alongside the final determination, we are concerned that this approach will not give PNGL or other stakeholders an opportunity to comment fully on UR's financeability analysis.

We would expect that at future reviews UR will provide a full and transparent financeability analysis alongside its draft determination.

UR has noted that the allowed cost of capital for PNGL at GD14 is *"substantially more than the 4.83% that Ofgem allowed GDNs in their recent RIIO-GD1 price control."*⁴³ We do not consider that this is relevant to UR's financeability analysis, and it cannot be the basis for determining that PNGL is financeable. The purpose of the financeability analysis is to test whether the price control determination overall is likely to place strain on financial metrics under different scenarios, given the cashflows derived from the regulatory model. Since financial metrics are based on cash measures, companies with the same WACC may have different outcomes from a financeability review. Comparisons of allowed cost of capital with Great Britain ("GB") may be relevant for determining the WACC (see next section), but are not relevant for stress testing the implications of that determined WACC (and the price control determination overall) for PNGL's cash position.

In addition, financeability testing should be used to test more than just the determined WACC. Regulators use financeability tests to understand whether their opex and capex forecasts, and overall incentive regime, result in financeability concerns. We therefore consider that UR will need to expand on its financeability analysis to test its determination in the round before it can conclude that PNGL is financeable under its proposals.

In terms of the initial financial analysis UR has published, we have a number of concerns with UR's approach.

- UR has not provided any scenario analysis to stress test its conclusions (e.g. scenarios in which the cost reductions UR has assumed in its initial determination are not realisable). We consider that a core purpose of financeability testing is to understand whether PNGL will remain financeable under a range of scenarios, given the price control determination.
- The metrics UR has considered do not cover the full range of metrics which are typically assessed by regulators and rating agencies. For example, UR has not calculated the ratio of Funds from Operations (FFO) to net debt or the ratio of Retained Cash Flows (RCF) to capex⁴⁴. UR has also omitted to calculate any equity metrics, which runs contrary to the approach of Ofgem under the RIIO model, Ofgem having highlighted that *"In terms of equity*

⁴³ Paragraph 12.45 of the consultation.

⁴⁴ These two credit metrics are highlighted in Moody's published methodology for assessing financeability of regulated electricity and gas networks.

*metrics, we will take into consideration the impact of our price determination proposals on such ratios as the notional RAV/ EBITDA and Regulated Equity/Earnings for the regulated company.*⁴⁵ We note also that the important metrics from PNGL bond holders' perspective are those covered by bond covenants and licence conditions.

- Although UR recognises that PNGL has recently paid a dividend to shareholders, it is not clear whether or how UR has approached dividends in its forward-looking analysis. It is standard practice for regulators, when making a financeability assessment, to allow for a reasonable level of dividends in each year. We anticipate UR would adopt this correct approach at this review and future reviews, in contrast to the flawed dividend assumptions it used to assess financeability at the PNGL12 control⁴⁶.

UR has also indicated that, in line with the approach taken by ratings agencies, it will consider the *"broader context"*⁴⁷ for PNGL in addition to financial metrics, highlighting that *"the low business risk associated with being a monopolistic network company, and the stable and transparent regulatory framework...provide substantial support to companies' credit ratings beyond what might be implied if only financial metrics were considered"*. While we agree that consideration of the broader context is important, this cannot be a substitute for thorough stress testing of financial metrics, including both debt and equity metrics.

In addition, we do not consider that the rating agencies would concur with UR's conclusions around the broader context for PNGL. For example:

- in commenting on the referral of the NIE price control to the Competition Commission, Moody's stated that *"this latest referral suggests that regulatory uncertainty remains in Northern Ireland"*. Moody's also noted that *"we currently score the 'stability and predictability of the regulatory regime' in Northern Ireland at Aa. The one-notch differential relative to the Aaa scoring of the framework for Great Britain reflects the fact that regulation is less established in Northern Ireland, with the regulator having a shorter track record in terms of transparent decision making. It also factors in a higher possibility of changes to the overall approach as the regulatory framework evolves."*⁴⁸; and
- in February 2013 Fitch decided to retain its Negative Outlook on PNGL, despite the *"favourable"* outcome of the Commission's PNGL12 determination and no concerns

⁴⁵ RIIO handbook, October 2010 <http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf>.

⁴⁶ See Section 8 and Annex 5 of PNGL's Response to the Authority's Supplementary Submission: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/phoenix-natural-gas-limited/non_confidential_response_to_the_authoritys_supplemental_submission.pdf.

⁴⁷ Paragraph 12.50 of the consultation.

⁴⁸ See *"New Competition Commission Referral Suggests Regulatory Uncertainty Remains in Northern Ireland"*, Moody's Investor Service, May 9 2013.

regarding PNGL's financial metrics, due to uncertainty about the future regulatory approach, particularly at GD14⁴⁹.

We look forward to discussing the appropriate approach to financeability analysis with UR following its GD14 final determination and at future reviews.

GD17 WACC

In addition to confirming the WACC for GD14, UR's consultation sets out what it calls "*a brief overview of the issues [it] expects to have to deal with*"⁵⁰ when setting the WACC for the next price control period, GD17. Investors need to be confident that any investment made during GD14 will be properly remunerated in subsequent price control periods, and that the approach adopted by UR at future reviews will establish a reasonable allowed cost of capital that will allow PNGL to finance its activities.

Overall, we are concerned that UR's brief overview does not represent a full or open consideration of the issues it will need to address to set an appropriate WACC. While we welcome the commitment to using a CAPM approach, and to make reference to GB regulatory practice and any relevant precedent, we consider that UR must seek to fully assess the specific circumstances of PNGL to set an appropriate WACC, including understanding all relevant differences between PNGL and GB utilities.

We believe that a complete analysis of the risks facing PNGL is likely to lead to setting an allowed WACC which is higher than that set for GDNs in GB. We do not consider that UR has put forward sufficient evidence to support its conclusions that it expects PNGL's WACC will be at or below GB levels because "*PNGL and FE are now much more mature and stable businesses*"⁵¹.

This view is supported by analysis undertaken by Professor Ian Cooper of the London Business School⁵². We appointed Professor Cooper to undertake a study to investigate the existence of a premium in PNGL's cost of debt relative to that of GB comparators, and the implications of any such premium for the overall cost of capital faced by PNGL relative to GB peers. Professor Cooper concluded that:

- PNGL has a cost of debt that is at least 110 bps greater than for a similar GB utility with similar leverage;

⁴⁹ See "*Fitch Affirms Phoenix Natural Gas at 'BBB': Outlook Negative*", February 2013.

⁵⁰ Paragraph 12.8 of the consultation.

⁵¹ Paragraphs 12.9 and 12.18 of the consultation.

⁵² Professor Ian Cooper, "*Evidence whether there is a premium in the WACC of Phoenix Natural Gas Limited relative to the WACC of mature GB utilities*", 22 May 2013.

- the higher debt spread is not caused by factors such as illiquidity or rating differences;
- the cause of the higher debt spread is that the capital market perceives PNGL to have higher business risk than similar GB utilities;
- the causes of this higher risk include regulatory risk, the relatively small size of the Northern Ireland market, the immaturity of PNGL relative to GB utilities, and the specific nature of the Northern Ireland gas market;
- PNGL's cost of debt premium relative to GB also implies an equity risk premium relative to GB. This is because most of the debt premium is caused by regulatory risk that is not compensated elsewhere in the price control mechanism.
- Professor Cooper's (conservative) estimate is that a multiplier of at least 1.69x should be used to convert the incremental debt spread to an incremental equity risk premium, implying an incremental cost of equity of at least $110 \times 1.69 = 186$ bps.

We welcome UR's commitment to engaging fully with Professor Cooper's analysis and conclusions at the GD17 review⁵³.

During the Commission's Inquiry into PNGL12, we undertook a detailed and robust analysis in which we concluded that the cost of capital faced by PNGL in 2012/13 was in the range 6.6%-7.7%. We have not updated this analysis for the purpose of this submission, but we remain of the view that PNGL continues to be a riskier proposition for investors than GB GDNs, and we expect this to continue into the GD17 period.

Further, while we have not sought to undertake a full review of the issues that UR will need to take account of when setting WACC in GD17, there are four aspects of the approach outlined by UR that warrant further comment at this stage:

- UR's analysis of PNGL's riskiness relative to GB DNOs;
- the metrics UR uses to claim that PNG has reached a level of maturity;
- the potential for UR to apply a different rate of return to different parts of the TRV, which we term a "split cost of capital" approach; and
- the approaches UR is considering for setting the cost of debt.

⁵³ Paragraph 12.28 of the consultation.

UR's assessment of the relative risk of PNGL

We agree that comparisons with GB will be relevant when setting the WACC for GD17, and in principle we agree with an approach involving setting the WACC based on a suitably adjusted benchmark. We used a similar approach in our submission to the Commission to estimate the PNGL WACC for 2012/13.

However, the initial analysis UR has set out in its consultation to compare the risks PNGL faces with the risks of GB networks is flawed and incomplete.

UR has only provided an assessment of two types of risk facing PNGL, namely cost risk (using its TRV:totex analysis⁵⁴) and stranding risk (using its analysis of the impact of connections on prices⁵⁵).

UR has emphasised its analysis of relative cost risk using the TRV:totex ratio because this ratio *"has been important in Ofgem's setting of the equity beta in recent price controls"*⁵⁶. However, we note that Ofgem only came to this conclusion after controlling for a number of other drivers of risk⁵⁷, and after assessing relative risk more widely. Ofgem clearly stated that the capex:RAB ratio cannot be considered in isolation to understand the relative riskiness of two different utilities.

*"It is important to note at the outset that cash flow risk is just one aspect of relative risk. When comparing risk across industries or countries, other factors would also need to be accounted for. That wider risk assessment was carried out during the strategy phase of the price control review, and informed cost of equity range in the strategy decision paper (6.0–7.2 per cent)."*⁵⁸

Ofgem's conclusions on relative risk based on capex:RAB were drawn in the context of comparing companies which are broadly similar across many of the other drivers of risk (such as financial and revenue risk), and in particular operate under the same (or similar) regulatory frameworks, and under the same regulator. This alone would allow Ofgem to conclude that it could narrow the scope

⁵⁴ See Figure 8 of the consultation.

⁵⁵ Paragraphs 12.25 and 12.26 of the consultation.

⁵⁶ Paragraph 12.15 of the consultation.. We note that UR stated in its consultation that Ofgem considered the ratio of totex to RAV, which is incorrect. This highlights one of the differences between the Ofgem approach and that used by UR, namely that Ofgem assesses the ratio capex:RAB whereas UR has published information based on totex. These ratios potentially capture different types of risk. Different regulators have looked at different ratios to inform their understanding of different aspects of relative risk over time. We therefore consider it will be important for UR to make clear its interpretation and understanding of what is revealed by the ratios it analyses as part of any relative risk assessment.

⁵⁷ See, for example, *Ofgem, "RIIO-GD1: Final proposals – Finance and uncertainty supporting document", December 2012, Table 3.3.*

⁵⁸ Ofgem RIIO-GD1 Final Proposals - Finance and uncertainty supporting document, paragraph 3.11.

of its assessment of relative risk, since some drivers of risk (in particular regulatory risk) can be automatically discounted as differentiators between Ofgem's comparator set.

Similarly, UR's analysis of stranding risk is partial. UR states that there is *"no real risk of a large spike in charges risking recovery of revenues"*⁵⁹ if connections and volumes fail to materialise. However, there are a number of other factors in addition to a failure to connect customers that risk the recovery of revenues, including for example regulatory intervention, changes to the part L of the Building Regulations in respect to existing buildings, changes in Government legislation, the development of new products/competitors⁶⁰, and other unanticipated events. The long-term revenue deferral embedded in PNGL's regulatory model increases this stranding risk relative to GB GDNs, since the longer duration of cashflows increases the probability of stranding over the duration of the cost recovery period. This includes relatively greater exposure to GB regulatory risk than is faced by GB networks.

A broader approach to risk assessment than UR has adopted is evident in the credit rating agencies' methodology for rating utilities. In Moody's ratings methodology the scale and complexity of the capital programme is combined with cost efficiency to assess overall efficiency and execution risk. Moody's attributes a weighting of 10% to this category of risk in its overall assessment. The figure below illustrates the range of other risks considered by Moody's, which includes revenue risk; cost recovery risk; stability and predictability of the regulatory regime; asset ownership model; and a range of financing risk factors.

Moody's rating methodology for regulated electric and gas networks:

Rating Factor/Sub-Factor Weighting			
Broad Rating Factors	Broad Rating Factor Weighting	Rating Sub-Factor	Sub-Factor Weighting
Regulatory Environment and Asset Ownership Model	40%	Stability and Predictability of Regulatory Regime	15.00%
		Asset Ownership Model	10.00%
		Cost and Investment Recovery	10.00%
		Revenue Risk	5.00%
Efficiency and Execution Risk	10%	Cost Efficiency	6.00%
		Scale and Complexity of Capital Programme	4.00%
Stability of Business Model and Financial Structure	10%	Ability and Willingness to Pursue Opportunistic Corporate Activity	3.33%
		Ability and Willingness to Increase Leverage	3.33%
		Targeted Proportion of Operating Profit Outside Core Regulated Activities	3.33%
Key Credit Metrics	40%	Adjusted ICR (or FFO Interest Cover)	15.00%
		Net Debt/RAV (or Fixed Assets)	15.00%
		FFO/Net Debt	5.00%
		RCF/Capex	5.00%
Total	100%		100.0%

Source: Moody's Global Infrastructure Finance, Rating Methodology, August 2009

⁵⁹ Paragraph 12.26 of the consultation.

⁶⁰ This type of stranding risk has been realised in the telecoms industry, where landlines have been displaced by mobile technology.

Finally, academic and industry evidence also suggest that other sources of risk are relevant.

- As noted above, Professor Cooper's paper highlights a number of risks that are likely to cause the higher debt spread for PNGL relative to GB comparators.
- In the spring of 2013, Water UK commissioned a survey of investors in the water sector in the UK. The survey found that *"the pre-eminent risk for all types of investor was regulatory risk"*⁶¹. Other types of risk that investors highlighted included inflation risk; political risk; operational risk; climate risk; public anti-investor sentiment and pressure to reduce prices; changes to rating agency methodology and liquidity risk. While the survey was specifically directed at current investors in the water sector in the whole of the UK, these conclusions are likely to be representative of the perception of risk in utility companies more broadly.

To come to a full conclusion on the level of risk of PNGL relative to GB GDNs, UR will therefore need to undertake a much broader range of analysis at the GD17 review than it has set out to date. Other types of risk that must be taken into consideration include (but are not necessarily limited to):

- **revenue risk**, capturing the uncertainty around the demand-side drivers of future cash flows;
- **financial risk**, reflecting the possibility of changes in the availability of funds to finance operations; and
- **regulatory risk**, including, for example, recognising the potential impact of regulatory decisions on the recovery of past and future investment.

In practice, identifying specific drivers of relative risk and estimating the magnitude of the impact of each of these drivers on the relative cost of capital is likely to be challenging. However, it is possible to capture investors' overall perception of relative risk by comparing market data on traded bonds across comparable utilities. For a suitable comparator set, such a comparison reveals information about perceived differences in risk, holding all else equal. Indeed, this is the approach taken by Professor Cooper which demonstrates that capital markets perceive PNGL to have higher business risk than similar GB utilities.

UR's approach to determining business maturity

UR's analysis of cost risk and stranding risk does not support its conclusion that PNGL is a mature business, or that PNGL's level of maturity is *"very similar to the GB GDNs"*⁶². UR has failed to take into account the broad range of evidence and context which is relevant to understanding the maturity of the business.

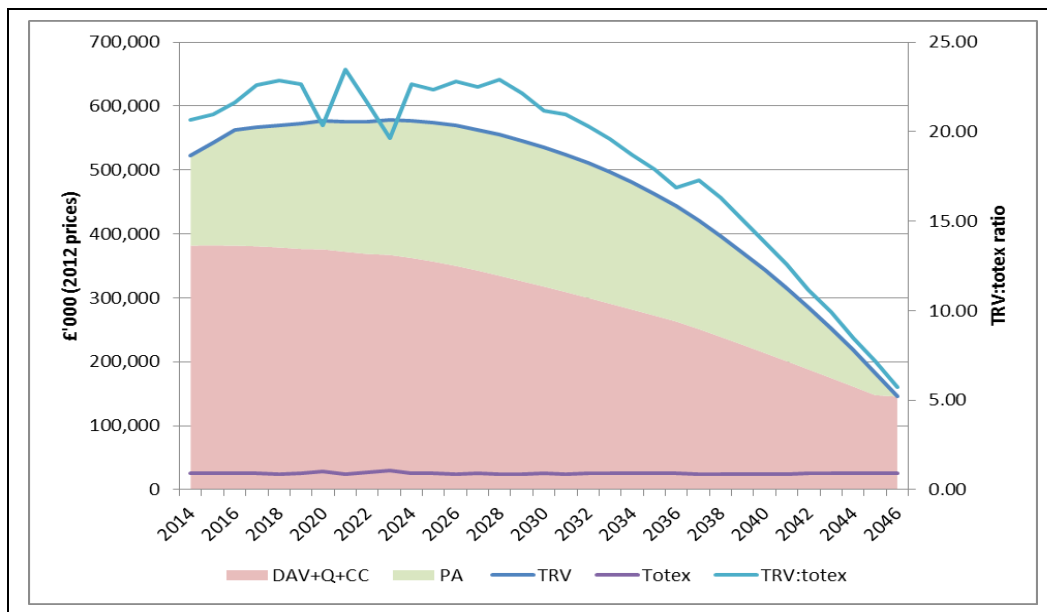
⁶¹ Indepen, Investor Survey June 2013.

⁶² Paragraph 12.26 of the consultation.

- UR's analysis fails to recognise that PNGL continues to face a significant challenge to connect customers in its Licensed Area. Within PNGL's Licensed Area, around 135,000 (50%) homes and business which have natural gas available are yet to connect, including over 60% of the owner occupied sector. Market penetration in Northern Ireland more broadly is c.20%, compared to c.85% in GB. The market for natural gas in Northern Ireland has some way to go before it can be considered to have reached a stage of maturity. This is also apparent since UR's statutory duty still includes promoting the development of the natural gas industry, which would be unnecessary were PNGL's market mature. Uncertainty around the timing of growth creates incremental operational and financing risk. The proposed changes to the connections incentive, which we discuss in Chapter 2, also increase uncertainty around the timing and financial implications of connections growth.
- The immaturity of PNGL's market is reflected in the continued deferral of revenue recovery relative to GB through the Profile Adjustment ("PA"). The PA is set to continue growing until 2028 according to UR's financial model. It is only at this point that PNGL can begin to recover deferred revenues. The resulting revenue profile means that the duration of cashflows for PNGL is longer than that for a mature utility (i.e. investments are recovered over a longer time period). PNGL's business will not have reached a stable and steady state until all deferred revenues have been recovered. Both debt and equity investors consider the existence of the PA as adding risk to PNGL compared to a typical regulated entity.
- PNGL operates in a regulatory environment that has proven relatively unstable, as reflected in the recent referral of both the PNGL and NIE price controls to the Competition Commission. Comments from rating agencies highlighted above indicate that relative to GB, PNGL's regulatory framework is considered to be more unstable and unpredictable. The rating agencies response to UR's initial proposals are also illustrative of the uncertainty surrounding Northern Ireland regulation: both Fitch and Moody's require further clarification in UR's final determination before they can draw conclusions about the stability and predictability of the regulatory regime. Until regulation in Northern Ireland establishes long-term credibility and stability, investors will continue to perceive the regulatory environment as immature relative to GB.

In addition, UR's assessments of cost risk and stranding risk do not inform conclusions as to the relative maturity of the business.

The chart below illustrates the forecast movement in PNGL's TRV:totex ratio over time, based on UR's GD14 financial model.



It is clear that the ratio for PNGL is expected to decrease significantly over time, driven primarily by movements in the TRV and in particular by the recovery of historically deferred revenues captured in the PA. PNGL can only be considered fully mature when it has recovered all deferred revenues, at which point the TRV:totex ratio will be more in line with GB comparators.

The chart reflects the long-term transition to a steady state which can be expected for a greenfield investment, and shows that PNGL has clearly not yet reached a steady state position in its life cycle. We therefore consider that point comparisons with mature, steady-state GB networks on the basis of this ratio cannot inform conclusions about the relative maturity or otherwise of the network.

UR's analysis of stranding risk also does not support the conclusion that PNGL is mature. The fact that UR is able to model scenarios in which PNGL fails to make connections illustrates a key difference in the risk environment for PNGL relative to GB, namely that PNGL is yet to connect a substantial number of customers in its Licensed Area. Irrespective of whether a failure to make further connections has implications for the recovery of revenues, PNGL operates in a less mature, more uncertain environment, since connections activity remains a substantial core activity. This drives incremental risk for PNGL.

UR has also failed to assess whether longer term trends in the energy sector represent new stranding risk for PNGL, including for example risks associated with decarbonising the energy sector. Ofgem has accelerated the depreciation profile for the GB GDNs in recognition of this risk. The relative immaturity of PNGL's business, with fewer customers already connected to the network and continued deferral of revenues, is likely to imply incremental stranding risk associated with long term energy sector trends for PNGL, relative to GB.

In addition, we would note that at the GD17 review we would expect UR to provide a greater degree of transparency around its analysis. In particular, we are concerned that the source information for UR's analysis of the TRV:totex ratio is not apparent in the consultation. We consider it to be good

regulatory practice that this type of analysis is transparent and replicable, so that all stakeholders have an opportunity to verify calculations⁶³. We do not comment further on the accuracy or validity of the underlying calculations in this response, as this is an issue which we expect will be picked up during the GD17 review.

UR's proposed split cost of capital approach

As we explained in Chapter 4, we fundamentally disagree with the breakdown of the PNGL TRV which UR has proposed in the consultation, since it is not consistent with our licence or with the Commission's conclusions at the PNGL12 Inquiry.

Further, on the basis of UR's notional TRV breakdown, UR has concluded that PNGL's TRV *"looks very different from normal RABs"*, and that *"retaining such an unusual TRV has implications for the appropriate WACC"*⁶⁴.

In terms of the implications for the cost of capital, UR has suggested that it will consider applying a different rate of return to its notional different components of the TRV, which would ultimately lead to a lower WACC being set.

*"we consider that there is merit in exploring whether the TRV should be divided into a conventional RAB and a separate "pot" with regulatory commitment to be recoverable from consumers. The values of these two pots would sum to the current TRV to ensure no loss of value. The RAB would then attract a normal regulated company rate of return and the remainder of the TRV would roll up at a lower rate to reflect relevant risk."*⁶⁵

Any such approach would be:

- conceptually flawed and practically difficult to implement;
- out of line with regulatory precedent; and
- inconsistent with the findings of the Commission.

Overall, we do not consider there is any merit in a split cost of capital approach and do not consider it would be appropriate for UR to consider applying such an approach at the GD17 review.

⁶³ For example, we cannot verify whether the analysis is made on a comparable basis across the comparator set (e.g. based on included/excluded costs, or with consistent rules for smoothing over time etc.).

⁶⁴ Paragraph 10.29 of the consultation.

⁶⁵ Paragraph 12.20 of the consultation.

A split cost of capital approach involves a number of conceptual flaws and practical complexities

In principle, the rate of return must be set to ensure that PNGL remains financeable and can continue to attract funding to support its ongoing activities. An appropriate approach to the cost of capital should therefore reflect investors' expectations of the risk surrounding the recovery of PNGL's investment over time.

Investment is recovered through cash flows derived from PNGL's regulatory model. Based on the formulae defined in PNGL's licence, the regulatory model produces a single line of expected cashflows on the basis of a number of model parameters, including the TRV as a whole. PNGL's model does not incorporate separate revenue streams associated with separate or separable levels of risk, nor can PNGL's regulated activities be meaningfully separated according to some proposed split of the TRV.

Investors' expectations do not, therefore, vary across different parts of the TRV. At the extreme, should the business fail, investors do not have different levels of guarantee that they will recover the value of different parts of the TRV. Similarly, PNGL raises both debt and equity against the value of its TRV as a whole, and investors do not face a different level of risk of under-recovery of their investment across different parts of the TRV.

We therefore do not agree with UR's contention that *"the current TRV is made up of very different components which have different opportunity costs of capital"*⁶⁶.

There are a number of other conceptual flaws and practical complexities associated with a split cost of capital approach, which have been recognised in both academic literature and regulatory commentary.

- A split cost of capital approach would imply the need for significant changes to the regulatory framework, so that the TRV (or any notional component of the TRV) would be subject to a genuinely different level of regulatory or political guarantee. Without this, a split cost of capital will not result in a reduction in the overall cost of capital allowed to the business to finance its regulated activities, since the underlying risk faced by the business has not changed. Absent a change in the regulatory contract, therefore, there is no reduction in overall business risk.
- The risk exposure of the TRV itself (or any notional component of it) is not necessarily debt-like, given future risks which could impact the recovery of the TRV.
- It is unlikely to be in the interest of customers for regulators to assume that the TRV (or any notional component of it) should be entirely debt funded. Equity has a disciplining effect on the company to operate efficiently and deliver outputs, and putting the recovery of historic investment (as reflected in the TRV) at risk is a core part of the incentive regime. The

⁶⁶ Paragraph 12.19 of the consultation.

Competition Commission noted this concern with a split cost of capital approach in its review of the Stansted Q5 control period⁶⁷.

- Regulators in general have tended not to prescribe particular corporate financial structures, instead basing allowances and incentives on an efficient notional capital structure. However, any split cost of capital approach implies that the regulator would determine that the TRV (or a notional component of it) should be entirely debt financed. Ofgem and Ofwat noted in 2006 that allowing flexibility in capital structures has allowed for innovative financing approaches to be adopted⁶⁸.

These concerns and others are highlighted by PwC in its April 2013 report for the CAA, which considered applying a split cost of capital at the Q6 review for UK airports⁶⁹. PwC reviewed the relevant academic literature⁷⁰; regulatory commentary; and evidence from potential parallels in commercial and financial structures. On the basis of this comprehensive review, PwC concluded that the CAA should not apply the split cost of capital approach.

Regulatory precedent supports a single allowed WACC for regulated business like PNGL

The overwhelming body of GB precedent is in line with the principles set out above for setting a single WACC for a single regulated activity. Ofgem, Ofwat, Ofcom and the Competition Commission have all adopted this approach, and there is little evidence that any serious consideration has been given to alternatives by most of these regulators.

The sector in which the potential for applying a split cost of capital has been considered most closely is UK airports. The CAA ultimately rejected the approach, stating (in relation to Heathrow) that “*On balance, the CAA considers that although the split cost of capital may have some academic attractions, it is not persuaded that it should employ it for HAL for Q6*”⁷¹. UR has highlighted a single example, that of Ofcom in its August 2005 determination for BT, as evidence of “*regulatory precedent for an approach which involves separating RAV into more than one pot*”. However, UR fails to acknowledge that this example is not analogous to its proposal for PNGL.

⁶⁷ See Competition Commission, Stansted Airport Ltd, Q5 price control, October 2008, Appendix L paragraph 10. <http://www.caa.co.uk/docs/5/ergdocs/ccstanstedl.pdf>.

⁶⁸ See Ofgem/Ofwat “*Financing Networks: A discussion paper*”, February 2006, paragraph 107. http://www.ofwat.gov.uk/regulating/reporting/pap_con_financingnetworks.pdf?download=Download.

⁶⁹ PwC, Cost of capital For UK Designated Airports, Paper on the split cost of capital and skewed returns – prepared to the Civil Aviation Authority, April 2013. <http://www.caa.co.uk/docs/78/Q6PwCCofCapitalSplitSkewed.pdf>.

⁷⁰ Notably papers by Professor Dieter Helm and Professor Ian Cooper.

⁷¹ CAA, Economic regulation at Heathrow from April 2014: initial proposals, paragraph 9.18. <http://www.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf>.

- ***In 2005, Ofcom made a distinction between separate businesses within the BT Group, whereas PNGL has a single activity as a DNO.***

In 2005, the BT group was a vertically integrated company that operated across all segments of the telecoms sector, including operating the regional, national and international networks as well as the local copper access network and the provision of retail fixed line services. Each segment of the telecoms industry constitutes a different activity with a distinct cost and revenue structure, and unique risk profile. Ofcom's objective when looking at the copper access network in isolation was to "*reflect variations in systematic risk between different activities*" within the integrated group, and to avoid competitive distortions in downstream markets associated with non-cost-reflective pricing. By contrast, PNGL operates the single activity of gas distribution and neither the company nor its risk profile are separable according to differences in underlying activity.

- ***Ofcom made its decision in the context of the upcoming structural separation of the copper access business from the rest of the BT group, which does not bear any resemblance with PNGL's circumstances.***

In September 2004, Ofcom launched its strategic review of telecommunications. Among other conclusions, its review identified competition concerns in fixed line services. Ofcom took the view that these could be mitigated via the promotion of equality of access to the copper network, and potential deregulation in other areas. In this context, BT offered to proceed with the structural and operational separation of its copper access business from the rest of the group⁷². This proposal was being consulted on at the time Ofcom published its 2005 decision on the WACC, and was eventually agreed in September 2005 (thereby concluding the telecoms review). The 2005 WACC was therefore set in the context of a vertically integrated industry that was in the process of being unbundled, which necessitated providing a view of the expected cost of capital post-unbundling. This context does not apply to PNGL, and the approach is therefore not analogous to the PNGL situation.

UR has not provided any reason that it would choose to ignore the substantial body of other regulatory decisions made over the last two decades which have all adopted a single WACC approach, and which are all more analogous to PNGL. UR's proposed departure from GB norms, without apparent justification or foundation in theory or precedent, only serves to highlight differences in the regulatory approach between Northern Ireland and GB, and is only likely to increase the perception of regulatory risk in Northern Ireland.

The Commission rejected a split cost of capital approach in its PNGL12 Inquiry

During the Commission's PNGL12 Inquiry, UR proposed a similar split cost of capital approach for PNGL to that which it describes as part of this GD14 consultation. The Commission clearly rejected this approach, concluding that the allowed rate of return did not over-compensate PNGL, and that it

⁷² http://stakeholders.ofcom.org.uk/consultations/statement_tsr/statement_tsr_pes.

remained appropriate to reward outperformance at the allowed rate of return so as to maintain the power of the incentive regime and avoid distortions (footnotes and emphasis added):

*“A second key point advanced by UR is that capitalization of outperformance over-compensates PNGL. **We do not agree.** While earning a return on an asset for a period of, in this case, 40 years will increase PNGL’s return in absolute terms, the value of the capitalized sum is equivalent in financial terms to the outperformance accrued **(always provided, of course, that an appropriate capitalization rate is used).**”*

[Footnote 22]: **We consider that the allowed rate of return is the appropriate interest rate to use in this context.** This is because the reward of outperformance is part of the incentive regime, and to use a lower rate than the allowed rate of return would reduce the power of those incentives. This is also so that the incentive to earn outperformance is the same as the incentive to use that money to make real expenditures, ie a different interest rate on accrued outperformance would reduce the relative incentive to achieve efficiencies.] We have set out ... why we consider that the rate of return used is not inappropriate. **We therefore do not accept that the fact that the sums under consideration here have been capitalized and a return realized over 40 years means that PNGL is being over-rewarded.** UR said that it was not intended that historic outperformance was to be rewarded at this rate. However, we have seen no indication in the 2007 determination that it was not intended to use the same rate of return for this purpose.”⁷³

In light of the Commission’s final determination for PNGL12, we consider it disappointing that UR continues to undo the progress made over the last two years to, as UR states, “draw a line under the past” so that UR, PNGL and its investors can move forward with clarity and confidence in the stability of the regulatory framework. Proposals such as these only support the view of the debt ratings agencies that regulation in Northern Ireland is less mature than GB, which adds to the risk profile of the company. We would not expect UR to re-open any issues the Commission has already covered and considered closed, and in line with the Commission’s conclusions we would not expect UR to impose any reduction in the value accruing to investors retrospectively via its proposals for the GD17 WACC.

Approach for the cost of debt

UR has indicated it is currently considering three options for setting the cost of debt at GD17:

- “to use CAPM to set an ex-ante allowance for debt for the whole of GD17”⁷⁴;

⁷³ see the Commission’s Final Determination, at paragraph 9.78.

⁷⁴ We note that it is not standard practice to describe CAPM as a model that can be used to set the cost of debt – rather, the cost of debt is one of the parameters of the CAPM model, in which market data and other evidence is analysed to determine the parameters of the model. We therefore assume that UR means it could adopt an approach based on market data and other evidence to set the cost of debt.

- “to use an indexed methodology in line with what Ofgem has introduced in RIIO”; and
- “to use a specific company-related cost of debt”⁷⁵.

We consider that an appropriate approach would be to set an ex-ante allowance for the cost of debt for the whole of GD17, on the basis of market data and other available evidence. In principle, this cost of debt would be determined by:

- beginning with a suitable benchmark, likely to be an appropriate cost of debt for a GB utility; and
- uplifting this benchmark to reflect differences between PNG and the benchmark, based on evidence available at the time and an assessment of the relevant drivers of relative risk.

We adopted a similar approach to this to estimate the cost of debt (as part of the Commission’s PNGL12 Inquiry). On this basis we estimated a range for the (real) cost of debt at PNGL12 of between 4.4 and 4.5%.

Our analysis was primarily based on evidence available in debt markets that PNGL’s bond traded at a substantial premium to GB bonds. Professor Cooper’s paper sets out one potential methodology for assessing the impact of this premium on the WACC, including an approach for understanding the associated impact on the cost of equity. In line with regulatory practice elsewhere, and similarly with other parameters of the WACC, this approach should reflect a long-term and forward-looking view of risk⁷⁶.

In addition, uplifts to the benchmark cost of debt may be necessary to account for other factors, including for example:

- transaction costs associated with the issuance of debt (in its review of Bristol Water, the Competition Commission allowed 10bps for the cost of issuing debt and 20bps for Bristol Water’s liquidity management costs (costs of carry)); or
- to take account of future uncertainty (for example, at DPCR5 Ofgem factored this uplift into its cost of debt allowance, and at RIIO-GD1 Ofgem stated that *“headroom exists when a fixed allowance is set in order to account for the risk of the cost of debt rising during the price control period”* although for RIIO-GD1 this is accounted for by indexing the cost of debt).⁷⁷

⁷⁵ Paragraphs 13.33 – 13.35 of the consultation.

⁷⁶ This is reflected in Ofgem’s use of a long-term trailing average of the iBoxx index, and its overarching principle of taking “a long-term view of financeability”. See Ofgem, *“Handbook for implementing the RIIO model”*, October 2010, Box 10 *“Summary of financeability principles”*.

⁷⁷ As UR notes in paragraph 12.33 of the consultation, the degree to which risk is shared between PNGL and customers will depend on its approach for setting the cost of debt – for example, if a trailing average of a

Clearly, the determination of the WACC for GD17 is of prime importance to PNGL. We therefore request that UR follows a timely and transparent process to ensure that these issues can be debated fully.

suitable market index is used, it may not be appropriate to allow for an uplift to account for uncertainty in debt market movements.

7. DRAFT GD14 OUTPUTS

Pis MODEL ISSUES AND REVENUE PROFILING

UR has signalled its intention in GD17 to *“assess whether the profile adjustment is still required or whether moving to a model more in line with GB GDNs would provide benefits”*⁷⁸. This is because it recognises that the profile adjustment *“reduces the tariff for current customers but increases the tariffs for future customers from what they otherwise would be”*⁷⁹ and it may no longer be necessary, since *“both FE and PNGL now have a solid base of customers”*⁸⁰.

We agree that an assessment of the merits of revenue profiling is needed and welcome engagement with UR on this issue. As we indicated during the Commission’s PNGL12 Inquiry, we are happy to consider value-neutral adjustments to the model that would accelerate the recovery of the PA.

It is therefore surprising that, despite UR’s apparent intention to reduce or remove revenue profiling from the PNGL model, other aspects of UR’s initial determination can be expected to have the opposite effect. This is because, for the purposes of establishing prices in the GD14 period, PNGL’s financial model requires cost and volume forecasts to be determined to 2046. If the long-term cost forecasts in PNGL’s model are too low, or volumes too high, revenues are deferred relative to a determination where long-term forecasts are set more accurately.

We accept that there is uncertainty surrounding long-term cost forecasts. However, given the intention is to look at whether continued deferral of revenue is appropriate at the next periodic review, forecasts should be set such that they are unlikely to result in additional deferral now. Failure to do this will result in the following detriments.

- It will **result in additional cross-subsidies from future customers to current customers**, which is inappropriate given the deferral that is already embedded in the model through the PA.
- **Prices will have to increase in future** once the cost forecasts are revised during future periodic reviews. This results in additional uncertainty and price variability for customers. For example, if the post-2017 WACC is 1% too low, GD14 revenues would be £10.3m too low over the period, which is revenue that would then need to be recovered through price increases in future⁸¹.

⁷⁸ Paragraph 15.15 of the consultation.

⁷⁹ Paragraph 15.13 of the consultation.

⁸⁰ Paragraph 15.15 of the consultation.

⁸¹ Holding all else equal, we estimate that a 1% increase in the WACC at GD17 above the current assumption of 4.83% would result in a price increase of 8.9% at GD17.

- **The business will face an increase in risk** from further deferral of cash recovery.

For these reasons, we have a particular concern about the WACC assumption that UR is proposing to use from 2017. UR has set the cost of capital in PNGL's model at 4.83%, a figure which is based on the rate Ofgem set in RIIO-GD1. As we explained in Chapter 6, we do not believe a straight read-across from the GB GDNs to the PNGL WACC is appropriate for PNGL, nor will it be appropriate at GD17. Further, there are a number of reasons why using a WACC based on the RIIO model is fundamentally incompatible with PNGL's regulatory framework.

- Under the RIIO model, the cost of debt is indexed, and therefore changes over time to reflect changes in debt markets. This means that the allowed cost of debt at RIIO-GD1 does not need to reflect future uncertainty in debt markets (whereas PNGL's cost of debt would need to account for this).
- The RIIO price control period is longer than PNGL's price controls. Ofgem considered that a longer price control period reduces regulatory risk⁸².
- The RIIO framework has a greater focus on incentivising outputs and innovation than PNGL's framework.
- At RIIO-GD1 Ofgem provided for an accelerated depreciation profile relative to GDPCR to mitigate stranding risk associated with increased long-term uncertainty over gas distribution. This means that the duration of cashflows for PNGL is longer relative to RIIO-GD1.⁸³

While we agree with UR that the long-term WACC assumption is made for modelling purposes alone, and does not establish a precedent for the GD17 decision⁸⁴, we believe that using the RIIO-GD1 value will result in the further deferral of revenue. Although the assumption is value-neutral for PNGL in the long-run, the assumption will drive further cross-subsidising from future to current customers.

To reduce this detriment, UR could continue to base the long-term WACC assumption on the value used at Ofgem's previous gas distribution price control ("GDPCR"). Although this was set at 5.83% for PNGL12, the pre-tax WACC based on Ofgem's parameters for GDPCR is 5.99%⁸⁵.

The assumption of 5.99% would not account for any reasonable uplift to the PNGL cost of capital relative to GB, which we believe would be merited (see Chapter 7 above). However, it would at a minimum be a more reasonable basis on which to set the long-term WACC than the RIIO-GD1 figure.

⁸² Ofgem, RIIO-GD1: Final Proposals – Overview, paragraph 6.10.

⁸³ In response to concerns raised over increased stranding risk due to the long-term uncertainty over gas distribution, Ofgem stated that *"We considered the stranding risk as part of our asset life review, and we consider that we have mitigated any risk by introducing a front end loaded depreciation profile."*

⁸⁴ Paragraph 12.37 of the consultation.

⁸⁵ Ofgem set the vanilla WACC at 4.94% based on a pre-tax cost of debt of 3.55%, post-tax cost of equity of 7.25%, and gearing of 62.5%. With a corporation tax rate of 28%, the equivalent pre-tax WACC is 5.99%. See Ofgem's GDPCR Final Proposals <https://www.ofgem.gov.uk/ofgem-publications/48550/final-proposals.pdf>.

CAPEX AND OPEX PROFILING POST 2016

We accept that there is uncertainty surrounding long-term cost forecasts. As we explained in the section above, if the long-term cost forecasts in PNGL's model are too low, revenues are deferred relative to a determination where long-term forecasts are set more accurately. While long-term cost forecasts are made for modelling purposes alone, and do not establish a precedent for the GD17 decision⁸⁶, we believe that UR's capex and opex profiling post 2016 will mean that prices will have to increase at the next periodic review.

We note that UR has largely used the Commission's PNGL12 Pis determination model as the basis of its capex and opex profiling post 2016. This methodology is fundamentally flawed. PNGL has highlighted to UR⁸⁷ that this proposal leads to some anomalies given that PNGL's profiling of capex and opex activities and indeed the basis upon which UR is proposing to determine allowances has changed between PNGL12 and GD14 e.g.

- UR cannot use the Commission's PNGL12 determination as the basis of feeder profiling post 2017 given that UR has analysed 4-bar and feeder as a single category of work in GD14. Under this methodology UR's trending does not allow for any feeder mains post 2016.
- UR cannot use the Commission's PNGL12 determination as the basis of the meter profiling post 2017. Under this methodology PNGL's I&C meter cost line is almost one third of that in 2016 from 2017 onwards and PNGL's domestic meter cost line is almost one third of that in 2020 from 2021 onwards. This is a direct result of PNGL's re-profiling of activities between PNGL12 and GD14.
- TMA should be calculated based on the actual forecast figures each year.
- UR has omitted the allowances for PRS installations post GD14.

PNGL has not looked at each cost line and the examples above are provided to illustrate the impact of the profiling of capex and opex.

In terms of methodology, if UR is unwilling to accept PNGL's forecasts at face value, PNGL believes that UR should largely profile capex and opex post 2016 based on PNGL's profiling of capex and opex within its GD14 submission. This will ensure that UR's trending is (i) reflective of PNGL's GD14 activity forecasts and not those determined for PNGL12; and (ii) unlikely to result in additional deferral of revenue now.

PNGL has provided UR with a model which applies PNGL's profiling of capex and opex within its GD14 submission post 2016 to those cost lines UR has profiled based on the Commission's PNGL12 Pis determination model. This methodology (i.e. using PNGL's profiling of capex and opex within its PNGL12 submission post 2013) was applied by UR in reaching its PNGL12 determination and seems a

⁸⁶ Paragraph 12.37 of the consultation.

⁸⁷ E-mail from Abigail McCarter to Paul Harland 30 August 2013.

more reasonable basis upon which the costs post 2016 are forecast by UR going forward for the purposes of calculating the GD14 Pis.

DESIGNATED PARAMETERS

PNGL notes the designated parameters detailed in Table 81 of UR's consultation. To improve transparency, PNGL believes that UR should present the designated parameters with reference to the price control and the price control period to which they relate i.e.

Designated Parameter	PC03 <i>(determined)</i> 2007 – 2011	PNGL12 <i>(determined)</i> 2012 – 2013	GD14 <i>(proposed)</i> 2014 - 2016
r_t	0.075	0.075	0.075
m	2006	2011	2013
n	2011	2013	2016
q	2046	2046	2046
RPI	200.1	225.3	244.2

ROLLING INCENTIVE MECHANISMS

PNGL welcomes UR's proposal to retain the five year capex rolling incentive mechanism for PNGL for GD14.

PNGL notes UR is not minded to switch on the opex rolling incentive mechanism and that UR plans to consider this as part of GD17.

INDEXATION AND EFFICIENCY TARGET

Efficiency Target

PNGL notes the decisions made by the SEM Committee on the form of SEMO regulation and the allowed revenue for SEMO for the period from 1 October 2013 to 30 September 2016⁸⁸. The SEM Committee have decided that **opex** should be subject to Revenue Cap ("**RPI-X**") Regulation with an X of 0.3 applied. RPI-X regulation incentivises SEMO to reduce costs by increased efficiency of processes and lower input prices. Any efficiency and price savings are retained by SEMO; overspends must conversely be absorbed by them.

⁸⁸ Single Electricity Market Operator (SEMO) Revenue Requirement, Price control commencing 1 October 2013, Decision Paper, 06 August 2013, SEM-13-054.

UR is proposing a 1% efficiency target for **both** opex and capex for GD14. The application of a blanket efficiency target is entirely inappropriate; applying a blanket efficiency target across all of PNGL's cost allowances effectively amounts to 'double counting' of efficiency.

As part of its bottom-up assessment of opex, UR is proposing to reduce allowances for many cost items to levels lower than those forecast by PNGL and experienced historically. The proposed efficiency target also requires that PNGL delivers efficiency savings on licence fees, despite the fact that it has already been established that these costs are outside of PNGL's control.

Similarly for engineering allowances, UR states:

"As in PNGL12 an efficiency factor of 10% has been applied to the baseline maintenance costs to reflect the efficiencies which we consider PNGL should be achieving if it had fully implemented an asset maintenance system."

For capex, UR has identified that PNGL is more efficient than the established mature GDNs in Great Britain and is the most efficient GDN in Northern Ireland.

As such, the proposed opex and capex allowances already embed challenging, and in some instances unfeasible, efficiency targets. Applying a 1% efficiency target in addition to these targets is arbitrary, and represents unjustified double counting of efficiency targets.

PNGL has prepared its GD14 submission using the same efficiency assumptions as its PNGL12 submission. As outlined in PNGL's PNGL12 submission paper "**RPI-X Efficiency**", provided to UR on 24th February 2011, PNGL's forecasts already account for potential efficiencies arising as the business grows and develops. PNGL uses a bottom-up analysis to forecast its costs to ensure that efficiencies for consumers are captured within each individual cost-line.

In short, UR's proposal to introduce a blanket 1% efficiency target is inappropriate in that it is applied as an efficiency incentive after each item has already been tested for efficiency. Since the first exercise of testing efficiency item by item is thorough, the scope for an additional efficiency target is much more limited, more so given that UR has already built challenging efficiency targets in to the allowances e.g. the target for owner occupied connection numbers is over 50% higher than the target set in PNGL12 while at the same time UR's proposal is to reduce the level of allowance for advertising, marketing and PR. The application of the efficiency target must be moderated to avoid double counting. The 1% efficiency target appears to represent an arbitrary addition.

PNGL would urge UR to moderate the application of the efficiency target in order to avoid double-counting and in order to secure a sustainable and justifiable price control.

Indexation

UR states:

“We will therefore implement the efficiency target detailed above by escalating opex and capex by an overall RPI minus one per cent per annum for GD14.”

UR has confirmed to PNGL that its proposals currently exclude the proposed 1% efficiency factor. UR has also advised that, when issuing its final determination, UR will provide the opex and capex allowances post any efficiency factor it deems appropriate having considered consultation responses.

8. GD14 UNCERTAINTY MECHANISMS

MATERIALITY THRESHOLDS

UR's proposal to maintain a materiality threshold for requests for additional costs at £100k is misguided. The proposed threshold is not appropriate to the size of PNGL's operations and should be removed.

To put this threshold into context, the cost of developing the semi-automated IT system which facilitated the introduction of supply competition within PNGL's Licensed Area was less than £100k. Under UR's materiality threshold proposal, PNGL would have had to fund fully development of the switching system, which benefits suppliers and consumers, for the Greater Belfast area but which is of no direct benefit to PNGL.

The application of such a materiality threshold over a cost category such as IT, where UR's proposed allowance is on average only c.£239k per annum, further demonstrates the inappropriateness of this threshold. Given the replacement cost of PNGL's current IT infrastructure, PNGL's IT allowance is already fully committed and therefore there would be no margin for absorbing any such de minimus expenditure.

This is another example of UR's proposals effectively 'double counting' efficiency.

9. FURTHER ISSUES

CONNECTIONS INCENTIVE AND CONNECTIONS POLICY

PNGL has provided detailed comment on the connections incentive and connections policy proposals outlined by UR in Chapters 1 and 2 above.

COST REPORTING

In PNGL's opinion UR's current cost reporting template is not fit-for-purpose; it does not reflect the operation of PNGL's business, it does not allow PNGL to communicate its cost forecasts to UR in a clear and effective manner and it does not provide UR with the level of detail and transparency which PNGL has provided to UR as part of the PNGL12 and GD14 price control submissions. If UR wishes to maintain continuity and simplicity, UR must consider the role of the annual cost reporting template in price control reviews.

PNGL notes UR's intention to have a comprehensive annual cost reporting system in place for GD17. Following completion of the GD14 review, UR will have a better understanding of the operational differences between Great Britain GDNs and Northern Ireland GDNs and indeed between the two GDNs in Northern Ireland. However the annual cost reporting system must be developed in conjunction with GDNs to ensure that PNGL is able to communicate its cost forecasts to UR in a clear and effective manner which accurately reflect the operation of its business. This will facilitate transparent discussion with UR and its consultants throughout the GD17 review and ultimately facilitate its timely completion.

ENERGY EFFICIENCY AND SHRINKAGE GAS

PNGL notes UR's intention to review the treatment of shrinkage gas following the introduction of Directive 2012/27/EU on 25 October 2012 and is happy to engage with UR at the appropriate time.

METER READING

The obligation to read and inspect meters is a condition within licences of regulated gas suppliers in Northern Ireland, as it is in Great Britain.

As part of the PNGL12 review, UR asked PNGL to consider whether it could undertake meter reading on behalf of all suppliers operating within its Licensed Area.

From an operational stance, PNGL is not presently involved with meter reading and therefore does not know details of what is involved in the current meter reading process. PNGL provided UR with a note in September 2010. This note was not intended to capture all the issues which need to be considered but provided UR with the high level macro and micro issues which PNGL had identified at that time that would need to be considered by UR as part of any review.

Based on the high level macro and micro considerations, PNGL believed that a minimum period of two years would be required to complete the analysis and implement system changes.

UR must allow stakeholders, including PNGL, sufficient time to give meter reading due consideration to ensure that all issues can be identified and ensure that any decision as to the future of meter reading in Northern Ireland is as informed as possible. It is therefore important that any such review commences as soon as possible following determination of the GD14 price controls.

10. NEXT STEPS

IMPLEMENTATION OF THE PRICE CONTROL

PNGL notes UR's comment that it will need to make some amendments to the PNGL licence to implement the price control. UR indicates that a statutory four-week consultation will be carried out to implement these licence changes, either at the same time that it publishes its final decision or shortly after.

PNGL understands that the only amendments that may be required relate to UR's timing of cash flows proposal, which PNGL has commented on earlier in this response, given that PNGL's licence includes a mechanism that allows price controls without licence modification. If this is not the case, UR should clarify its intentions and allow PNGL to engage with UR at the earliest opportunity.