

Graham Craig
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Queens House,
14 Queens St.,
Belfast BT1 6ED

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Dear Graham,

Gas Network Extensions in Northern Ireland: Approach to Comparing High Pressure Licence Applications

Over the long-term, BGE(NI) continues to believe that 'revenue cap' incentive regulation is likely to lead to better value for the consumer by driving Capital (CAPEX) and operating cost (OPEX) efficiencies. This benefit will be transferred to consumers across price controls.

As a general comment, most Regulators across Europe use a form of RPI-X regulation which provides for a sharing of risk between consumers and the Network Utilities and which strongly incentivises the Utilities to deliver efficiencies whilst achieving a fair return on their investments. In particular Ofgem, the Regulator in Britain has strongly endorsed a Revenue Cap RPI-X based model as the key to achieving long-term solutions to Britain's energy needs.

Firms bidding under an OPEX pass through model will be exposed to less risk and therefore will be able to bid a lower cost of capital. As such therefore we believe that there are two issues with NIAUR's current proposals for the risk-adjustment factor:

- The proposed level is too low, principally because the estimates of OPEX for the project and the volatility in these costs are too low.
- The methodology does not consider the allocation of CAPEX risk.

This response covers Questions 1 to 5 of those raised in the consultation.

The estimates of operating costs and volatility are too low

To calculate the impact of OPEX risk on the WACC, NIAUR first estimates the annual OPEX costs for the project (£1.5m in the central case) and then assumes a 90% confidence interval for these costs of +/-10%. Both these estimates are too low.

The overall OPEX estimates are too low. This is because the assumed linear relationship between existing OPEX and network length/asset value underestimates costs as the nature of the extension is different. The network extension project is different to the existing BGE(NI) pipelines (which we use for comparison purposes) in two ways:

- **The ‘Gas to the West’ (GTTW) project is going through more difficult terrain** (e.g. orchards, wetlands, lower quality farmland) compared to the existing networks. This means that agricultural remediation costs will be higher proportionately with pipeline length. It has also been the experience of BGE that the run rate for costs in this area has consistently exceeded allowances. The projected gas flows and pressures in the GTTW network are also likely to increase costs¹.

We conservatively apply an uplift of 15% the agricultural remediation costs. This increases the estimate of overall controllable OPEX by 0.8%; and

- **The GTTW network is more remote than the existing network.** On the present networks there are cost economies resulting from the proximity of different parts of the network to each-other (e.g. aerial surveillance and 24 hour emergency response).

The GTTW pipeline is more remote which also means maintenance costs will be proportionately higher with pipeline length. For example, aerial surveillance is costed on a per kilometre basis and due to the configuration of the proposed GTTW network the flight paths required would require distances to be flown that are greatly in excess of the actual network length.

Although the impact on OPEX from this factor is likely to be significant, the exact impact on costs is difficult to quantify without a detailed study. Therefore we do not apply an uplift to the OPEX estimates to reflect this factor and the OPEX estimate can be considered highly conservative.

With these updated assumptions, the ‘bottom-up’ estimate of OPEX costs rises to £1.519m per year (from £1.505m).

The variability in this OPEX has been also been underestimated. In the consultation, the 90% confidence interval for OPEX is assumed to be +/-10% (in the central case) based on an Ofgem assessment of volatility in TOTEX for GB transmission licence holders.

We do not believe this value is appropriate for three reasons.

- **The observed variability in OPEX for BGE(NI)’s existing network suggests greater variability than +/- 10% in OPEX.** Figure 1 shows that the difference

¹ Due to the projected flows and pressures on the networks it is unlikely that the operator would be able to ‘PIG’ the pipelines and would therefore require increased levels of Cathodic Protection. Aerial Surveillance and CIPS as well as desktop studies in order to conduct risk based assessment and management of the pipeline. Increases in these activities bring associated costs.

between actual and allowed controllable OPEX has been greater than 10% in 3 out of the last 8 years (twice with an overspend and once with an underspend). There was also a large overspend in 2004/5 but we discount this as it was the first year of the price control.

This suggests a 90% confidence interval of +/-10% is far too narrow. If it were correct we would expect the difference to exceed 10% in at most one of the nine years.

The main cost components driving the over/underspend vary from year to year: in some years maintenance is the main factor whereas in other years shared services or agricultural remedials are the main factor. This suggests it is difficult to find strategies to limit volatility. In addition, CAG, IME3 and network code costs are not included in the controllable cost figures used above and are a further source of volatility.

- **The nature of the GTTW pipeline is likely to result in increased OPEX risk relative to existing NI networks.** As discussed above, the GTTW pipeline is going through more difficult terrain and this is likely to increase volatility in OPEX (e.g. driven by weather). The fact that the pipeline is new also means there is greater uncertainty around OPEX (particularly in the first price control).
- **Recent precedent suggests maintenance CAPEX allowances may not be sufficient to allow OPEX risk to be properly managed.** In recent years proposals for additional maintenance CAPEX (REPEX) which would in part have the result of reducing future OPEX (and the risk around this) have been rejected by NIAUR. For the latest price control, BGE(NI) submitted proposals for £7.4m of CAPEX of which only £0.5m has been accepted to date by NIAUR. If this treatment is also applied to the GTTW maintenance CAPEX allowances then OPEX risk will be higher.

In NI where there is no specific allowance under the licences for REPEX. In contrast, in GB, Ofgem have a TOTEX approach giving network firms the flexibility to choose to spend on REPEX where this is efficient in reducing future OPEX costs and risks.

For these two reasons we believe OPEX for the GTTW pipeline is likely to be much more volatile than the +/- 10% assumed by NIAUR. We do however note that there is scope for reopener at around 20% of controllable OPEX.

A conservative central estimate of the OPEX volatility would be +/-20% given that OPEX has varied by more than this amount in 2 of the last 8 years.

Figure 1. Actual controllable OPEX versus allowances for BGE(NI)

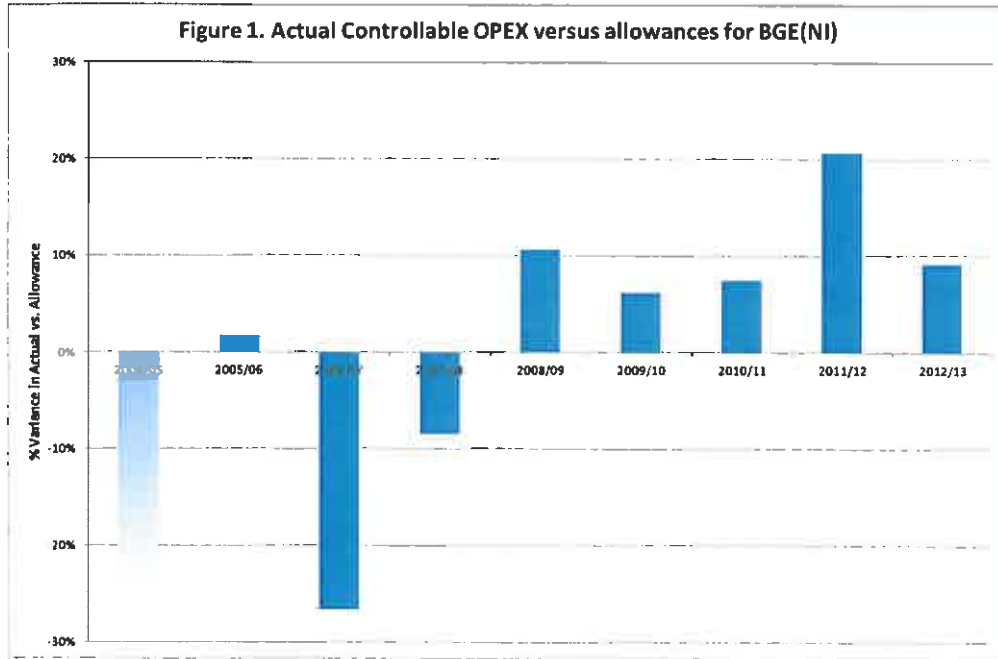


Table 1 shows the impact on the WACC adjustment if these updated assumptions on the OPEX and its variability were applied (using the NIAUR method and holding all other parameters constant).

Table 1. Sensitivity of central NIAUR risk-adjustment factor to updated OPEX assumptions

	WACC adjustment
NIAUR WACC adjustment (central case)	0.22%
Increase OPEX to £1.519m year	0.23%
Increase OPEX variation to +/-20%	0.44%
Increase OPEX to £1.519m year and variation to +/-20%	0.45%

We believe that NIAUR should use 0.45% as the figure for the risk adjustment factor. This estimate can be considered conservative because we have not uplifted the OPEX cost estimates to reflect the relative remoteness of the GTTW network and have assumed a volatility which is lower than that suggested by the last 8 years' experience on BGE(NI)'s existing network.

Allocation of capex risk

In the consultation, NIAUR state that a 'revenue cap' model will apply to capital expenditure in all circumstances, for all firms bidding (see Para 2.2). Therefore there is no risk-adjustment factor suggested to account for differences in CAPEX risk exposure.

However, NIAUR also makes clear that only a small proportion of CAPEX items will be competed on. Importantly, 'material's, 'construction', 'wayleaves' and 'land and site investigation / C&I / commissioning' costs will not form part of the competition.

This provides the possibility for very different assumptions on the allocation of CAPEX risk to be made by competing parties, and hence to a problem similar to that observed for OPEX. We believe this is likely to result in outcomes which are not in customers' interests and which could result in excess profits for the contractors or partners of parties bidding on an OPEX pass through model.

Bidders will need to consider their approach to contracting for the construction of the pipeline, and in doing so will need to consider their procurement approach. This will include defining how much CAPEX risk (cost overruns, time delays etc.) will be passed through to contractors.

In the Gas to the West information pack² NIAUR states that:

“The licence holder and its contractor will be expected to share risk in a way that minimises the cost of risk overall, this being achieved by allocating risk to the party which is best able to effectively manage that risk.”

However, views and incentives on the appropriate allocation of risk may differ depending on the types of bidder. Moreover, bidders do not appear to be bound to a particular type of contracting approach when they make their bid³. At the extreme ends of the spectrum, bidders could opt to take all price and timing risk themselves, or to pass this all through to contractors (e.g. via a completely fixed price contract). While bidders are unlikely to adopt these extremes, a range of different allocations of risk are possible within many other credible contracting approaches.

This is important, because those bidders who envisage passing on a greater share of risk to their contractors will bid a lower cost of capital and hence a greater likelihood of success in the tender. However, this will not mean they have a lower overall cost. Rather, they will have a higher expected construction cost proposal for their first price control (if selected). So a bidder with a higher total cost may win the tender, to the detriment of customers.

NIAUR may believe that it will be able to control for this by scrutiny of the price control submissions. We believe this is unlikely to be the case. This is because at the point of review of price control data, NIAUR will have no comparators for CAPEX

² http://www.uregni.gov.uk/uploads/publications/Gas_to_the_West_Annex_7.pdf

³ We note that NIAUR state that “*bidders should base their contingency request on the basis of an Option C [Target Cost contract with activity schedule] type of arrangement*”. However, this may not be the contract type used in practice and does not appear to be a requirement.

costs using alternative procurement approaches, and so will have little or no sound basis for refusing specific cost estimates that have been the subject of an open competitive tender (albeit on defined contract terms). Further, if bidders had been clear as to their contracting strategy prior to any bid, it is not clear that NIAUR's case for refusing costs would stand up to an appeals process.

The scale of this effect is likely to be material. For example we estimate that typical CAPEX risk premia for GB PFI projects (for building and then operating, rather than acquiring a fully constructed asset) are approximately 1.5% over the life of the asset.

We expect this issue will be of particular concern in relation to potential parties bidding on an OPEX pass through model. At present, there is a strong incentive for all bidders to submit bids based on a high level of risk transfer (i.e. with a low implied WACC). But this approach is likely to be of particular interest to parties bidding on an OPEX pass through model, as if they were not to pass construction risks to their contractors, they would need to increase their cash reserves or raise high-cost junior debt. Both would reduce their competitiveness in winning the tender.

We are therefore concerned about the tendering approach proposed on two levels.

First, and most importantly, it is not in customers' best interests. The incentives of the competition as structured by NIAUR may be for bidders to allocate risks to contractors even if they are better managed by the utility itself. This is not consistent with efficient risk allocation, and so is likely to raise the overall cost of the developments to customers.

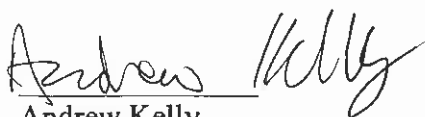
Second, we believe it could unduly favour parties bidding on an OPEX pass through model (and their contractors or partners). There is a strong risk that parties bidding on an OPEX pass through model will submit a bid which is at face value extremely attractive (on those items which are competed on), win the tender, and then submit cost proposals which are based on unduly high cost risk transfer contracts. The only parties that benefit from such an arrangement are the shareholders of the winning bidders contractors.

We believe NIAUR needs to consider its approach in this regard to ensure risks are allocated efficiently and that the competition is fair.

It is regrettable that such a significant consultation is being run so close to the tender submission date. That being said, a clear, unambiguous decision from NIAUR in sufficient time will allow parties considering a bid to adequately quantify the risks of making such a submission.

Should you wish to discuss these matter further, please do not hesitate to contact me.

Yours sincerely



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