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10th February 2015

Dear Paul,

Price Control for Northern Ireland's Gas Distribution Networks GD17 – Discussion Document

Thank you for the opportunity to respond to your Discussion Document setting out your overall approach to GD17. Recognising this is an informal Discussion Document, as opposed to a formal consultation, we have focused at this stage on some immediately identified headline issues, which are set-out in this letter and amplified in Appendix 1.

firmus energy (FE) would at the outset like to assure the Utility Regulator (UR) that it wishes to engage fully and productively throughout the GD17 process to develop a constructive and professional relationship aimed at achieving our respective objectives.

Our response to the Discussion Document is not at this stage a fully comprehensive statement of our position, as there are a material number of items mentioned briefly in the Discussion Document that have not been fully developed, such as the potential 'incentives regime'. In this regard, we note that we have not had the opportunity to consider such and reserve our right to do so at Board level, given sign-off by the Board is envisaged for the Business Plan.

The proposed Business Plan submission deadline of 30th June 2015 is six months ahead of FE's current licence requirement and inappropriate given the huge amount of data that has to be submitted in the Business Plan. FE proposes that the deadline date should be set at 30th September 2015, further background to this view is provided in Appendix 1.

With regard to the level of detail being requested by UR, we do not consider this is proportionate to the scale of the FE business. FE would welcome further workshops to be organised to develop and agree a more appropriate Business Plan spreadsheet to ensure a full understanding of the required inputs, and to receive guidance on completion.

The Discussion Document contemplates potential licence amendments. FE would expect full consultation on such, and that any changes are necessary and proportionate. Furthermore, any amendment should not go beyond a normal price control process and should fully respect the economic principles upon which the original licence was awarded.

In relation to UR's desire to further align the respective licences of the GDNs, FE is open to this provided that the balance of risk and value in relation to any changes is recognised and that any changes are consistent across the licences of all GDNs. Appendix 1 provides further comment on this subject.

We felt it unfortunate that UR did not engage with the NI GDNs on the overall approach to GD17 prior to publication of the Discussion Document. We would propose going forward that full engagement takes place at all levels of our respective organisations at the earliest possible stage, so that there is a clear understanding of UR's information requirements and objectives.

We welcome UR's approach to best practice regulation and its commitment to provide a consistent framework within which, in return for providing monopoly services to an acceptable quality, UR will ensure GDNs receive a reasonable assurance of a revenue stream in future years that will cover their costs and ensure fairness to the consumer. We therefore welcome the GD17 process being conducted in line with UK Principles of Better Regulation of transparency, accountability, proportionality and consistency.

We further note that Ofgem applied the above standards in the GD1 – RIIO process. Ofgem applied best practice in relation to full engagement with GDNs and went to significant lengths to clearly and transparently set out the processes involved to all stakeholders at the earliest possible stage. Ofgem provided supporting documentation and spreadsheets which clearly illustrated how the process would operate and the format in which data should be provided. We would welcome a similar approach by UR in relation to GD17 and believe this to be a key element of a transparent process.

We are particularly focussed upon the key decisions of GD17 in relation to operating and capital expenditure allowances, targets for new gas pipelines and connections, proposed rate of return and duration of the price control. FE is also supportive of a six year price control period, provided the outcome of GD17 balances the objectives of UR and FE and supports the long term financing of the business. In this respect we have provided some comments on 'Re-Openers' in Appendix 1.

In relation to rate of return, we note that UR has recently undertaken an effective market testing of cost of capital in the NI market in the context of the Gas to the West (GTTW) competitive tender. FE believes that this provides the best and most appropriate point of reference for the cost of capital for NI gas networks. FE believes that there is a need to take into account the significant differences between GB and NI networks in relation to the price control.

It is very encouraging to note that UR states that a principal aim of the price control is to develop the gas industry in NI, with GDNs investing efficiently and effectively. FE fully supports this objective and is committed to the development of the gas network through the economic connection of customers.

In the wider context of entering into the GD17 process in a productive manner, FE believes that fast resolution to the currently outstanding GD14 issues would help enormously. Appendix 1 outlines the outstanding GD14 issues, and FE requests that UR applies resources to close these items in the immediate future.

FE looks forward to engaging with UR in a productive and professional manner aligned to achieving our respective objectives and meeting the expectations of our customers. FE believes the GD17 process provides the opportunity for both parties to establish efficient processes and communications, which will provide a backdrop to the effective development of the FE gas network in NI.

Yours Sincerely,

John French
Director of Regulation and Pricing

Appendix 1

Price Control for Northern Ireland's Gas Distribution Networks GD17 – Detailed Comments on Discussion Document

GD17 Timescales

In relation to the proposed Business Plan submission date of 30th June 2015, we do not feel this allows sufficient time to provide the considerable quantity of information which UR has indicated to be required. In addition, FE wishes to present a robust and professional Business Plan which fully meets UR's objectives and avoids ambiguity, difference and further process.

For background, FE's current licence condition 4.4.7 states:

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

(a)the date occurring 12 months prior to the end of each Formula Year t = n; and

(b)the date occurring two months after the date on which the Authority has provided to the Licensee its proposed values for the Designated Parameters for that Review."

The proposed Business Plan submission deadline is therefore six months ahead of FE's current licence requirement. FE proposes a submission deadline of 30th September 2015, three months ahead of the current licence date. Given UR is not proposing to finalise its approach to GD17 and the related spreadsheet model until 30th March 2015, FE considers this to be a sensible deadline. Further comments on data requirements are provided below.

UR Approach to Key Areas

We note UR's approach to key areas within the Discussion Document. Whilst FE understands and acknowledges UR's objective to further align the regulation of NI GDNs within the price control, FE requests that UR takes full account of the differences in scale of the FE business and the other UK GDNs, including PNGL. Table 1 below provides an indication of the respective scale of the GDN businesses, illustrating in particular the material difference in staff levels.

Table 1: Size Comparison of the UK GDNs

Company	Gas Main	Customers	Staff
SGN	74,000km	5.8m	1400
Northern Gas Networks	37,000km	2.7m	1300
National Grid	130,000km	10.9m	4100
Wales and West Utilities	35,000km	2.5m	1500
PNGL	3,000km	170k	125
FE (Distribution Only)	900km	24k	59

We also note the level of resources that Ofgem applied to GD1 – RIIO to ensure that the GDNs were fully clear about how the architecture of the process would work, with Ofgem clearly defining inputs and outputs to the process. We note the material level of information that the GD1 – RIIO process required and the size of the respective regulatory teams at both Ofgem and within the UK GDN businesses.

FE fully supports the objective of NI GDNs to be fully transparent and accountable throughout the GD17 process. We would ask UR to recognise the material differences in the resources of both UR and the NI GDNs versus the GB GDNs to support such a detailed approach. Therefore, we would ask that UR is mindful of these significant differences and develops a price control process that is proportionate to the resources of UR and the NI GDNs to meet the UR's information requests and deadlines.

Licence Differences

FE understands UR's objective to undertake a parallel benchmarked price control process with both FE and PNGL. However, it is important that UR recognises the current licence differences between the NI GDNs when finalising any decision. Table 2 below outlines some of the salient licence differences.

Table 2: Differences between FE and PNGL

	FE	PNGL
Licence Award	2005	1996
Type of Regulation	Price Cap	Revenue Cap
Licence Recovery Period	30 years	50 years
Connection Model	Thin model	Fat model
Properties Passed	c.75k	c.300k
I&C vs. Domestic Volumes	10% I&C vs. 90% Domestic	2% I&C vs. 98% Domestic
Treatment of under-recoveries	Standalone	Within the TRV
Risk	Volume	Connections
Network Distance	c.270km	c.75km
Nature of Network	Rural and Provincial	Urban Conurbation
Customers	c.24,000	c.170,000
Network Length	c.900km	c.3,000km
Gas in Licence area	c. 8 years	c.18 years
Towns Covered	21[1]	13[2]

FE is open to constructive dialogue in relation to alignment of licence conditions provided this is undertaken on an holistic basis considering the value and risk associated with the full package of potential licence changes.

Economic Regulator

The principal objective of UR in its regulation of the NI gas industry is '*to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland'.* We believe that some of the UR's decisions within GD14, especially in relation to capital allowances, have had the unfortunate effect of suppressing network development within the FE licence area. It is therefore essential that this does not take place within the GD17 process and FE is committed to work closely with UR to avoid such an outcome. FE believes that the properties passed model utilised within GD14 should be re-visited in order that it enables all NI GDNs to economically develop the gas network to the benefit of customers and in a manner which is cognisant of the geographical/physical conditions on the ground within the licensee's network area.

Benchmarking

FE recognises that benchmarking is a useful comparison technique to identify outliers, however as academic literature[3] sets out benchmarking has shortcomings especially when comparing with a small sample size and there is the distinct possibility of unreasonable results if rigid comparisons are made with companies who are significantly different in both size and scale. As Table 1 has set out, FE is markedly smaller than PNGL and substantially smaller than the GB GDNs and therefore it is important that UR is mindful of such differences when developing such benchmarking techniques such as Frontier Shift.

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

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

[3] Benchmarking of electricity networks: Practical problems with its use for regulation, Graham Suttleworth, Utilities Policy 13 (2005) and Benchmarking and Regulation in the Electricity Distribution sector, Farsi et al, CEPE 2007.

GD17 Duration

Regulatory certainty is a key component of the risk profile of FE's business and is therefore critical to the funding of the business. FE is supportive of a six-year price control period, provided it is based upon an equitable conclusion to the GD17 process that is aligned to UR, FE and customer objectives and which, importantly, supports the efficient financing of the business throughout the price control period.

GD 17 Reopeners

Aligned with FE's view on the price control period and the need for a stable regulatory environment, FE considers the concept of re-openers to be inconsistent with the platform required for investment unless exceptional and unforeseen circumstances develop. FE is therefore very concerned about the proposed application of price re-openers in GD17 and would welcome positive and constructive dialogue with UR to avoid an outcome to the GD17 process which relies upon re-openers as 'standard practice'.

GD17 Business Plan - Spreadsheet

We look forward to working with UR to develop the Business Plan spreadsheet into a suitable tool and to ensure it is populated in the required way. Provision by UR of detailed guidance on how the GD17 Business Plan spreadsheet operates would be extremely helpful to avoid future ambiguity and re-working. We would also welcome a workshop meeting with UR on this subject with a view to tailoring the spreadsheet to reflect the size and scale of the NI GDNs as compared to GB GDNs. We do not consider a requirement for tens of thousands of individual data inputs to be proportionate to FE's scale.

FE will provide full commentary on the UR Business Plan/spreadsheet guidance, along with commentary on the final spreadsheet version upon its release by UR, which we understand will be on 31st March 2015. FE believes that it is vital for the success of GD17 that the NI GDNs have sufficient time to provide full feedback on the Business Plan/spreadsheet guidance to UR and that UR has sufficient time to implement any necessary amendments to the Business Plan/spreadsheet and guidance before the GDNs are asked to populate the model.

Input from Consumers and Stakeholder Engagement

Since FE's licence award in 2005, FE has focussed on delivering the best possible service to its customers. As a result, FE is always receptive to consumers' views on how we can improve our performance in our licence area. FE undertakes its own consumer research several times a year to understand and develop positive customer relationships.

It is correct and vital that consumer and other stakeholder input forms a central part to the GD17 process. FE would reiterate its request that the architecture regarding this input is agreed at the earliest stage in the process and that there is a clear understanding of how this will be applied to the outputs of the GD17 determination. This process is applied within NI Water's price control process, and is currently being developed for NIE within RP6.

Price/Revenue Cap

Due to the relative immaturity of the FE network, FE is currently regulated under a Price Cap regime. FE is currently 10 years into its 30 year licence period and is still in the development phase of the core network. We note UR's proposal (section 4.5 of the Discussion Document) to set revenue limits and would ask that any change to the current FE licence Price Cap regime should take account of the maturity of the network and be considered along with any wider licence amendments/alignment of the licences of GDNs.

Customer Connection Incentives

From recent discussions we are concerned that UR has pre-determined that the current customer connection incentive should be removed for GD17.

We have previously provided UR with substantive quantitative information from NISRA highlighting the low income levels of households within our licence area. Low income/fuel poor households continue to need financial support to afford the upfront costs of converting to natural gas, a situation that could be further exacerbated with potential cuts to the public sector workforce.

Recent[4] research undertaken by Millward Brown Ulster in oil burning households within our licence area has shown that:

- 41% of households state the upfront cost of installation is the main reason they would not convert to natural gas; and
- 55% of households state that they would be likely to switch if grants were available to help with installation costs.

FE therefore believes there is robust evidence for a continued importance for consumer connection incentives in growing the gas network in our licence area.

Capital Expenditure

We understand the premise of the UR's benchmarking proposals with regard to capital expenditure. It is however important that a balance is achieved in relation to capital allowances and the key objective of growing the gas network and providing economically robust natural gas connections to NI customers.

We would propose to work closely with UR to develop an economic model/approach to customer connections and capital allowances such that the gas network is developed in an economically robust manner and with a long term perspective to the potential number of economic connections. FE will utilise expert consultants to assist with this analysis through GD17 and would propose working with UR on an open book basis in relation to such analysis.

Operating Expenditure

FE recognises that it is important that both a top-down and bottom up approach to analysing operating expenditure is undertaken within the GD17 process. This process should recognise the requirement for a suitable level of operating expenditure to allow FE to develop and maintain its network and customer base. The process should also recognise that in benchmarking such operating expenditure the respective scale of a business cannot be simply pro-rata to operating expenditure and issues such as a minimum level of fixed cost and nature of the business, including factors such as geography need to be considered.

Volumes

Since 2005, FE has transparently reported to UR gas volume levels and currently, we provide quarterly volume and connection reports to UR.

90% of FE's volumes are supplied to industrial and commercial customers. Therefore, FE is greatly concerned about the potential loss of Gallaher's Ballymena plant, which is planned to close in 2017. This plant alone accounts for 6% of FE gas volume. We would ask UR to revisit its GD14 assumption that there should be no volume allowance for factory closures. At that time, UR believed another factory would open in its place, but this assumption has proved to be unfounded as it assumed that a new factory would open with a similar consumption, and that there was no time variable between a factory closing and a new one opening. With such volume uncertainty, a transparent evidence based bottom-up approach is needed in GD17.

[4] December 2014

Rates of Return

A suitable rate of return consistent with the risk profile of the business and cost of equity and debt needs to be applied to the GD17 term. FE will undertake detailed analysis of its view of the cost of equity and cost of debt along with all other weighted average cost of capital (WACC) inputs and risk factors and openly share this analysis with UR.

FE disagrees with UR's assertion that the GB headline WACC is an appropriate benchmark for the FE business. The reasons for this view are that FE is not a low risk business as it continues to develop its network area, and appropriate adjustments need to be made for FE's maturity, size and scale when compared to GB utilities.

FE also notes that UR has recently undertaken an effective market testing of cost of capital in the NI market in the context of the Gas to the West (GTTW) competitive tender. FE believes that this provides a point of reference to the cost of capital in NI networks and represents a robust reference, as compared to references such as the UK GDN's network rate. FE believes that there is a need to recognise the significant differences between GB and NI networks in relation to the price control.

Under-Recoveries

In relation to under-recoveries, FE's licence was awarded on the basis that FE would receive the same rate of return on any under-recoveries. Condition 4.10.4 establishes that the rate of return adjustment to encourage or discourage accumulated under-recoveries (X_u) shall be zero until Formula Year 2034, when it shall be the rate of return for 2033 +1. Therefore whilst the FE licence contains a designated parameter that allows UR to adjust the rate of return on under-recoveries below the allowed cost of capital, the licence does not provide for such an adjustment until 2034.

Although FE is keen to see under-recoveries reduced as fast as is practically possible, we do not consider setting deadlines for the removal of the current accumulated under-recovery to be a robust approach in the current period of price uncertainty with competing fuels. Given the current commodity prices for oil, we are concerned that Gas Distribution charges should not suddenly spike significantly in the short term (over-recovering) and then be followed by lower long term charges. We believe it is more beneficial to implement a steady recovery profile rather than one that has significant short term peaks and troughs.

Total Regulatory Value (TRV)

We have not yet closed out the TRV/Under-Recoveries position for GD14 following UR publication of the Final Determination on 20th December 2013. FE believes that this is not a positive backdrop to move into the GD17 process and would therefore welcome closing these items as soon as possible to permit a constructive GD17 process, which is void of any outstanding GD14 issues.

As UR is aware, FE queried the calculation of the TRV value in the determination document in relation to the following:

- a transposition error between the volumes for different categories of customer;
- an incorrect Depreciation Adjustment;
- a consequent amendment needed to the prices used to calculate under-recoveries and the application of gamma, the factor limiting new under-recoveries when actual volumes are higher than those determined at the last price control; and
- the addition of the retrospective adjustments needed to be split between opex in the Profile Adjustment and the different asset lives for capex in the Depreciated Asset Value.

Following the highlighting of our concerns, discussions were held in February 2014 and it was agreed that an adjustment to the TRV relating to the calculation of determined depreciation in the PCR2 determination should be made. In July 2014, FE agreed the TRV and since then FE has been waiting for final confirmation from UR.

In discussions in late 2014 on conveyance revenue, FE became concerned that UR intends to replace the conveyance revenue under the agreed netback arrangement with notional revenue calculated on the basis of assumptions used in deriving the published conveyance charges and this will have serious consequences for the FE business.

FE was granted a conveyance licence and a supply licence for the Ten Towns network area on 24th March 2005. As part of the licence process and the basis on which the investments were made, UR (formerly Ofreg) provided a side letter on the Proposed Grant of Licences, also dated 24th March 2005 (Side Letter). The Side Letter sets out, amongst other things, the netback mechanism agreed between the licensee and UR and states that the licensee will supply gas under the Supply Licence on a "no profit, no loss basis" (i.e. Supply must pay all net profit to Distribution). The Side Letter states (Paragraph 5.6) that:

> *"The Licensee will undertake its operations on the basis set out above (Paragraph 5.5), whilst there is <u>any</u> exclusivity under the Supply Licence <u>and</u> until there is no net under-recovery of revenue across all of the conveyance categories. Subject to the constraints set out in the price control, any under-recovery of revenue will be accumulated on an annual basis of return."* (emphasis added)

Therefore the netback arrangement shall continue until (a) FE no longer holds any exclusivity under its supply licence; and (b) there is no net under-recovery of revenue across all conveyance categories. Neither of these conditions has yet been met. Any change to the agreed TRV calculation and any potential disregard of the agreed netback arrangement during GD17 could endanger our ability to finance the further development of the network.

In addition, in relation to the consistent regulatory calculation of TRV, FE believes that in a developing an immature network, appropriate future operating costs should continue to be capitalised.

Examiner/Audit of Specific Information

FE is concerned about the UR's proposal to reserve the right to appoint an examiner to examine the recording of relevant information by the GDNs. This issue was discussed within the Competition Commission's Final Determination on NIE's RP5 price control, which states that, "*We did not find that the introduction of a reporter was the best way to achieve greater data transparency".* It was determined rather that, "*greater data transparency would be best achieved through the publication of more useful data which would be prepared according to clearly-defined rules".*

FE has been providing UR with annual cost reporting data since 2010, which ties in with the Competition Commission preferred approach to transparency of focusing on the amount of useful and comparable data which the company produces. Therefore we do not believe that this additional regulatory process is necessary to ensure a successful outcome to the GD17 process, and indeed may cause significant delays.

In addition, FE believes that the use of audits of specified information relating to the GD17 price control is also a unnecessary process, given UR has proposed that the Board of the GDN takes "responsibility for and sign-off the assurance of the data and plans submitted for the GD17 price control."

Smart Meters

FE would welcome further engagement with UR and the other NI GDNs in relation to developing a joined up and cost effective approach to the roll-out of smart metering in NI. This is especially pertinent to FE as 80% of FE's current domestic base use pay-as-you-go meters.

Incentives and Innovation

FE would request further clarity from UR on this subject and how it will operate in the GD17 process. It would also be beneficial to understand if mechanisms as utilised within Ofgem's RIIO model will be applied.