

# **WTL Facilitating Pre-Construction Financing**

## **Proposed Modification of Gas Conveyance Licence**

### **Notice under Article 14(2) of the Gas (Northern Ireland) Order 1996**

**Consultation  
28 March 2018**



## About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

### Our Mission

Value and sustainability in energy and water.

### Our Vision

We will make a difference for consumers by listening, innovating and leading.

### Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

## Abstract

This paper gives notice of the modifications the Utility Regulator proposes to make to the gas conveyance licence of West Transmission Limited (WTL) to facilitate pre-construction financing of the network, along with a few minor amendments to improve clarity and transparency. In particular the modifications amend the process by which the capital allowance for network construction will be determined. This allowance will be paid by WTL to SGN Natural Gas Limited (SGN) who are constructing the network on behalf of the licence holder.

## Audience

This document will be of interest to both WTL and SGN. It is also likely to be of interest to other regulated companies in the energy industry, government and other statutory bodies as well as consumer groups with an interest in the energy industry.

## Consumer Impact

By facilitating pre-construction financing the proposed modifications will allow consumers to lock-in the benefit of the historically low cost of debt that currently exists. Pre-construction financing will therefore deliver benefits to consumers for up to 40 years. Even in the absence of this cost of debt benefit, consumers will benefit from limiting the period of time over which they are required to pay return to SGN and Phoenix Natural Gas for constructing the Gas to the West and East Down network extensions respectively.

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# ACRONYMS AND GLOSSARY

AFCE	Actual Controllable Capital Expenditure
ARE	Adverse Regulatory Event
DPO	Designated Pipeline Operator
FOIA	Freedom of Information Act
NIE	Northern Ireland Electricity – now known as NIEN
OAV	Opening Asset Value
PE	Polyethylene
PNGL	Phoenix Natural Gas Limited
PoT	Postalised Transmission
RPI	Retail Price Index
SGN	SGN Natural Gas Limited
SONI	System Operator Northern Ireland (electricity network)
VFCE	Verified Controllable Capital Forecast
WTL	West Transmission Limited

# NOTICE UNDER ARTICLE 14(2) OF THE GAS (NORTHERN IRELAND) ORDER 1996

In pursuance of its powers under Article 14(1) of the Gas (Northern Ireland) Order 1996 (as amended) (the “Order”) the Northern Ireland Authority for Utility Regulation (hereafter referred to as the Utility Regulator) hereby gives notice under Article 14(2) as follows:

The Utility Regulator proposes to modify the gas conveyance licence held by West Transmission Limited. The proposed modifications will:

- Amend the process by which the capital allowance for constructing the Gas to the West network extension will be determined, although there will continue to be only one final determination. This is now scheduled for a pre-determined Cut-Off Date, 30 months after the First Operational Commencement Date. In addition there will also be a provisional estimate of the final determination value made by the Utility Regulator 21 months after the First Operational Commencement Date.
- Provide for amending the VFCE (Verified Controllable Capital Forecast) and AFCE (Actual Controllable Capital Expenditure) values in light of a number of new concepts including Fixed and Capped Sums, Change of Law and the treatment of capital expenditure incurred after the Cut-Off Date as an Eligible Pass-Through Cost.
- Limit the period over which SGN can earn returns on their investment in the network to 21 months after the First Operational Commencement Date.
- Provide a return of 5.3% (real) to the £50m of capital allowance that relates to the PE (polyethylene) intermediate pressure pipeline section of the network extension, while retaining the return of 1.98% (real) for the steel high pressure section of the network.
- Revise the calculation of Required Revenue to take account of the proposed method of raising the required finance.
- Introduce the concept of an Adverse Regulatory Event into the licence.
- Remove the Concept of an Approved Surplus from the calculation of Required Revenue.
- Amend the definition of Eligible Pass-Through Costs to provide financiers with greater certainty as to the costs so categorised.
- Introduce a switch into the licence that will switch of Part 4 and Conditions 2.27.1 to 2.27.4 as well as 2.27.6 with respect to Network Development Duties, of the

existing licence and switch on the proposed Part 6 of the licence once the Authority has issued a Direction to the licence holder.

- Enhance clarity and transparency of the licence drafting through correction of a number of minor drafting issues.

The reasons for and effects of these modifications are explained in sections 2 to 5 of this document. The proposed modifications are set out in Annexes 1 to 4 of this document.

The purpose of this notice is to bring the proposed modifications to the attention of persons likely to be affected by them, and to invite representations or objections in connection thereto. In line with Article 14(3) of the Order, any representations or objections with respect to the proposed modifications may be made on or before 12.00 noon on 27 April 2018 to:

Graham Craig  
Utility Regulator  
Queens House  
14 Queens Street  
Belfast BT1 6ED

Email: [Gas\\_networks\\_responses@uregni.gov.uk](mailto:Gas_networks_responses@uregni.gov.uk) with cc to [graham.craig@uregni.gov.uk](mailto:graham.craig@uregni.gov.uk)

The Utility Regulator has, pursuant to Article 14(4) of the Order, served a copy of this notice on the licensees and sent a copy to the Department for the Economy. The Utility Regulator has also sent a copy of this notice to the Consumer Council.

Dated this 28th March 2018.



**Jenny Pyper**

**Chief Executive**

**For and behalf of the Northern Ireland Authority for Utility Regulation**

# 1 Introduction

## Purpose of this Document

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- 1.1 Our principal objective in carrying out the duties associated with our gas functions is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland, and to do so consistently with our fulfilment of the objectives set out in the European Gas Directive<sup>1</sup>, and by having regard to a number of matters, as set out more fully in the Energy (Northern Ireland) Order 2003.
- 1.2 In line with these duties this document sets out proposals to modify the gas conveyance licence held by West Transmission Limited<sup>2</sup> (WTL). The proposed modifications have been deemed necessary to facilitate the pre-construction financing of the network by the licence holders.
- 1.3 The proposed licence modifications will:
  - Amend the process by which the capital allowance for constructing the Gas to the West network extension will be determined, although there will continue to be only one final determination. This is now scheduled for a pre-determined Cut-Off Date, 30 months after the First Operational Commencement Date. In addition there will also be a provisional estimate of the final determination value made by the Utility Regulator 21 months after the First Operational Commencement Date.
  - Provide for amending the VFCE<sup>3</sup> and AFCE<sup>4</sup> values in light of a number of new concepts including Fixed and Capped Sums, Change of Law and the treatment of capital expenditure incurred after the Cut-Off Date as an Eligible Pass-Through Cost.
  - Limit the period over which SGN can earn returns on their investment in the network to 21 months after the First Operational Commencement Date.
  - Provide a return of 5.3% (real) to the £50m of capital allowance that relates to the PE (polyethylene) intermediate pressure pipeline section of the network extension, while retaining the return of 1.98% (real) for the steel high pressure section of the network.
  - Revise the calculation of Required Revenue to take account of the proposed method of raising the required finance.

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<sup>1</sup> Directive 2009/73/EC of the European Parliament and the Council of 13 July concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC.

<sup>2</sup> This is the licence granted to Northern Ireland Energy Holdings Limited on 11 February 2015 and last modified on 15 January 2018.

<sup>3</sup> Verified Controllable Capital Forecast.

<sup>4</sup> Actual Controllable Capital Expenditure.



- Introduce the concept of an Adverse Regulatory Event into the licence.
- Remove the Concept of an Approved Surplus from the calculation of Required Revenue.
- Amend the definition of Eligible Pass-Through Costs to provide financiers with greater certainty as to the costs so categorised.
- Introduce a switch into the licence that will switch of Part 4 and Conditions 2.27.1 to 2.27.4 as well as 2.27.6 with respect to Network Development Duties, of the existing licence and switch on the proposed Part 6 of the licence once the Authority has issued a Direction to the licence holder.
- Enhance clarity and transparency of the licence drafting through correction of a number of minor drafting issues.

## Background & Overview

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- 1.4 After a competitive process, a licence was awarded to WTL in February 2015 to convey gas to the following towns in Tyrone and Fermanagh.
- Strabane
  - Dungannon including Coalisland
  - Omagh
  - Cookstown including Magherafelt
  - Enniskillen including Derrylin
- 1.5 The town of Strabane was connected in January 2017 and work has begun on the main part of the network. It is anticipated that the first operational commencement date is expected to be during the final quarter of 2018. Consistent with their original licence application WTL is working in partnership with SGN (SGN Natural Gas Limited) to deliver the network. SGN is responsible for constructing and financing the network prior to it being handed over to WTL. A key part of the licence application bid was the proposal for WTL to raise finance by raising a bond to pay SGN for their investment once the network is fully operational.
- 1.6 The current licence was designed to facilitate these arrangements. For example Condition 4.5.3 (e) permits the licence holder to request the rate of return to be fixed for an extended period over a number of price control periods. It was envisaged that this rate of return would match the interest rate paid on the bond. The licence contains provision for Eligible Pass-Through Costs to be fully funded by consumers. This provision is in line with the Belfast Gas Transmission and Premier Transmission licences and was included to facilitate financing entirely by debt in the form of a corporate bond.

- 1.7 Noteworthy for the purpose of this consultation is that it was envisaged that the licence conditions in Part 4 of the current licence relating to capital allowances and the opening asset value would be used to set the value that WTL would pay to SGN for their investment in the network.
- 1.8 With our agreement WTL has since explored the feasibility of raising the necessary finance pre-construction as opposed to post construction as originally intended. Expert advice provided by Moody's and BNP Paribas has led WTL to conclude that pre-construction financing is not only feasible but can also be achieved at no premium to the financiers in relation to post construction financing. On this basis and taking account of the historically low cost of debt for corporate bonds, WTL has sought our agreement to go to market in the first half of 2018 while the main pipeline network is still being constructed.
- 1.9 We have reviewed the WTL proposal and are content, based on our own independent expert advice that pre-construction financing is both feasible and beneficial to consumers. It should be noted however that any final decision to proceed will only be made at the point at which the bond agreement is signed and a Direction is issued by the Authority.
- 1.10 In effect the only alteration to the process that was envisaged at the point at which the licence was granted is the timing of when WTL will raise the necessary finance from post to pre-construction. Facilitating this change will require some amendments to the process by which capital allowances are calculated. This will include providing greater certainty as to the timing of any final determination of capital allowances. It will also mean that the period over which SGN receive a return on their investment will be limited and provide certainty as to the payment of Phoenix Natural Gas for their investment in the East Down network.
- 1.11 We also propose to reflect the final network design in the return SGN will earn for their investment in the network, in particular the substitution of intermediate pressure PE (polyethylene) pipe for high pressure steel pipe.
- 1.12 We furthermore propose to correct a number of minor drafting issues in the interest of clarity and transparency of licence drafting.

## Responding to the Consultation

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- 1.13 Responses to this consultation paper should be submitted by 12.00 noon on 27 April 2018. Responses should be sent to:  
Graham Craig  
Utility Regulator  
Queens House

14 Queens Street

Belfast BT1 6ED

Email: [Gas\\_networks\\_responses@uregni.gov.uk](mailto:Gas_networks_responses@uregni.gov.uk) with cc to  
graham.craig@uregni.gov.uk

- 1.14 The Utility Regulator's preference would be for responses to be submitted by e-mail.
- 1.15 Individual respondents may ask for their responses (in whole or in part) not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, the Utility Regulator will also ask respondents to supply the redacted version of the response that can be published.
- 1.16 As a public body and non-ministerial government department, the Utility Regulator is required to comply with the Freedom of Information Act (FOIA). The effect of FOIA may be that certain recorded information contained in consultation responses is required to be put into the public domain. Hence it is now possible that all responses made to consultations will be discoverable under FOIA, even if respondents ask us to treat responses as confidential. It is therefore important that respondents take account of this. In particular, if asking the Utility Regulator to treat responses as confidential, respondents should specify why they consider the information in question should be treated as such.
- 1.17 This paper is available in alternative formats such as audio, Braille etc. If an alternative format is required, please contact the office of the Utility Regulator, which will be happy to assist.

## Document Structure

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- 1.18 This consultation paper is structured in a number of chapters as follows:
  - *Chapter 1 Introduction* provides background as to the reasons for the proposed modifications and their effect;
  - *Chapter 2 Proposed Modification – Part 3 Additional Special Conditions* details the modified licence conditions with this respect as well as the associated reasons and effects;
  - *Chapter 3 Proposed Modification – Part 4 Price Control Conditions* details the modified licence conditions with this respect as well as the associated reasons and effects;
  - *Chapter 4 Proposed Modification – New Part 5 Special Condition – Re-Financing* details the new licence conditions with this respect as well as the associated reasons and effects;

- *Chapter 5 Proposed Modification – New Part 6 Price Control Conditions After Re-Financing* details the modified licence conditions with this respect as well as the associated reasons and effects;
- *Chapter 6 Next Steps* sets out the proposed next steps and associated timelines for the licence modification process;
- *Chapter 7 Annexes* provides an overview over the annexes to this consultation paper.

1.19 For each Part of the licence, there is an annex in which we set out the proposed licence modifications as tracked changes to the current licence conditions. Within the annexes proposed deletions are indicated by red text that has been struck through, proposed additions are indicated by red text highlighted in yellow.

## 2 Proposed Modification – Part 3 Additional Special Conditions

### Proposed Licence Modifications

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- 2.1 We propose to update a number of erroneous cross-references in Condition 3.1.
- 2.2 We furthermore propose to delete the terms “(UK GAAP)” and “(IFRS)” from Condition 3.1.6, Accounting Statements as these abbreviations are introduced in Condition 1.2.9, Form of financial statements.
- 2.3 Details of these modifications are set out in Annex 1 to this consultation paper.

### Reasons and Effects

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- 2.4 The proposed update of erroneous cross-references serves to correct known drafting errors. This will enhance clarity and transparency of licence drafting.
- 2.5 The proposed deletion of the terms “(UK GAAP)” and “(IFRS)” removes superfluous drafting from the licence. This will enhance clarity and transparency of licence drafting.

### 3 Proposed Modification – Part 4 Price Control Conditions

#### Proposed Licence Modifications

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- 3.1 We propose to modify the Capital Expenditure Condition 4.2 by inserting new sections at Condition 4.2.2, Fixed and Capped Sums and at Condition 4.2.3, Actions Taken Before Part 4 Comes Into Effect.
- 3.2 Condition 4.2.2 introduces two additional concepts into the determination of the Verified Controllable Capital Expenditure Forecast determination by the Authority. The first is the Fixed Sum for a particular activity which will have the same value in both the Actual Controllable Capital Expenditure and Verified Controllable Capital Expenditure Forecast determinations irrespective of actual expenditure. The second is the Capped Sum which puts a cap on the value for a particular activity in the determination of Actual Controllable Capital Expenditure irrespective of actual expenditure.
- 3.3 Condition 4.2.3 provides that any decisions the Authority might make prior to the coming into effect of the modification that it would be entitled to make under the provisions of Condition 4.2.2, shall be treated as having been made in accordance with Condition 4.2.2. This modification will not be reflected in the proposed new Part 6 of the licence as it will be unnecessary there.
- 3.4 We furthermore propose to modify Condition 4.2.1(f) by including reference to the consideration of Fixed Sum and Capped Sum in the determination of the Actual Controllable Capital Expenditure. We also propose to make a consequential modification to Condition 4.1.2, Definitions.
- 3.5 Also, as a consequential change to the proposed introduction of the new Part 5 of the licence (for further details see chapter 4), we propose to insert a new paragraph (a) in Condition 4.1.1 which refers to the provisions of Part 5 and their relevance for the cessation of Part 4.
- 3.6 We also propose to include clarification, in Condition 4.1.3, Eligible Operating Pass-Through Costs, that the sum of such costs is determined by the Authority.
- 3.7 Also, in Condition 4.5.8, Grants Received, we propose to clarify that  $m=p$  is the first month that the capital grant is received by the Licensee where this month is before the First Operational Commencement Date.

- 3.8 In addition, we propose to make a number of minor drafting corrections and clarifications in:
- Conditions 4.3.2, Revenue Restriction during the Period of Designation;
  - Condition 4.4.3, Definition of Formula Terms;
  - Condition 4.5.4, The Error Correction Mechanism;
  - Condition 4.7, The Approved Surplus and Other ARR Components;
- 3.9 We furthermore propose to renumber the sub conditions of Part 4 as appropriate as a result of the above mentioned modifications.
- 3.10 The text of these modifications are set out in Annex 2 to this consultation paper.

## Reasons and Effects

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- 3.11 The proposed introduction of paragraph (a) in Condition 4.1.1 is consequential to the proposed introduction of the new Part 5 of the licence. For the associated reasons and effects see chapter 4 of this document.
- 3.12 The proposed modifications of the definitions in Condition 4.1.2 to define a “Capped Sum” and a “Fixed Sum” by reference to Condition 4.2.2(c) and 4.2.2(b) respectively are consequential to the introduction of these concepts in respect of the determination of Actual Controllable Capital Expenditure in Conditions 4.2.2 and 4.2.3.
- 3.13 The proposed modifications to Condition 4.2.1(f) is consequential to the introduction of the concept of a “Fixed Sum” and a “Capped Sum” in respect of the determination of Actual Controllable Capital Expenditure in Conditions 4.2.2 and 4.2.3. The reason and effect of the proposed modification is to allow the Authority to amend the Actual Controllable Capital Expenditure as it considers appropriate to give effect to any Fixed Sum or Capped Sum that is determined by the Authority in accordance with proposed Condition 4.2.2.
- 3.14 The proposed introduction of Condition 4.2.2 makes provision for the determination of “Fixed Sums” and “Capped Sums” for the purpose of approval or determination of the Allowable Controllable Capital Expenditure in accordance with Condition 4.2.1(f). The reasons and effect of the determination of a “Fixed Sum” is to allow a sum which is determined as fixed at the time of the Verified Controllable Capital Expenditure Forecast to be included in the Allowable Controllable Capital Expenditure. The reasons and effect of the determination of a “Capped Sum” is to allow a sum determined as capped at the time of the Verified Controllable Capital Expenditure Forecast to be capped in the determination of the Allowable Controllable Capital Expenditure so that costs

included in the Allowable Controllable Capital Expenditure is limited to the lesser of the expenditure incurred or the capped amount.

- 3.15 The proposed introduction of Condition 4.2.3 allows actions taken as part of any determination of Verified Controllable Capital Expenditure Forecast before these proposed modifications come into effect to be purposively construed in respect of the determination of Fixed Sums or Capped Sums. The reason and effect of the proposed modifications is to allow any determination of Verified Controllable Capital Expenditure Forecast made prior to Condition 4.2.2 coming into effect to be construed purposively and for the Authority to be deemed to have determined a Fixed Sum or Capped Sum where that is the clear purpose and substantive effect of the determination (regardless of the terminology used in it).
- 3.16 The proposed amendments to 4.1.3, Eligible Operating Pass-Through Costs and 4.5.8, Grants Received are designed to add clarity to the licence drafting. The underlying policy has not changed and the proposed changes are expected to have little or no impact on the licence holder.
- 3.17 The minor drafting corrections and clarifications in Conditions 4.3.2, 4.4.3, 4.5.4 and 4.7 are designed to address grammatical inconsistencies, erroneous numbering and cross-references, wording inconsistencies as well as superfluous wording. This will enhance clarity and transparency of licence drafting.



## 4 Proposed Modification – New Part 5 Special Condition – Re-Financing

### Proposed Licence Modifications

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- 4.1 We propose to modify the licence by adding a new Part 5 of the licence that will consist of a single licence condition 5.1 with four sub conditions:
- Condition 5.1.1 Cessation of Part 4
  - Condition 5.1.2 Coming into effect of Part 6
  - Condition 5.1.3 Co-ordination of directions
  - Condition 5.1.4 Transitional Provisions
- 4.2 The text of this new Condition 5.1 is set out in Annex 3 to this consultation paper.

### Reasons and Effects

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- 4.3 New Conditions 5.1.1 to 5.1.4 taken together act as a switch that when triggered will switch off Conditions 2.27.1 to 2.27.4 as well as 2.27.6 with respect to Network Development Duties, and all the conditions in Part 4 of the existing licence and switch on the conditions that we propose to include in the new Parts 6 of the licence. The trigger will be a Direction issued by the Authority to that effect.
- 4.4 The WTL licence was granted with the understanding that, as set out in their licence application, WTL would finance the Gas to the West extension entirely through the issuance of a corporate bond.
- 4.5 Our [decision](#) to approve the East Down extension<sup>5</sup> included the provision that the project would be partially funded through the postalised transmission tariff. To achieve this WTL would make a financial contribution to Phoenix Natural Gas which would also be financed through the corporate bond.
- 4.6 As set out in chapter 1, WTL has explored the feasibility of raising the necessary finance pre-construction as opposed to post construction as originally intended. With consideration of the outcomes of this assessment WTL has sought our agreement to go to market in the first half of 2018 while the main pipeline network is still being constructed.

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<sup>5</sup> The East Down extension relates to the extension of the PNGL natural gas network to 13 towns in the East Down area. The extension was approved by the Utility Regulator on 10<sup>th</sup> December 2015 and construction is expected to be completed during the first half of 2019.

- 4.7 It is necessary to modify the licence now as it will allow WTL and SGN to make the necessary amendments to their contractual arrangements to facilitate pre-construction financing. It will also permit WTL to market the corporate bond on the basis of enduring licence conditions.
- 4.8 However there can never be certainty as to prevailing market conditions at any particular point in the future. So it might be that issuing a corporate bond in the first half of 2018 might not be in the interests of consumers. We therefore consider it advisable that the current licence conditions remain in force up until the point at which they need to be replaced by the new arrangements.
- 4.9 Providing a switch within the licence that is a trigger archives these objectives.
- 4.10 Discussions with West Transmission have persuaded us that in order for pre-construction finance to deliver the best outcome for consumers, financiers will require consumers to bear any residual construction risk that may exist at the point at which the Direction is issued by the Authority. We therefore proposed that the trigger not only switches off Part 4 of the existing licence but also Conditions 2.27.1 to 2.27.4 as well as 2.27.6 with respect to Network Development Duties. This will have the effect of removing the Authority's ability to take enforcement should the licence holder fail to meet their development duties.
- 4.11 We find it difficult to envisage circumstances in which West Transmission would have any incentive to frustrate the Authority on developing the network. We also note that the Gas Distribution 2017 Price Control determination<sup>6</sup> imposes a volume incentive on Scotia Gas Networks Northern Ireland that provides an incentive to develop the network.
- 4.12 This does not mean of course that some external event such as insolvency of the mains work contractor could not disrupt network development. But in any case it would hardly seem appropriate to use enforcement action to deal with such an eventuality. Also, construction of the network will have significantly progressed by the time the Authority is able to issue a Direction, no earlier than the end of June 2018. It is conceivable that having the finance to hand would place West Transmission in a stronger position to address any unforeseen impediment network development than if the finance was yet to be raised.
- 4.13 The proposed licence modification does not in itself switch off the Network Development Duties. This only occurs once the Direction is issued. The Authority can always delay the issue of a Direction should it consider that it is necessary to retain these duties.

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<sup>6</sup> [Price Control for Northern Ireland's Gas Distribution Networks GD17, Final Determination, 15 September 2016.](#)

- 4.14 For these various reason we consider that our proposed modification, while potentially transferring some residual construction risk from financiers to consumers in return for pre-construction financing at a competitive cost, will facilitate us acting in line with our statutory duties.

## 5 Proposed Modification – New Part 6 Price Control Conditions After Re-Financing

### Proposed Licence Modifications

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- 5.1 This proposed modification creates a new Part 6 of the WTL licence. This Part 6 will consist of:
- A number of conditions that are currently in Part 4 of the licence that will be switched off as a result of the trigger mechanism we propose to introduce, but which continue to be required. In addition certain of these conditions will require additional amendment to facilitate the proposed financing arrangements.
  - A number of new conditions that are proposed specifically to facilitate the proposed financing arrangements.
- 5.2 The text of the conditions in this new Part 6 is set out in Annex 5 to this consultation paper. Table 2 below maps licence conditions between the current Part 4 and the new Part 6.

**Table 1: Licence Conditions Mapped from Part 4 to Part 6**

<b>Part 4</b>	<b>Condition</b>	<b>Part 6</b>
4.1.1	General Provisions	6.1.1
4.1.2	Definitions	6.1.2
	Adverse Regulatory Event	6.1.3
4.1.3	Eligible Pass-Through Costs	6.1.4
4.1.4	Reporting	6.1.5
4.2.1	Allowed Capital Expenditure	6.2.1
4.2.2	Fixed and Capped Sums	6.2.2
4.2.3	Actions Taken Before Part 4 Comes Into Effect	
4.2.4	Uncontrollable Capital Expenditure	6.2.3
	Change of Law	6.2.4
4.3.1	Revenue Restriction if no Designation Order	6.3.1
4.3.2	Revenue Restriction during the Period of Designation	6.3.2
4.4.1	Forecast Required Revenue	6.4.1
4.4.2	Actual Required Revenue	6.4.2
4.4.3	Definition of Formula Terms	6.4.3
	Ratio Account Credit	6.4.4
	OAV <sup>7</sup> Deduction	6.4.5
	OAV Addition	6.4.6
	Licensee's Forecast OAV	6.4.7
	Actions Taken Before Part 6 Comes Into Effect	6.4.8
	The Fixed Amount	6.5.1
	The Licensee's Revenue Entitlement	6.5.2
4.5.1	Capital Revenue Requirement	
4.5.2	The Monthly Capital Revenue Requirement	
4.5.3	The Rate of Return	6.5.3
4.5.4	The Error Correction Mechanism	
4.5.5	The Opening Asset Value	6.5.4
4.5.6	The Allowed Capital Expenditure	6.5.5
4.5.7	Capitalised Interest	6.5.6
4.5.8	Grant Funding	6.5.7
4.5.9	Early Section Completion	6.5.8
	Base Return	6.5.9
	Supplemental Return	6.5.10
	Forecast Inflation Figures	6.5.11
4.6.1	The Postalisation Adjustment	6.6.1
	DPO <sup>8</sup> Payment Failures	6.6.2
4.7.5	The Termination Payments	6.7.1
4.7.6	The Supplemental Income	6.7.2
4.8.1	Allowed Revenue after the Final Payment Date	6.8.1
	Certain Conditions to apply until the Final Repayment Date	6.9
4.7.1	Approved Surplus	
	General	6.10.1
4.7.2	Determined Controllable Operating Expenditure	6.10.2
4.7.3	Actual Controllable Operating Expenditure	6.10.3
4.7.4	Definition of Controllable Operating Expenditure	6.10.4

<sup>7</sup> Opening Asset Value.

<sup>8</sup> Designated Pipeline Operator.

- 5.3 We set out below a description of each of the new licence conditions that we propose to include in the new Part 6 of the licence. While each is a new condition, the table above illustrates that many of these new conditions can be mapped back to conditions in Part 4 which were consulted on previously. We therefore intend to restrict our comments to those conditions, or parts of conditions which are either entirely new or have been materially modified.

### **Condition 6.1 General Provisions, Definitions and Reporting**

- 5.4 This Condition is equivalent to Condition 4.1 in Part 4 of the existing licence.
- 5.5 Similar to our proposed modification to Part 4 (for further details see chapter 3), and as a consequential change to the proposed introduction of the new Part 5 of the licence (for further details see chapter 4), we propose for Condition 6.1.1(a) to refer to the provisions of Part 5 and their relevance for the taking effect of Part 6.
- 5.6 We propose furthermore to amend the Definitions section, Condition 6.1.2, so that it fully reflects the various conditions contained in the proposed Part 6 of the licence. This will involve deletion, addition and modification of the definitions currently in Condition 4.1.2. We draw particular attention to a number of instances in which the definitions will be set out in the Authority's Direction rather than on the face of the licence, in particular the definition of ARE<sup>9</sup> Suspense Account and Available Post-ARE Cash.
- 5.7 We propose to add a new section, Condition 6.1.3 Adverse Regulatory Event. This is a concept that has previously been adopted in the regulatory framework for the financing of Belfast Gas Transmission and Premier Transmission. However in those instances the cause and effect of such an event is not set out on the face of the licence but rather in other documents. We propose in this instance to include all the relevant details on the face of the licence. The Condition sets out the various circumstances which might constitute an Adverse Regulatory Event. The consequences of such an event are set out in Condition 6.4.4, Ratio Account Credit. The inclusion of the concept has also required us to propose a number of new definitions in Condition 6.1.2 including,
- Adverse Regulatory Event Period,
  - Adverse Regulatory Event Year,
  - ARE Rectification Gas Year,
  - ARE Suspense Account,

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<sup>9</sup> Adverse Regulatory Event.

- Ratio Account Credit,
- Net Debt Service,
- Available Post-ARE Cash
- Transaction Authorisation.

5.8 We propose to amend the definition of Eligible Pass-Through Costs, Condition 6.1.4 in a way which gives greater certainty to potential financiers that all operating expenditure incurred in the carrying out of the licenced business will be funded by consumers. In particular the definition has been amended to specifically include:

- Capital expenditure other than Actual Controllable and Uncontrollable Capital Expenditure that is determined in accordance with Condition 6.2;
- Monies required to maintain suitable balances in accounts necessary to meet financier's requirements;
- A sweeper to cover all eligible expenditure which has not been specifically mentioned elsewhere in the condition;
- Clarification that Eligible Pass-Through Costs are to be interpreted as a cash-flow rather than accruals-based concept.

Amounts incurred as a result of changes in law and determined in accordance with Condition 6.2.4 are proposed to be excluded from Eligible Pass-Through Costs.

5.9 We propose no material amendments to the Reporting requirements, Condition 6.1.5 from those that are currently in Part 4 of the licence. We note, however, the proposal to provide clarification that the method to be provided for in the compliance plan shall account for Actual Controllable Capital Expenditure or Actual Uncontrollable Capital Expenditure not being treated as Eligible Pass-Through Cost, in line with the amended definition of Eligible Pass-Through Costs.

### **Condition 6.2 Capital Expenditure**

- 5.10 This Condition is equivalent to Condition 4.2 in Part 4 of the existing licence.
- 5.11 We propose to amend the Allowed Capital Expenditure section, Condition 6.2.1. Some changes such as the proposed introduction of "high pressure" in Condition 6.2.1(h)(ii)(A) are minor and designed to enhance consistency of licence drafting.
- 5.12 Other proposed amendments are more material. One of these will commit the Authority to providing the parties with a value relating to the Provisional Controllable and Uncontrollable Capital Expenditure figures no later than 21 months after the First Operational Commencement Date. These Provisional

figures will include both actual expenditure which has already occurred and an estimate of additional capital expenditure that will be incurred prior to the Cut-Off Date which is proposed to be 30 months after the First Operational Commencement Date, see definition in Condition 6.1.2.

- 5.13 The proposed amendment will also commit the Authority to making a final determination of Actual Controllable and Uncontrollable Capital Expenditure by no later than the Cut-Off Date.
- 5.14 A further amendment will also allow the Authority to amend its previous determination of the Verified Controllable Capital Forecast to take account of capital expenditure that was included in the original forecast but which has not actually occurred prior to the Cut-Off Date. Such capital expenditure, if and when it occurs, will then be treated as an Eligible Pass-Through Cost. As noted above we propose to amend the definition of Eligible Pass-Through Costs, Condition 6.1.4 accordingly.
- 5.15 We propose to add a new section, Condition 6.2.2 Fixed and Capped Sums and to include reference in Condition 6.2.1 to the consideration of Fixed Sum and Capped Sum in the determination of the Actual Controllable Capital Expenditure. We also propose that an equivalent modification will be made to Conditions 4.1 and 4.2 of the existing licence. A full explanation of the reasons and effects of this modification is set out in Chapter 3 above.
- 5.16 We propose no material amendments to Uncontrollable Capital Expenditure, Condition 6.2.3 from those that are currently in Part 4 of the licence.
- 5.17 We propose to add a new Condition 6.2.4, Change of Law. This is a concept that is incorporated into other licences, for example SONI and NIE. However in this instance it is restricted to the impact of such changes on capital expenditure. The Authority will be permitted to amend its determination of Verified Controllable Capital Forecast to reflect a change of law.

### **Condition 6.3 Revenue Restriction**

- 5.18 This Condition is equivalent to Condition 4.3 in Part 4 of the existing licence.
- 5.19 We propose no material amendments to the Revenue Restriction, Condition 6.3 from those that are currently in Part 4 of the licence.

### **Condition 6.4 Forecast & Actual Required Revenue**

- 5.20 This Condition is equivalent to Condition 4.4 in Part 4 of the existing licence.



- 5.21 We propose no material amendments to Forecast Required Revenue, Condition 6.4.1 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.
- 5.22 We propose to amend the Actual Required Revenue formula, Condition 6.4.2 as follows:
- Replacement of the  $A_t$  Capital Revenue Requirement term with  $F_t$  Fixed Amounts (see Condition 6.5.1).
  - Insertion of three new terms  $G_t$ , Ratio Account Credit,  $H_t$  OAV Deduction and  $I_t$  OAV Addition (see Conditions 6.4.4, 6.4.5 and 6.4.6 respectively)
  - Deletion of the  $Z_t$  and  $S_t$  terms relating to the calculation of the Approved Surplus which we propose to delete from the regulatory regime for WTL.
- 5.23 We propose to amend the Definition of Formula Terms, Condition 6.4.3 in line with our proposed amendments to Condition 6.4.2 above.
- 5.24 We propose to introduce a new section Ratio Account Credit, Condition 6.4.4. This includes the formula used to calculate the Ratio Account Credit in each year using the Net Debt Service Value and the number of days in the Gas Year during which an Adverse Regulatory Event is in progress<sup>10</sup>.
- 5.25 We propose to introduce a new section OAV Deduction, Condition 6.4.5. The value of this term will be zero other than during OAV Adjustment Years, which are restricted to three Gas Years following the Cut-Off Date. During this period the OAV Deduction is one third the value of the OAV Shortfall. This shortfall is equal to the amount (if any) by which the Licensee's Forecast OAV, Condition 6.4.7 exceeds the calculation of the Opening Asset Value, Condition 6.5.4.
- 5.26 We propose to introduce a new section OAV Addition, Condition 6.4.6. The value of this term will be zero other than during OAV Adjustment Years, which are restricted to three Gas Years following the Cut-Off Date. During this period the OAV Addition is one third the value of the OAV Surplus plus the true-up rate of return (3.5%). This surplus is equal to the amount (if any) by which the Licensee's Forecast OAV, Condition 6.4.7 is less than the calculation of the Opening Asset Value, Condition 6.5.4.
- 5.27 We propose to introduce a new section Licensee's Forecast OAV, Condition 6.4.7. This requires the licence holder immediately after the Direction under Condition 5.1.2 is issued, to submit for approval a statement specifying the different uses to which the amount drawn down under the Financial Documents

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<sup>10</sup> For a full explanation of how the Ratio Account mechanism is expected to operate see section on Reasons & Effects below.

will be put, including in particular the element that is assigned to fund the Opening Asset Value, Condition 6.5.4.

- 5.28 We propose to introduce a new section Actions Taken Before Part 6 Comes Into Effect, Condition 6.4.8. This provides that any action or resulting decision that either the licence holder or the Authority is permitted or required to take under the provisions of Condition 6.4.7, if taken prior to the coming into force of Part 6, shall have the same effect as if they had been taken after the coming into effect of Part 6 of the licence.

### **Condition 6.5 The Licensee's Capital Revenue Entitlement**

- 5.29 This Condition is equivalent to Condition 4.5 in Part 4 of the existing licence.
- 5.30 We propose to introduce a new section Fixed Amounts, Condition 6.5.1 which will include the values to be included in the  $F_t$  term in the formula to calculate the Actual Revenue Requirement, Condition 6.4.2. The table however is empty at present as no monies have as yet been drawn down under the Financial Documents. The Condition therefore provides that the table can be populated by means of a Direction issued by the Authority. This Direction may also make any consequential or supplemental amendments as the Authority considers appropriate, in particular for indexation. The Direction may also make provision for the amendment of the definition of Eligible Pass-Through Costs, Condition 6.1.4 and the definition of ARE Suspense Account and Available Post-ARE Cash. Any Direction issued by the Authority will have the effect of modifying the relevant conditions in the licence, Condition 6.1.4, Eligible Pass-Through Costs and Condition, 6.5.1 The Fixed Amount as well as Condition 6.1.2, Definitions.
- 5.31 We propose to introduce a new Condition 6.5.2, The Licensee's Revenue Requirement to clarify that save to the extent expressly provided for by the operation of the provisions with respect to OAV Deduction and Addition, nothing in Conditions 6.5.3 to 6.5.11 shall affect the calculation of the Actual Required Revenue, or the entitlement of the licence holder to recover the Actual Required Revenue.
- 5.32 We propose to amend The Rate of Return, Condition 6.5.3 such that it is expressed as a fixed monthly value equal to 1.98% (real) which is the default value included in the equivalent condition of Part 4 of the existing licence.
- 5.33 We propose to amend the calculation of Opening Asset Value, Condition 6.5.4 such that it now includes the value of Base Return, Condition 6.5.9 and Supplemental Return Condition 6.5.10.

- 5.34 We propose to amend the Allowed Capital Expenditure, Condition 6.5.5 to remove the reference to present value that is currently in the equivalent condition of Part 4 of the existing licence.
- 5.35 We propose to amend Capitalised Interest, Condition 6.5.6 to remove the reference to present value that is currently in the equivalent condition of Part 4 of the existing licence. We also propose to make some typographical corrections in the definition of m. We furthermore propose to add clarification that parameter N is the 30<sup>th</sup> month after the month in which the First Operational Commencement Date occurs and to add a definition of the regulatory allowed nominal weighted average rate of return.
- 5.36 We propose to amend Grant Funding, Condition 6.5.7 to remove the reference to present value that is currently in the equivalent condition of Part 4 of the existing licence. We also propose to provide clarification that the first part of the grant funding formula relates to the scenario where the first month in which an amount of capital grant is received is before the First Operational Commencement Date.
- 5.37 We propose no material amendments to Early Section Completion, Condition 6.5.8 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.
- 5.38 We propose to introduce a new section Base Return, Condition 6.5.9 to contain the formula used to calculate the value of the Base Return element of the Opening Asset Value, Condition 6.5.4. This value will be derived by applying the Rate of Return, Condition 6.5.3 plus inflation as measured by the Retail Price Index (RPI), for a period of 21 months to the value of 'A' as calculated in Condition 6.5.4 Opening Asset Value.
- 5.39 We propose to introduce a new section Supplemental Return, Condition 6.5.10 to contain the formula used to calculate the value of the Supplemental Return element of the Opening Asset Value, Condition 6.5.4. This value will be derived by applying 3.26% (real) plus inflation as measured by the Retail Price Index, for a period of 21 months to a fixed value of £50,000,000.
- 5.40 We propose to introduce a new section Forecast Inflation Rate, Condition 6.5.11. This states that the assumed inflation rate for any year as measured by the Retail Price Index shall be 3%. The condition also sets out how and when this forecast should be used.
- 5.41 It should be noted that a number of concepts included in the equivalent condition in Part 4 of the existing licence are no longer relevant and are not included in Part 6. These are Capital Revenue Requirement, Condition 4.5.1, The Monthly Capital Revenue Requirement, Condition 4.5.2 and The Error Correction

Mechanism, Condition 4.5.4. These have been rendered redundant by the Fixed Amounts Condition 6.5.1.

### **Condition 6.6 The Postalisation Adjustment**

- 5.42 This Condition is equivalent to Condition 4.6 in Part 4 of the existing licence.
- 5.43 We propose no material amendments to The Postalisation Adjustment, Condition 6.6.1 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.
- 5.44 We propose to introduce a new section DPO Payment Failures, Condition 6.6.2. This is a concept that has previously been adopted in the regulatory framework for the financing of Belfast Gas Transmission and Premier Transmission. However it is not set out on the face of the licence but rather in other documents. We propose in this instance to include all the relevant details on the face of the licence. The condition deals with a circumstance in which a DPO Payment Failure under Condition 2A 6.1.3 has not led to an adjustment of the licence holder's Forecast or Actual Revenue Requirement, Condition 6.4 by year t+2. This will then result in a Postalised Adjustment in accordance with Condition 6.6.1.

### **Condition 6.7 Other ARR Components**

- 5.45 This Condition is equivalent to Conditions 4.7.5 and 4.7.6 in Part 4 of the existing licence.
- 5.46 We propose no material amendments to Termination Payments, Condition 6.7.1 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.
- 5.47 We propose to amend Supplemental Income, Condition 6.7.2 such that the Authority is no longer able to amend the value of actual Supplemental Income submitted to it by the licence holder.

### **Condition 6.8 Allowed Revenue after the Final Repayment Date**

- 5.48 This Condition is equivalent to Condition 4.8 in Part 4 of the existing licence.
- 5.49 We propose to amend Allowed Revenue after the Final Repayment Date, Condition 6.8 such that it now includes specific reference to decommissioning costs and any cash surplus that have accumulated prior to the Final Repayment.

### **Condition 6.9 Certain Conditions to apply until the Final Repayment Date**

- 5.50 We propose to introduce a new Condition 6.9, Certain Conditions to apply until after the Final Repayment Date. This simply states that a number of Conditions will apply until the Final Repayment Date has passed. These are Conditions 6.3, 6.4, 6.5.1, 6.5.2 and the relevant sections of Condition 6.1.2, 6.1.3 and 6.1.4.

### **Condition 6.10 The Shadow Price Control**

- 5.51 This Condition is equivalent to Conditions 4.7.1 to 4.7.4 in Part 4 of the existing licence.
- 5.52 We propose to introduce a new Condition 6.10.1 to clarify that Conditions 6.10.2, 6.10.3 and 6.10.4 have no impact on the calculation of the Actual Required Revenue in Condition 6.4.
- 5.53 We propose no material amendments to Determination of Controllable Operating Expenditure, Condition 6.10.2 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.
- 5.54 We propose no material amendments to Actual Controllable Operating Expenditure, Condition 6.10.3 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.
- 5.55 We propose no material amendments to Definition of Controllable Operating Expenditure, Condition 6.10.4 from the provisions that are currently in the equivalent condition of Part 4 of the existing licence.

## **Reasons and Effects**

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- 5.56 The proposed licence modification includes the entirety of the new Part 6. As can be seen from Table 1 and the above discussion, however, the majority of this modification replicates provisions that are included in Part 4 of the existing licence, that is provisions that have previously been consulted on either prior to the grant of the licence or in subsequent modification processes. This discussion will therefore focus on the amendments that we propose to make to the various conditions that have been replicated from Part 4 of the existing licence.
- 5.57 Before the detailed discussion it is worth considering the reasons for and effects of the proposed amendments when taken together. The proposed modification is to support the pre-construction financing of the Gas to the West network.
- 5.58 WTL have contracted out not only the construction of the network but also the financing of this construction to a third party, SGN. Based on the existing licence WTL and SGN have entered into a contractual arrangement whereby the

former would only purchase the network once the Authority had made a final determination on Actual Controllable and Uncontrollable Capital Expenditure. Now that pre-construction financing is considered to be to the benefit of consumers a new set of arrangements needs to be put in place requiring both licence modifications and a new contractual arrangements between the parties. The necessary licence changes are reflected in the following conditions.

- Allowed Capital Expenditure, Condition 6.2.1
- OAV Deduction, Condition 6.4.5
- OAV Addition, Condition 6.4.6
- Licensee's Forecast OAV, Condition 6.4.7
- Actions Taken Before Part 6 Coming Into Effect, Condition 6.4.8
- The Rate of Return, Condition 6.5.3
- The Opening Asset Value, Condition 6.5.4
- Base Return, Condition 6.5.9
- Supplemental Return, Condition 6.5.10
- Forecast Inflation Figures, Condition 6.5.11

5.59 The effect of these various conditions will be to facilitate early financing. There will be a pre-determined timetable for the Authority to make the necessary determinations and a mechanism to ensure that WTL has sufficient funds to meet its financial obligations to SGN under all circumstances. In return SGN will receive a return on their investment for pre-agreed and limited time period of 21 months.

5.60 WTL propose to finance the purchase of the network from SGN entirely through the issuance of debt in the form of a corporate bond. There will be zero equity in the WTL financing model. As there will be no equity buffer in the WTL financing model the financiers will require a number of bespoke arrangements to be put in place that guarantee that debt payments are met according to the agreed repayment schedule. Having these arrangements in place reduces any default risk and thus allows the licence holder to raise the necessary finance by issuing an investment grade corporate bond. Consumers benefit through the minimisation of interest payments on the borrowed funds. These bespoke arrangements include:

- Adverse Regulatory Event, Condition 6.1.3
- Eligible Pass-Through Costs, Condition 6.1.4
- Ratio Account Credit, Condition 6.4.4
- The Fixed Amount, Condition 6.5.1
- The Licensee's Revenue Entitlement, Condition 6.5.2
- DPO Payment Failures, Condition 6.6.2
- The Supplemental Income, Condition 6.7.2

- Allowed Revenue after the Final Repayment Date, Condition 6.8
  - Certain Conditions to apply until the Final Repayment Date, Condition 6.9
- 5.61 The effect of these arrangements is to ensure that Required Revenue is calculated in a way that assures bond holders that in any gas year the licence holders will recover sufficient revenue to meet the schedule of repayments or Fixed Amounts, Condition 6.5.1.
- 5.62 The licence modifications therefore when taken together have two separate but linked purposes, to facilitate pre-construction financing and to facilitate a financing model without any equity element. Each of these will be discussed separately. The modifications will also have a number of other effects which will also be considered separately.

### **Amendments to Facilitate Pre-Construction Financing**

- 5.63 The reason for the proposed amendments to the calculation of Opening Asset Value, Condition 6.5.4, is to reflect our view of what is a fair remuneration to SGN for developing the network and facilitating pre-construction financing. The Opening Asset Value will equal the payment that WTL is permitted to make to SGN for the Gas to the West network. The effect of the proposed amendment is to add both a Base Return and Supplemental Return value onto the calculation of the Opening Asset Value.
- 5.64 The reason for the proposed new Base Return, Condition 6.5.9 is to set out the formula by which the Base Return to be earned by SGN is to be calculated. The effect of the proposed new condition is to limit the period over which the Base Return is to be earned to 21 months after the First Operational Commencement Date. The Rate of Return to be applied in this period is set out in Condition 6.5.3.
- 5.65 The reason for the proposed amendments to the Rate of Return, Condition 6.5.3 is that this return will only apply for 21 months, so much of the drafting in the equivalent condition in Part 4 of the existing licence which deals with the Authority's power to review this figure is now redundant. The effect of the proposed amendment is to set out the formula for calculating the monthly value of a real rate of return of 1.98% per annum.
- 5.66 The reason for the proposed new Supplemental Return, Condition 6.5.10 is to set out the formula by which the Supplemental Return to be earned by SGN is to be calculated. The final design of the Gas to the West network has markedly changed from the anticipated design at the time the licence was granted. In particular it has been possible to use PE (polyethylene) intermediate pressure pipeline for much of the network rather than more costly steel. This has been of substantial benefit to consumers. The PE pipeline, although funded through the

postalised tariff, will be owned and operated by Scotia Gas Networks Northern Ireland going forward. In our Gas Distribution Price Control determination of 2017<sup>11</sup> we determined that Scotia Gas Networks Northern Ireland should receive a rate of return of 5.3%. As the Base return of 1.98% is already applied to these assets, the Supplemental Return is 3.26%<sup>12</sup>. The effect of the proposed new condition is to limit the period over which the Supplemental Return is to be earned to 21 months after the First Operational Commencement Date and to set the capital value on which this is to be earned at £50m which is estimated to be the capital cost of the PE sections of the pipeline network.

- 5.67 The reason for the proposed new Forecast Inflation Figures, Condition 6.5.11 is to establish in advance the value of any inflation forecasts that might be required to forecast nominal rather than real rates of return. The effect of the proposed new condition is to set inflation forecasts as measured by the Retail Price Index at 3.0% per annum.
- 5.68 The reason for the proposed new Licensee's Forecast OAV, Condition 6.4.7 is to act as the link between the value which will be paid by WTL for constructing the Gas to the West network and the OAV Addition and Reduction terms in the calculation of Actual Required Revenue, Condition 6.4.2. The effect of the proposed new condition will be to require WTL to submit and have approved by the Authority, at the time of the Direction, the value of the various building blocks that contribute to the overall value of the corporate bond that will be repaid through the Fixed Amounts, Condition 6.5.1. The largest building block will be an estimate of the Opening Asset Value calculated in accordance with Condition 6.5.4.
- 5.69 The reason for the proposed new section Actions Taken Before Part 6 Coming Into Effect, Condition 6.4.8 is to facilitate the timely raising of the required finance. Only after a minimum of 56 days following a decision by the Authority to modify the licence does the actual modification take effect. West Transmission will only be in a position to proceed with the process of raising the necessary finance once the Authority has approved their OAV forecast, Condition 6.4.7. The effect of the proposed condition will facilitate the process of raising finance in advance of Part 6 having actually come into effect.
- 5.70 The reason for the proposed new OAV Deduction, Condition 6.4.5 is to deal with a situation in which the Licensee's Forecast OAV, Condition 6.4.7 is greater than the out-turn Opening Asset Value calculated in accordance with Condition 6.5.4. The effect of this proposed new condition will be to ensure that should WTL have

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<sup>11</sup> [Price Control for Northern Ireland's Gas Distribution Networks GD17, Final Determination, 15 September 2016.](#)

<sup>12</sup> Calculated using Fisher Formula



borrowed more money than is necessary to pay SGN then this will be returned to consumers over a three year period following the Cut-Off Date. A positive value for this term will reduce the value of the Actual Required Revenue calculated in accordance with Condition 6.4.2.

- 5.71 The reason for the proposed new OAV Addition, Condition 6.4.6 is to deal with a situation in which the Licensee's Forecast OAV, Condition 6.4.7 is less than the out-turn Opening Asset Value calculated in accordance with Condition 6.5.4. This provides SGN with assurance that in all circumstances WTL will have access to sufficient funds to meet their financial obligations to SGN. The effect of this proposed new condition will be to ensure that should WTL have borrowed less money than necessary to pay SGN, then the missing funds will be recovered from consumers over a three year period following the Cut-Off Date. In addition the OAV Addition will include a 3.5% rate of return to compensate SGN for the delay in receiving full payment. A positive value for this term will increase the value of the Actual Required Revenue calculated in accordance with Condition 6.4.2.
- 5.72 The reason for the proposed amendments to the Allowed Capital Expenditure, Condition 6.2.1 is to facilitate the final value of the Opening Asset Value to be calculated 30 months after the First Operational Commencement Date. The effect of the proposed amendments is to require the Authority to determine Provisional Controllable and Uncontrollable Capital Expenditure figures 21 months after the First Operational Commencement Date and to make the final determination by the Cut-Off Date, 30 months after First Operational Commencement Date. The amendment will also permit the Authority to adjust the determined Verified Controllable Capital Forecast to take account of minor outstanding capital works that will be delivered by WTL rather than SGN. This will facilitate the Authority reaching its final determination by the Cut-Off Date and will mitigate the advantage that SGN could have gained through the operation of the Pain Gain mechanism from simply shifting capital works from Actual Capital Expenditure to Eligible Pass-Through Costs.
- 5.73 We recognise that in any major construction project there is always the possibility that significant issues relating to capital works may not be resolved on schedule. Should this prove to be the case we may need to consider at an appropriate point in time, modification of the licence to re-define the Cut-Off Date. This would ensure that material capital expenditure items were not shifted from Actual Capital Expenditure to Eligible Pass-Through Costs simply to comply with an artificial Cut-Off Date.
- 5.74 Meeting the timetable of decisions set out in this condition will require the co-operation from the licence holder. We have not at this stage proposed the

inclusion of an obligation on the licence holder to facilitate timely decision making. However, we may include such an obligation in our final modification.

### **Amendments to Facilitate Equity Free Financing**

- 5.75 The reason for the proposed new section The Fixed Amounts, Condition 6.5.1 is to permit the schedule of payments agreed between WTL and their financiers to be written into the licence by means of a Direction to be issued by the Authority after the licence modifications become effective. At the time the modification decision is made the value of these Fixed Amounts is unknown. Writing these Fixed Amounts onto the licence for inclusion in the calculation of Actual Required Revenue, Condition 6.4.2 is regarded by potential financiers as reducing their revenue risk and so will result in a lower cost of debt for consumers. In the case of Premier Transmission and Belfast Gas Transmission these Fixed Amounts were included in the Direction. In this instance, however, we prefer to include them on the face of the licence. As there are a number of other matters which can only be known once agreement with financiers has been reached, which will not be before any decision to modify the licence by the Authority, this condition permits the Direction to modify the licence in a number of other ways to reflect that agreement. The effect of the proposed new condition will be to permit the Authority to modify the licence in a number of specific ways by means of a Direction in order to reflect the details of the agreement reached between WTL and their financiers, including in particular:
- To write the value of Fixed Amounts into the licence;
  - To write the method of Fixed Amount indexation into the licence;
  - To modify the definition of Eligible Pass-Through Costs, Condition 6.1.4;
  - To modify the definition of ARE Suspense Account and Available Post-ARE Cash, Condition 6.1.2.
- 5.76 The reason for the proposed new Licencee's Revenue Entitlement, Condition 6.5.2 is to provide clarity for financiers that Condition 6.5.3 to 6.5.11 shall not impact WTL's revenue entitlement and so pose no risk to any agreed repayment schedule. The effect of this greater certainty is expected to be lower financing costs for consumers.
- 5.77 The reason for the proposed new Ratio Account Credit, Condition 6.4.4 is to provide financiers with accelerated repayments in a situation where there is no equity buffer to provide similar assurance. In the absence of such a mechanism financiers would face increased revenue risk and would demand higher interest payments or be unwilling to provide the necessary finance at all. Neither outcome would be of benefit to consumers. In the case of Premier Transmission and

Belfast Gas Transmission the same mechanism is included in the Direction. In this instance, however, we prefer to include it on the face of the licence. The section Fixed Amounts, Condition 6.5.1 that will be written into the licence by the Direction issued by the Authority will have a value twice that of those in the repayment schedule agreed between WTL and their financiers. The effect of the proposed new condition is to create a mechanism by which excess revenues are collected from consumers should an Adverse Regulatory Event be triggered by WTL, Condition 6.1.3. In a normal gas year the Ratio Account Credit will have a value 50% of the Fixed Amount. Thus when it is deleted from the calculation of Actual Required Revenue, Condition 6.4.2 the value of the Fixed Amount minus the Ratio Account Credit equal the scheduled repayment to financiers in that Gas Year. In a Year where an Adverse Regulatory Event is called the Ratio Account Credit is less than 50% of the Fixed Amount. Thus when it is deleted from the calculation of Actual Required Revenue, Condition 6.4.2 the value of the Fixed Amount minus the Ratio Account Credit is greater than the scheduled repayment to financiers in that Gas Year.

- 5.78 Any over-repayment as a result of the Adverse Regulatory Event Mechanism and the Ration Account Credit will need to be taken account of in future years. The precise mechanisms by which this will be done will need to be agreed between WTL and the Financiers prior to the issuing of the direction issue under Part 5 of the licence by the Authority. For this reason, a number of the definitions related to the Adverse Regulatory Event will need to be modified by the Direction. See Condition 6.5.1.
- 5.79 The reason for the proposed new section Adverse Regulatory Event, Condition 6.1.3 is to set out the circumstances in which WTL can trigger the mechanism that will reduce the value of the Ratio Account Credit. As noted above this is required to provide financiers with assurance over revenues in a situation where there is no equity buffer. In the case of both Premier Transmission and Belfast Gas Transmission the same mechanism was included in the Direction. In this instance, however, we prefer to include it on the face of the licence. The effect of the proposed new condition is to set out two broad sets of circumstances in which an Adverse Regulatory Events might be said to have occurred. These are:
- Where the Authority or Government Agency indicates that it may or will act in a way that does not observe or is contrary to the Transaction Authorisations. This includes where legislation has a material impact on these Transaction Authorisations. Excepted would be cases where the Authority or Government Agency is exercising powers or functions derived from either the Gas or Energy Order.
  - Where the Authority or Government Agency having responsibility for the network or licenced business indicates that it may or will act in a way that

has a materially adverse impact on the issuers financing arrangements or materially increases the level of risk undertaken by Designated Pipeline Operators. Designated Pipeline Operators are those licence holders who recover their allowed revenue through the postalised transmission tariff and PoT (Postalised Transmission) Account as set out in Part 2A of the existing licence.

We propose to define Transaction Authorisations in Condition 6.1.2 as including:

- The licence or any document entered into in pursuance of the licence;
- Any letter from the Authority dealing with modification or revocation of the licence;
- Any letter from the Department dealing with future modification or revocation of the licence;
- Any letter from the Authority which contains a consent to the granting of security over relevant assets;
- The Designation Order;
- Any Direction issued by the Authority under Part 5 or Condition 6.5.1 of the licence.

We also propose to add a definition of Adverse Regulatory Event Year in Condition 6.1.2. This requires the licence holder to consult with the Authority as to the events or other circumstances which if they occur would cause the triggering of an Adverse Regulatory Event.

5.80 The reason for the proposed amendments to Eligible Pass-Through Costs, Condition 6.1.4 is to clarify that certain operating costs are included in the definition. As the proposed financing model has no equity buffer, operating expenditure is treated as a pass through item, that is WTL is permitted to recover its actual operating costs in any Gas Year. This is the basis on which the current licence was granted. These amendments do not therefore represent any policy development but rather clarification. The effect of these proposed amendments will be to include within the definition:

- Capital expenditure other than Actual Controllable and Uncontrollable Capital Expenditure that is determined in accordance with Condition 6.2;
- Monies required to maintain suitable balances in accounts necessary to meet financier's requirements;
- A sweep to cover all eligible expenditure which has not been specifically mentioned elsewhere in the condition;
- Clarification that Eligible Pass-Through Costs are to be interpreted as a cash-flow rather than accruals-based concept.

Amounts incurred as a result of changes in law and determined in accordance with Condition 6.2.4 will be excluded from Eligible Pass-Through Costs.

- 5.81 The reason for the proposed new section DPO Payment Failures, Condition 6.6.2 is to allow WTL to recover any shortfall in revenue from the PoT Account as a result of a DPO Payment Failure with respect to Condition 2A 6.1.3 of the existing licence. In the case of Premier Transmission and Belfast Gas Transmission the same mechanism is included in the Direction. In this instance, however, we prefer to include it on the face of the licence. The effect of the proposed new condition is to permit WTL to recover any shortfall through the Postalised Adjustment term in the Actual Required Revenue formula, Condition 6.4.2.
- 5.82 The reason for the proposed amendments to Supplemental Income, Condition 6.7.2 is to make the condition fully compatible with the financing model in which the financiers require certainty with regard to future revenues in the absence of an equity buffer. The effect of the proposed amendment is to remove the Authority's ability to verify and amend actual Supplemental Income values reported by the licence holder. Our assumption is that Supplemental Income is a non-material matter. Should this change, we may consider a related licence modification.
- 5.83 The reason for the proposed amendments to section Allowed Revenue after the Final Repayment Date, Condition 6.8 is to provide clarity as to which costs might be recovered after this date. The effect of the proposed amendment is to clarify that the licence holder may recover costs related to the decommissioning of the network during this period. The amendment also clarifies how any cash surplus from the previous period will be treated.
- 5.84 The reason for the proposed new section Certain Conditions to apply until after the Final Repayment Date, Condition 6.9 is to provide financiers with assurance with regard to our policy intent not to change those conditions in the licence which set out the revenue entitlement of West Transmission during the period until the Final Repayment Date. The effect is to set out our policy intent that the calculation of Required Revenue, The Fixed Amounts and the definition of related issues such as the definition of Adverse Regulatory Event and Eligible Pass-Through Costs shall apply unto the Final Repayment Date, subject to any modifications made to them by virtue of the Gas Order.

#### **Condition 6.2.4 Change of Law**

- 5.85 The reason for the proposed new section Change of Law, Condition 6.2.4 is to ensure that neither customers nor the licence holder are negatively impacted by

a change of law that effects the cost of constructing the Gas to the West network. The effect of the proposed new condition will be to allow the Authority to vary its determination of Verified Controllable Capital Forecast in the light of changes to the law which impact on capital expenditure.

#### **Part 4 Conditions Not Included in Part 6**

- 5.86 The reason why a number of conditions in Part 4 of the current licence have no equivalent in our proposed Part 6 modification is because they have been rendered redundant by the Fixed Amounts, Condition 6.5.1 which includes the schedule of repayments to be made to financiers. The redundant conditions are those which in Part 4 set out the methodology for calculating Monthly Capital Revenue Requirement. These are:
- Capital Revenue Requirement, Condition 4.5.1
  - The Monthly Capital Revenue Requirement, Condition 4.5.2
  - Error Correction Factor, Condition 4.5.4
- 5.87 We also propose not to have an equivalent of the Approved Surplus, Condition 4.7.1. The Approved Surplus is an adjustment to the Actual Required Revenue to provide monies for the Social Enhancement Fund. As we noted in the GT17 Price Control for Northern Ireland's Gas Transmission Networks<sup>13</sup> we are unsure of the value of this mechanism and have set this value to zero in future. Our intention was to remove the Approved Surplus from all the relevant licences, Belfast Gas, Premier Transmission and WTL at the time of the price control. However the licence holders suggested this would require review by financiers, incurring non marginal legal costs for consumers, and so we simply set the value to zero. As the WTL bond has not been issued this issue does not arise and so we propose to remove the concept from the licence. The purpose of the removal of this add-on to the calculation of Actual Required Revenue is to remove any concern that financiers may have about the Authority being able to adjust Required Revenue. It is anticipated this simplification will make the marketing of any bond more straight forward.
- 5.88 Furthermore, we propose not to have an equivalent of the section Actions Taken Before Part 4 Comes into Effect, Condition 4.2.3. By virtue of Condition 5.1.4(c), the effect of Condition 4.2.3 flows through into Part 6, without the need for a further reinstatement of retrospectivity.

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<sup>13</sup> [Price Control for Northern Ireland's Gas Transmission Networks GT17, Final Determination, 1 August 2017.](#)

### **Condition 6.4.2 Actual Required Revenue and Condition 6.4.3 Definition of Formula Terms**

- 5.89 The reason for the proposed amendments to these conditions is to ensure that the Actual Required Revenue Formula fully reflects the other proposed amendments previously discussed. The effect of the proposed amendments will be:
- Replacement of the  $A_t$  Capital Revenue Requirement term with  $F_t$  Fixed Amounts (see Condition 6.5.1).
  - Insertion of three new terms  $G_t$ , Ratio Account Credit,  $H_t$  OAV Deduction and  $I_t$  OAV Addition (see Conditions 6.4.4, 6.4.5 and 6.4.6 respectively)
  - Deletion of the  $Z_t$  and  $S_t$  terms which relate to the calculation of the Approved Surplus which we propose to delete from the regulatory regime for WTL.

### **Condition 6.10 The Shadow Price Control**

- 5.90 The reason for the proposed creation of a separate condition for these items is to make clear that these provisions are completely separate from the calculation of Actual Required Revenue, Condition 6.4.2. This has been facilitated by our decision to remove the concept of an Approved Surplus from the calculation of Actual Required Revenue. This proposed new condition will have no impact on the regulatory regime.

### **Consequential changes**

- 5.91 The proposed introduction of paragraph (a) in Condition 6.1.1 is consequential to the proposed introduction of the new Part 5 of the licence. For the associated reasons and effects see chapter 4 of this document.

### **Minor drafting changes**

- 5.92 Our proposed modification also include a number of non-material drafting changes compared to Part 4 of the existing licence. These are designed to address drafting issues with the effect of enhancing clarify and transparency of licence drafting.

## 6 Next Steps

- 6.1 Table 2 summarises the next steps and associated timelines for the licence modification process.

**Table 2: Next Steps**

Next Steps	Proposed Date
Notice of proposal to modify published	28 March 2018
Statutory consultation closes	27 April 2018
Notice of licence modification decision published	4 May 2018
Competition & Markets Authority application for referral permission deadline	6 June 2018
Licence modification effective date (if approved)	29 June 2018

- 6.2 We note that the timelines indicated in Table 2 for the publication of the licence modification decision and, if applicable, the licence modification effective date are of indicative nature and subject to change.



# 7 Annexes

## Annexes

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- 7.1 Table 3 provides an overview over the annexes to this licence consultation document.
- 7.2 In each annex proposed modifications are in red font, deletions are ~~struck through~~ while additions are highlighted in yellow.

**Table 3: Annexes to this licence consultation**

Annex Number	Annex Name
Annex 1	<a href="#"><u>Part 3 Additional Special Conditions</u></a>
Annex 2	<a href="#"><u>Part 4 Price Control Conditions</u></a>
Annex 3	<a href="#"><u>Part 5 Special Condition – Re-Financing</u></a>
Annex 4	<a href="#"><u>Part 6 Price Control Conditions After Re-Financing</u></a>