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John Mills  
The Utility Regulator  
Queens House  
14 Queen Street  
Belfast  
BT1 6ED

2 February 2018

Dear John,

**RE: firmus energy's response to the Utility Regulator's consultation regarding the CMA Decision on the GD17 referral by firmus energy**

On behalf of firmus energy, I very much welcome the opportunity to respond to the Utility Regulator's consultation regarding the CMA Decision on the GD17 referral by firmus energy.

We recognise that this consultation, reflecting the Utility Regulator's decisions in respect of our Appeal Ground 2A (owner occupied connection targets) and Appeal Ground 2B (non-additionality), are in line with directions provided by the CMA in their Final Determination of 26 June 2017.

Since publication of this consultation on 19 December 2017, we have undertaken a thorough review and analysis of the Utility Regulator's decision's on each of the Appeal Grounds remitted by the CMA for remedy.

In relation to Appeal Ground 2A, we welcome the further consideration given by the Utility Regulator to the modelling of owner occupied connections, and welcome redetermination of firmus energy's owner occupied connection targets for GD17.

We also acknowledge the further considerations given by the Utility Regulator under Appeal Ground 2B.

Within our consultation response, we have provided, what we trust you will find, constructive observations and commentary on each of the four case studies undertaken by the Utility Regulator.

In order to support our considerations of the Utility Regulator's remedy under Appeal Ground 2B, and in particular, the Utility Regulator's customer survey and comparative analysis of the development of the gas market in the Republic of Ireland, firmus energy engaged Millward Brown and Frontier Economics (Dublin).

As experts in their respective fields, we believe their analysis provides valuable input to the matters being consulted upon under Appeal Ground 2B. Along with our commentary, we have therefore included two appendices (i.e. one addressing the customer survey, and one addressing the Republic of Ireland comparative analysis), which we trust will helpfully inform your further considerations.

We recognise that in order to give effect to the CMA Determination, the Utility Regulator is required to modify firmus energy's Licence, and the Utility Regulator's proposed replacement of the table of 'Determination Values' at Condition 4.7 of our Licence does indeed reflect the changes proposed within this consultation.

I trust that you and your team will find our consultation response constructive and helpful.

I, along with my team, would welcome an opportunity to discuss our consultation response with you further, prior to publication of your decision to proceed with the requisite Licence modifications.

I look forward to hearing from you.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Niall Martindale', written in a cursive style.

Niall Martindale  
**Director of Regulation and Pricing**

February 2018

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## Introduction

Firmus energy welcomes the opportunity to respond to the Utility Regulator's Consultation on the Competition and Markets Authority (CMA) Decision on the GD17 referral by firmus energy, published on 19 December 2017 ("The Consultation").

The Consultation represents the Utility Regulator's decision in respect of its determination of CMA Appeal Ground 2A – connection targets and Ground 2B – non-additionality. We note that this decision has been taken in accordance with that directed by the CMA in its Final Determination of 26 June 2017.

This response provides comment on the Utility Regulator's findings and decisions included within The Consultation. Our response also offers supporting information which we trust will be of assistance to the Utility Regulator.

Our response outlines firmus energy's acceptance of the Utility Regulator's redetermination of Ground 2A, the Connection Target.

In accepting the redetermination we note that the correction results in a challenging, but consistently determined, upper bound for owner occupied connections during GD17.

Our response provides a more detailed commentary regarding Ground 2B, non-additionality.

The CMA remitted the determination of the non-additionality rate to the Utility Regulator for reconsideration and redetermination. In doing so the CMA stated:

*"In respect of Ground 2B, we have decided to remit the matter back to the UR for reconsideration and determination and to give directions, which include: that the UR undertake further analysis to **determine** and **calculate** a revised non-additionality rate; calculate the consequential effects; and proceed with the necessary modification of FE's licence."*<sup>1</sup>

We note that these directions include the requirement to **undertake further analysis** and **calculate a revised non-additionality rate**.

The Utility Regulator has concluded it cannot rely on three of its four case studies. As a result these case studies neither address the CMA requirement for further analysis, nor address the CMA requirement to calculate a revised non-additionality rate.

We consider the Utility Regulator's customer survey, in greater depth. In doing so we note that it does not encompass all aspects of the connection incentive and does not therefore provide statistically robust data to support the calculation of the non-additionality rate.

None of the Utility Regulator's four workstreams has provided a robust conclusion regarding the calculation of the non-additionality rate.

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<sup>1</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 197, paragraph 8.38

For this reason we conclude that the redetermination of non-additionality is not based on sufficient evidence, substantiation or calculation to satisfy the CMA direction to the Utility Regulator,

*“that the UR undertake further analysis to **determine** and **calculate** a revised non-additionality rate”.<sup>2</sup>*  
[Emphasis added]

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<sup>2</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 197, paragraph 8.38

## Ground 2A – Connection Target

Firmus energy welcomes the further consideration given by the Utility Regulator to its GD17 owner occupied connection modelling in order to develop the proposals within The Consultation.

To assist with the Utility Regulator's reassessment, firmus energy responded to a number of information requests, including providing the tenure details for each of the 100,000 properties passed, and all the properties connected as at 31 December 2016.

The Consultation proposes a revised owner occupied connections target for the GD17 period. We recognise that this revision relates solely to one aspect of the owner occupied connection modelling, i.e. the classification of Housing Association properties within historically reported owner occupied connection numbers.

Firmus energy's assessment, and subsequent forecast in its GD17 Business Plan, included the separation of Housing Association properties from the owner occupied market segment for the first time. This was not reflected by the Utility Regulator in the GD17 Final Determination.

The Utility Regulator has now adjusted their connection modelling, concluding:

*"In line with the CMA direction we have recalculated the connection target using the connection model we used in the GD17 final determination. Having corrected Housing Association data we have determined a revised connection rate of 5% and a revised GD17 owner occupied connection target of 19,400."*<sup>3</sup>

Firmus energy welcomes this recalculation of the owner occupied connection target for the GD17 period.

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<sup>3</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 11, paragraph 2.10

## Ground 2B – Non-Additionality

Firmus energy acknowledges the consideration given by the Utility Regulator to non-additionality in order to inform The Consultation. This undertaking is important given the findings of the CMA Final Determination:

*“We have therefore reached the view that the UR made an error when it decided to make an adjustment for non-additionality which was not based on evidence, in circumstances in which it could and should have sought to obtain evidence on which to base its decision.”<sup>4</sup>*

*“We have therefore reached the conclusion that the UR’s decision to set the non-additionality rate at 25% was wrong, as the basis for the UR’s approach has been so fundamentally undermined that it cannot stand.”<sup>5</sup>*

This section of the firmus energy response contextualises non-additionality before providing comment on each of the four case studies undertaken by the Utility Regulator to produce the non-additionality section of The Consultation.

### Strategic Purpose of the Connection Incentive

The Northern Ireland Government, the Utility Regulator and firmus energy share a common goal to extend the reach of the gas network in the Ten Towns. From the outset, the Utility Regulator’s stated primary objective for the GD17 Review has been to:

*‘promote the development and maintenance of an efficient, economic and coordinated gas industry in Northern Ireland’.<sup>6</sup>*

The connection incentive was introduced to assist in achieving this shared goal by promoting network development. The GD17 Final Determination notes:

*“The connection incentive is a per connection allowance to encourage the connection of domestic owner occupied (OO) properties. This is unique to NI and was created due to initial difficulties in driving gas connections.”*

The connection incentive has a vital role to play as not only does it promote network development but, by encouraging network growth, it enables costs to be spread over a larger customer population. This produces an economic benefit, reducing the cost for all customers, both current and future.

The concept of non-additionality is applied to the connection incentive. The GD17 Final Determination notes:

*“we have used a concept of non – additionally [sic], as we consider that there will be a certain number of OO connections that would occur anyway without any direct marketing or selling to these customers. We describe these connections as “non-additional”. Since FE could in theory avoid any sales-related costs to connect such customers, no allowance will be applicable for these customers.”<sup>7</sup>*

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<sup>4</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 117, paragraph 5.148,

<sup>5</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 117, paragraph 5.150

<sup>6</sup> Utility Regulator, GD17 Discussion Document on our Overall Approach, page 7, paragraph 1.4

<sup>7</sup> Utility Regulator, GD17 Final Determination, page 88, paragraph 6.157

Determining that a connection is non-additional concludes that no cost allowance is required (or provided) for that connection. Therefore, in determining that a connection (or category of connection) is non-additional it is critical that the Utility Regulator is able to ascertain that firmus energy has not incurred (or will not incur) any cost to achieve that connection (or category of connection).

## Activities Funded by the Connection Incentive

The connection incentive is of significant importance for firmus energy given the wide scope of activities the allowance provides for, all of which are essential to achieve owner occupied connections. The Utility Regulator recognised this in the GD17 Final Determination stating:

*“It should be noted, that the impact of this incentive is wide ranging for the overall business, as it covers a certain percentage of costs to cover all overheads of the organisation.”<sup>8</sup>*

The Utility Regulator determined four groups of connection activity that are covered by the connection incentive. i.e.:

- *“Advertising, marketing and PR;*
- *Incentives (for OO properties only);*
- *Sales related staff, including relevant director; and*
- *Shared corporate overheads.”<sup>9</sup>*

## Utility Regulator Non-additionality Case Studies

### 1. Withdrawal of Incentives for Small I&C Consumers in the PNGL Area

Firmus energy acknowledges the Utility Regulator’s attempt to analyse the impact of customer incentives.

Direct incentives from firmus energy to domestic owner occupied customers to assist them with the cost of installation are vital to network growth. Given continuing and challenging economic conditions the necessity for these incentives will remain throughout the GD17 period and beyond.

We note the Utility Regulator bases its analysis on an assumption:

*“Our analysis and the comparisons drawn is predicated on the assumption that gas consumption and economic drivers for I&C which would be served by a U6 meters [sic] to connect to gas are similar to those of domestic properties.”<sup>10</sup>*

This assumption, which has not been underpinned by new evidence, is at odds with the statement in CMA Final Determination:

*“We do not place much weight on the evidence from removing the connection allowance for PNGL’s I&C customers, as we consider that the behaviour of firms is likely to be different to that of domestic customers. Furthermore, the UR did not provide any evidence that demonstrates that this category of customer provides a useful comparison for OO properties.”<sup>11</sup>*

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<sup>8</sup> Utility Regulator, GD17 Final Determination, page 82, paragraph 6.119

<sup>9</sup> Utility Regulator, GD17 Final Determination, page 82, paragraph 6.121

<sup>10</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 17, paragraph 3.19

<sup>11</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 115, paragraph 5.138

As no new evidence has been provided in The Consultation to demonstrate small I&C consumers in the PNGL area are a useful comparator we welcome the Utility Regulator's decision not to draw any conclusions from this analysis.

## **2. Survey of Owner Occupiers**

In its Final Determination of 26 June 2017, the CMA suggested further analysis was undertaken in order to assist with the assessment of non-additionality. Firmus energy welcomed the Utility Regulator's adoption of this suggestion and requested the opportunity to be involved in the development of the survey.

Following publication of an initial draft of the survey in its Invitation to Tender on 25 September 2017, the Utility Regulator developed the survey methodology in conjunction with social research experts Social Market Research (SMR) during October 2017.

While not involved in the development of the survey methodology, firmus energy proactively sought to assist the survey development by sharing with the Utility Regulator some suggested survey questions which had been developed with assistance from social research specialists Millward Brown. We also shared the joint Competition Commission and Office of Fair Trading publication, "Good practice in the design and presentation of consumer survey evidence in merger inquiries" and the Market Research Society Guidelines for Questionnaire Design.

Firmus energy also highlighted the difference in scope between the GD17 Final Determination definition of non-additionality and the definition used in the survey. This definitional change remained in the final survey, whereby the survey only undertakes analysis into one of the categories funded by the connection incentive, advertising and marketing, and does not consider customer incentives and affordability.

This difference in definition between the GD17 Final Determination and that used in the survey is critical.

Even if it were possible for the survey to confirm that some customers connected to the natural gas network without exposure to firmus energy advertising or marketing, it does not appropriately consider other sales related costs incurred, such as Energy Advisor assistance, incentive payments, and/or customer service support.

It is worth noting that non-additionality is not a test of the effectiveness of firmus energy advertising. Rather, non-additionality is an assessment of the number of customer connections firmus energy could achieve without any marketing, advertising or sales expenditure.

The Utility Regulator shared the survey results data and a draft report on the survey results ("Draft SMR Survey Report") with firmus energy on 6 December 2017. On 15 December 2017, prior to the publication of The Consultation, firmus energy provided commentary on the Draft SMR Survey Report. This commentary has been included at Appendix 2 of this document.

### **No Affordability Considerations**

It is notable, that the level of Government incentives which exists for customers, whilst itself a recognition of the importance of affordability in the development of the domestic natural gas market, was not addressed by the survey that has led to the proposed non-additionality figure contained within The Consultation.



The suggested survey questions firmus energy shared with the Utility Regulator included targeted questions relating to incentives that are provided to customers in order to achieve the determined rate of owner occupied connections. The final survey questions did not incorporate any questions relating to customer subsidisation.

Given that approximately 75% of firmus energy owner occupied connections (as at the end of 2016) required some form of government-funded grant assistance, the absence of a question directly relating to incentives, or affordability, serves to undermine the resultant analysis pertaining to non-additionality.

It is also important to note that every owner occupied connection achieved with Government-funded grant assistance requires investment by firmus energy, including Energy Advisor salaries, advertising and marketing materials, and often funding toward the Government schemes.

The narrowed definition used in the Utility Regulator's survey ignores legitimate costs required to attract customers. In any event, the survey did not provide for the consideration of these costs, and therefore cannot reasonably assist the Utility Regulator to evidence, substantiate and determine a non-additionality rate.

### **Survey Analysis**

Firmus energy recognises that the survey undertaken for The Consultation was conducted by social research experts SMR. We note however that the subsequent analysis and interpretation of data was undertaken by the Utility Regulator.

By splitting the responsibility in this way, with SMR conducting the survey and the Utility Regulator undertaking the data interpretation and analysis, the project appears at odds with guidance in the Market Research Society Guidelines for Questionnaire Design, which firmus energy shared with the Utility Regulator on 2 October 2017. It states:

*"It is impossible to divorce good practice in questionnaire design – in terms of ethical and technical responsibilities – from the interpretation of the resulting data. As part of the questionnaire design process, researchers should consider how they expect to analyse and report the results."*<sup>12</sup>

This approach has limited the ability of the Utility Regulator to make use of SMR's market research expertise when undertaking the interpretation and analysis of results.

### **Specialist Assessment**

By choosing to undertake the analysis and interpretation of the survey without the independence and expertise of SMR, the Utility Regulator introduced two additional risks, i.e. that the interpretation of the results is undertaken inappropriately and that the interpretation is compromised by confirmation bias.

The presentation of data and conclusions developed suggest that the Utility Regulator has not taken advantage of specialist input from social research practitioners when interpreting the data to draw informed conclusions.

In correspondence to the Utility Regulator prior to the publication of The Consultation we noted:

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<sup>12</sup> Market Research Society, MRS Guidelines for Questionnaire Design, July 2011, Updated September 2014, Page 23, <https://www.mrs.org.uk/pdf/2014-09-01%20Questionnaire%20Design%20Guidelines.pdf>

*“If the data gathered by The Survey were interpreted inappropriately it could be used to support a wide range of opinion regarding the potential level of non-additionality, none of which is statistically robust.”<sup>13</sup>*

The analysis undertaken by the Utility Regulator and reported in The Consultation interprets non-additionality between 21%<sup>14</sup> and 95%<sup>15</sup> before concluding that non-additionality is in the range 30% to 50%<sup>16</sup> without providing a statistically robust justification of this range over any specific calculation within the survey analysis.

This range highlights that no point estimation contained within the Utility Regulator’s survey can be supported as statistically robust, and therefore, the survey cannot be utilised to **“determine”<sup>17</sup>** or **“calculate”<sup>18</sup>** non-additionality.

In commenting on the previous assessment of non-additionality undertaken by the Utility Regulator the CMA stated:

*“In our view, the evidence used to support the UR’s 25% non–additionality rate is potentially consistent with a wide range of different values for the non–additionality rate.”*

It would appear that the Utility Regulator’s interpretation of the survey again provides a wide range of different values. As such, it cannot be concluded that this result is evidence of sufficient quality to fulfil the CMA direction that the Utility Regulator **“calculate”<sup>19</sup>** the rate of non-additionality.

### 3. RoI gas market as a Comparison

#### Appropriate Benchmarking

Firmus energy acknowledges the Utility Regulator’s consideration of the Republic of Ireland gas market in developing The Consultation.

From the outset of the GD17 Price Control process firmus energy has recognised the importance of benchmarking as a comparison technique. We have also noted the importance of appropriate benchmarking that makes adjustments for network characteristics. Our response to the Utility Regulator’s 17 April 2015 GD17 Approach Document noted:

*“FE recognises that benchmarking is a useful comparison technique to identify outliers, however as academic literature<sup>20</sup> 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.”<sup>21</sup>*

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<sup>13</sup> Firmus energy comments on the Draft SMR Survey Report shared by the Utility Regulator on 6 December 2017, page 5. Submitted to the Utility Regulator on 15 December 2017

<sup>14</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 23, paragraph 3.46

<sup>15</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 28, paragraph 3.71

<sup>16</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 28, paragraph 3.71

<sup>17</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 197, paragraph 8.38

<sup>18</sup> *ibid*

<sup>19</sup> *ibid*

<sup>20</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 117, paragraph 5.147

<sup>21</sup> Firmus energy response to Price Control for Northern Ireland’s Gas Distribution Networks GD17 – Discussion Document. Submitted to the Utility Regulator on 10 February 2015.

Annex 3 to the Utility Regulator's consultation, Case Study of the Republic Of Ireland Market outlines the significant difference in the scale of the organisations and the age of the networks.

Table 1 of Annex 3, shows that firmus energy (7,596 owner occupied connections) has approximately 1% of the owner occupied connections of GNI (636,012) and GNI has connected 68% of properties passed in comparison to firmus energy's 16%<sup>22</sup>. Annex 3 also notes that the firmus energy Licence was awarded in 2005 while the RoI gas market development commenced in 1976<sup>23</sup>.

While noting these factors, the Utility Regulator does not seek to investigate the impact of these significant market differences. These may include the impact of economies of scale when purchasing advertising space, the beneficial impact of repeat messaging over a prolonged period of time, and economies of scale that may be possible in manpower and corporate overheads.

Instead the Utility Regulator justifies the direct comparison by stating that GNI "*cannot be considered mature*"<sup>24</sup> without identifying a mature network they have used for benchmarking purposes, or indeed providing any definition of maturity.

### **Regulatory Incentives**

When undertaking benchmarking it also is important to ensure that cost activities are comparable across the GDN's datasets.

As highlighted by specialist economic consultants Frontier Economics (Ireland) in Appendix 1 of this response, the Utility Regulator has not accounted for the large opex allowance (c. €1.5m / £1.3m per annum) provided to GNI for growth promotion activities.

When accounting for this allowance the incentive rate per connection provided to GNI is three times greater than that considered by the Utility Regulator.

This omission undermines the credibility of the resultant analysis. This includes analysis of regulatory incentives, the assumed differences between the practices undertaken by firmus energy and GNI to achieve connections and the consequential non-additionality assessment and determination.

### **Calculations Undertaken from the Utility Regulator's RoI assumptions**

The Utility Regulator has assumed that up to 50% of GNI's new connections occur as a result of its "*limited marketing activities*"<sup>25</sup>. However, as outlined in Frontier Economics' (Ireland) note, Appendix 1 of this paper, GNI's growth promotion allowances are actually five times larger in PC4 than what the Utility Regulator has assumed in its analysis. That said, if we were to use the Utility Regulator's method, and we account for the fact that GNI's growth promotion activities are five times larger than previously assumed, then up to 100% of GNI's new connections are a result of its growth promotion activities.

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<sup>22</sup> Utility Regulator, Annex 3, Remedy 2b – Further Analysis on Non-Additionality Case Study of the Republic of Ireland Market, page 5, Table 1

<sup>23</sup> Utility Regulator, Annex 3, Remedy 2b – Further Analysis on Non-Additionality Case Study of the Republic of Ireland Market, page 5, paragraph 1.9

<sup>24</sup> Utility Regulator, Annex 3, Remedy 2b – Further Analysis on Non-Additionality Case Study of the Republic of Ireland Market, page 7, paragraph 1.14

<sup>25</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 25, paragraph 3.57

## Conclusions from RoI Benchmarking

The Utility Regulator states:

*“However, due to the lack of directly comparable data and the need to allow for some impact of GNI activities, we do not place a strong weight on this assessment.”<sup>26</sup>*

We note that in having assessed evidence from the Republic of Ireland presented by the Utility Regulator the CMA Final Determination stated:

*“We have a number of concerns with this piece of evidence...”*

*These factors in our view call into question the UR’s assumption that the total number of OO connections (or equivalent) in the Republic of Ireland are equivalent to the number of connections that would result without any sales or advertising spend from FE.”<sup>27</sup>*

For the reasons outlined above firmus energy agrees that the Utility Regulator should not place any weight on its assessment of the RoI gas market.

## 4. Greater Belfast Case Study

Firmus energy acknowledges the intention of the Utility Regulator to consider Greater Belfast as a comparator. As noted above, firmus energy recognises the importance of benchmarking as a comparison technique.

We note that there are significant differences between firmus energy’s network and the PNL network during the period 2010 to 2016, including the presence/absence of supply competition, the alignment of gas and oil prices, housing market activity and wider economic conditions. Therefore, we again welcome the Utility Regulator’s recognition that none of these factors have been accounted for as part of their analysis.

Moreover, we note that the Utility Regulator states they have not been able to produce sufficient data from this case study to enable statistically robust analysis.

*“The Greater Belfast case study identified a number of concurrent changes which might contribute to the change. However, there was insufficient data to undertake a statistically robust analysis capable of distinguishing between the impacts of different factors on connection rate reach specific conclusions on non-additionality.”<sup>28</sup>*

Given these findings from the Utility Regulator we agree that no weight should be given to this case study and, as such, any resultant analysis should be discounted.

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<sup>26</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 25, paragraph 3.57

<sup>27</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 115-6, paragraphs 5.139 and 5.144

<sup>28</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 29, paragraph 3.73

## Non-additionality Evidence Threshold

As noted in our introduction, the CMA remitted the determination of the non-additionality rate to the Utility Regulator for reconsideration and redetermination. In doing so the CMA stated:

*“In respect of Ground 2B, we have decided to remit the matter back to the UR for reconsideration and determination and to give directions, which include: that the UR undertake further analysis to **determine** and **calculate** a revised non-additionality rate; calculate the consequential effects; and proceed with the necessary modification of FE’s licence.”<sup>29</sup>*

The Consultation describes only four areas of “Further work undertaken to calculate a revised non-additionality rate”<sup>30</sup> by the Utility Regulator.

As the Utility Regulator has recognised, case studies 1, 3 and 4 do not provide any further evidence to inform the determination of a non-additionality rate.

Consequently case study 2, the customer survey, is the only workstream the Utility Regulator might rely on to calculate a rate of non-additionality. Our views on the customer survey have been noted on pages 5-7.

The CMA Final Determination notes:

*“We would expect assumptions that are major drivers of the price control to be based on robust evidence.”<sup>31</sup>*

The Utility Regulator has determined it cannot rely on three of the case studies and therefore they cannot be assessed as **further analysis** and in any case, do not **calculate** a revised non-additionality rate.

The fourth workstream, the customer survey, fails to appropriately **calculate** a revised non-additionality rate. In any event, the survey’s failure to encompass all aspects of the connection incentive, notably the impact of customer incentives, undermines the value of the survey undertaken, and any subsequent analysis and interpretation.

On this basis it is difficult to conclude that the determination of non-additionality in The Consultation is based on sufficient evidence, substantiation or calculation.

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<sup>29</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 197, paragraph 8.38

<sup>30</sup> Utility Regulator, Consultation on CMA Decision on GD17 referral by firmus energy, page 16, paragraph 3.16

<sup>31</sup> CMA, Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation Final determination, page 101, paragraph 5.85

## **Proposed Licence Modifications**

Firmus energy recognises that in order to give effect to the CMA Final Determination the Utility Regulator is required to modify the firmus energy Licence.

Firmus energy notes that the proposed deletion and replacement of the table of Determination Values from Condition 4.7 of the Licence reflects the proposed changes contained within The Consultation.

We recognise the necessity to use an average 2014 price base when adopting changes to the firmus energy Licence.

We agree that the Designated Parameters should not change in regard to this proposed licence modification.

Firmus energy notes the connection target numbers are not specifically referenced in the firmus energy Licence. We would therefore welcome clarification from the Utility Regulator regarding how the alteration of connection target numbers, as published within the GD17 Final Determination, will be communicated to ensure future clarity of the updated determination figures.

10 January 2018

# NON-ADDITIONALITY IN THE REPUBLIC OF IRELAND'S GAS MARKET

## Comment on the Utility Regulator's further analysis

On 19 December 2017, the Utility Regulator published a document entitled “*Consultation on CMA Decision on GD17 referral by firmus energy*”. Frontier Economics has been asked by firmus energy to provide comment on Annex 3 of that document, which is titled “*Case study of the Republic of Ireland market*”.

### The Utility Regulator's findings

Annex 3 presents the Utility Regulator's analysis of domestic connections in the Republic of Ireland (ROI) gas market, and uses that to draw inferences on “non additionality”, that is, the proportion of gas connections that would occur without spending on marketing and sales.

The Utility Regulator appears to consider that GNI undertakes relatively limited connection growth activities. For example, the Utility Regulator states:

*In the PC3 period there were no regulatory incentives for GNI to connect domestic owner occupied properties to the gas distribution network, nor were there any specific allowances for market development for the domestic owner occupied section. Therefore any expenditure by GNI on marketing and development in the PC3 came from within its overall opex allowance.*

In relation to PC4, the Utility Regulator states

*The CRU<sup>1</sup> introduced an incentive for GNI for connections it attains over and above its projected Business as Usual connections as part of its PC4 determination which began in October 2017, however this connection incentive is much more limited than that which is available to firmus in the GD17 period.*

On the basis of its views that GNI engages in limited connection growth activity, the Utility Regulator infers possible non- additionality by comparing “connection rates”<sup>2</sup>. The Utility Regulator calculates the “connection rate” in the Republic of Ireland and firmus energy's area at 2.3% and 5%, respectively.

The Utility Regulator suggests that this means the “non-additionality could be as high as 46%”. In other words, the Utility Regulator appears to be saying that all of the connections in ROI could be “non additional” as the ROI connection rate (2.3%) is 46% of firmus energy's connection rate (5%).

<sup>1</sup> The Irish Commission for Regulation of Utilities (i.e. CRU).

<sup>2</sup> The number of new owner occupied connections as a proportion of (total domestic properties minus the number of domestic properties rented from local authority).



The Utility Regulator goes on to conclude the following:

*While GNI does not have the same incentive based funding for advertising and marketing available to firmus energy, and the connection charge in ROI will act as a disincentive to connections, it is possible that GNI's activities will have some impact on connection rates. It is reasonable to assume that some part of the connection rate in ROI will be attributable to GNI activities but this will not be high. **Assuming that up to 50% of connections would not be made without GNI's limited marketing activities** {emphasis added}, we arrive at a range for non additionality of 20% to 45%. Taking account of the awareness and influence of advertising / activities revealed in our survey of firmus energy consumers it is reasonable to conclude that non- additionality is at the upper end of this range.*

## Our comments on the Utility Regulator's findings

The Utility Regulator has compared GNI and firmus energy's network as if they were like-for-like networks. However, there are a number of factors that should be controlled for when comparing across networks. For instance, the gas network in ROI is more mature than the network in firmus energy's area due to the network been established for a longer period of time. Moreover, GNI's network is larger and therefore may benefit from economies of scale in some of its activities. To ensure a like-for-like comparison, such factors need to be controlled or adjusted for in any cross-jurisdiction benchmarking analysis.

Our main concern with the Utility Regulator's analysis, however, is that its analysis and assumptions in relation to the impact of GNI's growth activities appear to be based on a misunderstanding of GNI's regulatory incentives and the extent of GNI's growth promoting activities.

In particular, as we detail further below, GNI has:

- had a significant growth promotion allowance for new connections since PC1;
- been allowed a significant increase in its growth promotion allowance for new connections in PC4, which suggests this spending is required to meet business as usual growth targets.

## GNI has had a growth allowances since PC1

The Utility Regulator stated that GNI had no specific allowance for growth promotion activities in PC3, but these costs have formed a specific part of GNI's opex allowance.

From PC1 to PC3, GNI has had an opex allowance for market development and new business costs (which is now called "growth promotion activities")<sup>3</sup>. GNI's allowed costs for these activities were a specific component of the CRU's bottom-up assessment of GNI's opex. If GNI had not been able to justify these costs,

<sup>3</sup> See, for example: CRU, 2012, *Decision on October 2012 to September 2017 distribution revenue for Bord Gáis Networks: Decision Paper*

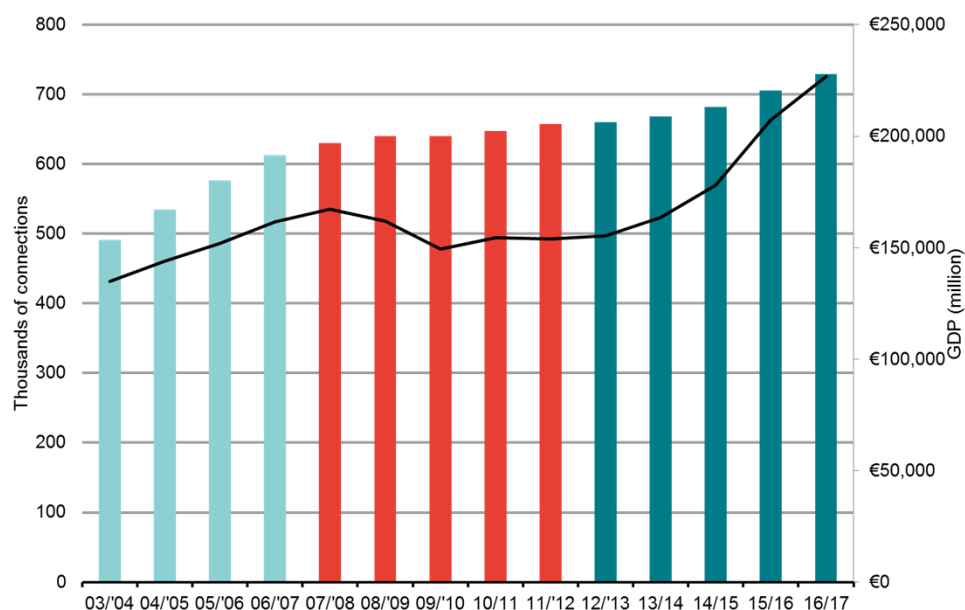


then they would have been disallowed, and its allowance would have been commensurately lower.

Unlike firmus energy's connection incentive, this allowance was in the form of a lump sum, rather than a per connection allowance. This lump sum is a significant amount. For example, according to the CRU, GNI spent about €1.5 million on growth promotion activities in 2015/16, which is the last year of available data<sup>4</sup>.

Throughout this period, GNI achieved substantial customer growth, including during the PC2 period when there was a significant economic downturn in Ireland (Exhibit 1).

**Exhibit 1. Estimated GNI customer numbers from 2003/04 to 2016/17**



Source: CRU price control determinations

We note that the CRU assesses GNI's spend on an ex ante basis to determine whether that spend was required to meet connection targets. Following this assessment, the CRU has allowed for growth promotion spend in the next price control, which presumably is because they found the previous spend to be effective in growing connections (i.e. led to additional connections).

In fact, as discussed below, the CRU welcomed GNI's proposals to grow connections further in PC4 as it "recognises the benefit of increased utilisation of the existing gas network for gas customers"<sup>5</sup>. Therefore, the CRU allowed for significant increases in growth promotion activities, which suggests it found that such spending on growth promotion activities would result in additional connections compared to a situation without that spend.

<sup>4</sup> CRU, 2017, Decision on October 2017 to September 2022 Distribution Revenue for Gas Networks Ireland.

<sup>5</sup> CRU, 2017, Response Paper to Consultation on GNI Revenue for PC4.

## GNI's growth allowance has increased significantly in PC4

In PC4, the CRU allowed GNI €15.3 million (or, over €3 million per year) for growth promotion activities<sup>6</sup>, which is a substantial increase above current spend.

*“As explained in Section 3.2.3 the commercial department was established in early 2015, to address the need to increase utilisation of the gas network. A substantial element of the department's costs is allocated to growth promotion activities, with GNI requesting €18.1m over PC4. The CER {i.e. CRU} recognise the benefit to existing consumers of exploiting the installed network assets, however, the CER has decided to allow €15.3m, which is a 100% increase {emphasis added} on the annual expenditure incurred in the last full year of actuals (2015/16).”*

This growth promotion activities allowance has been provided to meet business-as-usual connection targets.

GNI's growth promotion activities are based on GNI's “detailed growth strategy which identifies measures it believes can increase market share in the residential and industrial and commercial sectors during PC4”<sup>7</sup>. Some of the measures identified in that strategy in relation to residential include:

- marketing;
- targeting new housing by providing advice to industry participants;
- working with vendors to promote gas heat pumps and domestic Combined Heat and Power (CHP) units; and
- supporting additional regulatory and commercial schemes<sup>8</sup>.

In PC4, the CRU also introduced an additional growth promotion incentive on a per connection basis, which incentivises additional connections above business-as-usual. This per connection allowance could be worth up to €3.5 million, if GNI reaches its targets.

While the Utility Regulator discusses this additional allowance in its Annex, it does not discuss the lump sum allowances. We note that, at most, the per-connection allowance could account for 19% of GNI's growth promotion activities allowances. The primary connection allowance is the lump sum allowance. By ignoring this, the Utility Regulator has significantly underestimated the impact that GNI's activities have on the number of connections.

## Conclusion

The Utility Regulator's analysis on non-additionality in ROI hinges on its views of the impact of GNI's growth promotion activities on its new connections. The Utility Regulator assumes that the proportion of GNI's new connections that result from

<sup>6</sup> CRU, 2017, Decision on October 2017 to September 2022 Distribution Revenue for Gas Networks Ireland.

<sup>7</sup> CRU, 2017, Response Paper to Consultation on GNI Revenue for PC4.

<sup>8</sup> CRU, 2017, Response Paper to Consultation on GNI Revenue for PC4.

that spend is between 0% and 50%<sup>9</sup>. However, it has failed to appropriately evidence this assumption.

In fact, in our view, the Utility Regulator's analysis does not accurately portray the extent on GNI's growth promotion activities. This appears to stem from a misunderstanding of GNI's allowances, as GNI receives a significant lump sum allowance for growth promotion activities. Over time GNI has invested heavily in growth promotion to help drive significant growth across its network, and this is forecast to continue in PC4.

Therefore, as the assumption in relation to the additionality impact of GNI's growth promotion activities has not been substantiated, and as this assumption has been based on a misunderstanding of GNI's allowances and activities, we consider that no conclusion can be drawn from the Utility Regulator's ROI analysis in relation to non-additionality for firmus energy.

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<sup>9</sup> This figure has already adjusted for an estimated 22.8% of connections that result from suppliers' growth promotion activities.

15 December 2017

## **Introduction**

This document provides a commentary on the survey undertaken by Social Market Research (SMR) on behalf of the Utility Regulator by means of a questionnaire (**"The Survey"**). SMR questioned Owner Occupied customers regarding their reasons for connecting to natural gas in the Ten Town's Licensed Area. The Utility Regulator shared The Survey results data and a draft report on The Survey results (**"Draft SMR Survey Report"**) with firmus energy on 6 December 2017.

## **Definition of Non-Additionality**

In our 2 October 2017 correspondence regarding The Survey development firmus energy highlighted the necessity that the Utility Regulator comprehensively explain the concept of non-additionality to the survey contractor when appointed, stating:

*"As part of this process the successful survey contractor should be provided with a comprehensive explanation of the concept of non-additionality and its significance within the GD17 Final Determination and CMA appeal."*

The regulatory definition for non-additionality was outlined in the GD17 Final Determination as follows:

*"Connection Incentive: Non – additional connections*

*6.157 As in GD14, we have used a concept of non – additionally [sic], as we consider that there will be a certain number of OO connections that would occur anyway without any direct marketing or selling to these customers. We describe these connections as "non-additional". Since FE could in theory avoid any sales-related costs to connect such customers, no allowance will be applicable for these customers."*<sup>1</sup>

The Utility Regulator also shared with firmus energy the definition of non-additionality provided to SMR:

*"The Additionality Rate is a component of the Connection Incentive. The Connection Incentive is a mechanism that provides a cash allowance for each domestic owner occupied customer (This excludes any property type classified as part of the Northern Ireland Housing Executive or New Build properties of were [sic] no allowance is payable) who connects to the natural gas network. This allowance is to typically cover the costs in relation to getting a customer connected, which would typically be as follows: Advertising, Marketing, Customer Sales Staff etc. and any financial incentive given to installers or directly to customers."*<sup>2</sup>

Both definitions highlight the wide scope of sales related costs encompassed within non-additionality allowance.

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<sup>1</sup> GD17 Final Determination, page 88, para 6.157

<sup>2</sup> Email from Paul Harland to Peter McClenaghan on 19.10.17

The Survey, however, did not align with the regulatory definition. This is apparent from the executive summary of the Draft SMR Survey Report which describes the significantly narrower scope of The Survey as:

*“The survey also sought to estimate the percentage of owner occupiers who would have connected to the Firmus Energy gas network without any advertising or media awareness.”*

This SMR definition aligns to the background provided in the Invitation to Tender issued by the Utility Regulator.

*“This will assist the UR in setting an appropriate rate for the percentage of customers which would have connected to the FE gas network without any advertising or media awareness and set appropriate connection allowances and targets within the price control for GD17.”<sup>3</sup>*

This difference in definition between the GD17 Final Determination and that used in The Survey is critical.

Even if it were possible for The Survey to confirm that some customers connected to the natural gas network without advertising or media costs, it does not confirm if other sales related costs were incurred, such as Energy Advisor assistance, incentive payments, and/or customer service support. This narrow definition therefore risks penalising firmus energy by ignoring legitimate costs required to attract customers. In any event, The Survey does not provide for the consideration of these costs, and therefore cannot reasonably assist the Utility Regulator in substantiating and determining non-additionality.

### **Application of Non-Additionality**

The Draft SMR Survey Report notes 58% of all respondents claim not to have been influenced by firmus energy advertising or activities in their decision to connect. This figure cannot be applied as a proxy for non-additionality. Nor can the 30% of respondents who claim not to have seen firmus energy advertising.

This is because, as noted above, the concept of non-additionality is not simply a test of advertising effectiveness, instead it is a test of how many Owner Occupied connections would result without any action from firmus energy.

Firmus energy has taken upfront action to reach all those individuals regardless of whether they believe they have seen our advertising and/or been influenced by it.

This action to achieve Owner Occupied connections includes investment in advertising, marketing, Energy Advisors, business support staff, literature and financial incentives. All these costs are borne by firmus energy before a connection is made.

It is not possible to apportion every one of these costs to individual customer interactions but all are essential costs in making Owner Occupied connections.

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<sup>3</sup> Contract for FE CMA Survey – Invitation to Tender, Terms of reference for a survey services in connection with gas customer switching.

## **Design of The Survey**

Following publication of an initial draft of The Survey in the Invitation to Tender on 25 September 2017 the Utility Regulator developed The Survey methodology in conjunction with SMR during October 2017. SMR undertook a pilot of The Survey during the week of Monday 16 October 2017.

Despite repeated requests to be appropriately engaged throughout the process, firmus energy's input was not adequately considered. For example, firmus energy were provided no opportunity to input into either the pilot used to test The Survey or the methodology for The Survey. The Survey methodology was first shared with firmus energy in its final form on 23 October 2017.

Firmus energy was provided the opportunity to comment on The Survey questionnaire. When doing so on 18 October 2017 we noted that:

*"It is apparent to firmus energy in assessing the latest version of the survey that ambiguity, bias, a lack of context and inappropriate response options still remain embedded in the survey design."*

On receipt of the Draft SMR Survey Report we remain of this view and do not believe it provides any basis to develop a statistically robust conclusion on the appropriate level of the non-additionality rate, nor a basis to assist any aspect of the Utility Regulator's consideration of non-additionality.

In this regard, as highlighted in our correspondence on 2 October 2017 and 18 October 2017, question 5 "How did you know or become aware that natural gas was available in your area?" relates to customer awareness of natural gas and not customer motivation for connecting to natural gas. Consequently, the responses to this question do not yield data from which to determine the influences on the customer's decision making process. As a result, the data from this question cannot directly contribute to any consideration of non-additionality.

Similarly, we also highlighted in our correspondence on 2 October 2017 and 18 October 2017 that question 7 "Of the reason(s) you mentioned for connecting to natural gas, which was the most important?" is not relevant to non-additionality as the "most important" reason for connecting is not necessarily the only contributing reason for that decision. Whilst respondents may have identified the 'most important reason' for connecting to natural gas from the motivational factors that they were able to recall, it does not follow necessarily that no other influences contributed to that decision.

It cannot be derived from the responses to question 5 as posed whether the option selected by respondents was the only reason that they decided to connect to natural gas.

Even if individual questions, such as 5 and 7 discussed above, did adequately capture customer responses in a manner that could assist the consideration of non-additionality, they would still fail to do so as The Survey has not been designed to consider all legitimate costs firmus energy require to attract and connect Owner Occupied customers.

## **Economic Considerations**

It is notable, that the level of Government incentives which exists for customers, whilst itself a recognition of the importance of affordability in the development of the domestic natural gas market, has not been reflected in The Survey.

In our correspondence on 2 October 2017 we provided suggested questions for discussion which we had developed with assistance from market research specialists Millward Brown. This included targeted questions relating to incentives provided to customers in order to achieve the determined

rate of Owner Occupied connections. The final iteration of The Survey did not incorporate questions relating to customer subsidisation.

Given that approximately 75% of the Owner Occupied connections as at the end of 2016 required some form of government-funded grant assistance, the absence of a question directly relating to incentives, or affordability, serves to undermine any resultant analysis pertaining to non-additionality.

It is also important to note that every Owner Occupied connection achieved with Government-funded grant assistance requires investment by firmus energy, including Energy Advisor salaries, advertising and marketing, and often funding toward the Government schemes.

### **Analysis of The Survey**

The Invitation to Tender issued by the Utility Regulator provided an outline of requirements, stating:

*“6. Production of a detailed analysis of the data, report on the responses, drawing out trends and identifying any correlation with particular demographic or geographical factors and a high level summary report highlighting the main themes and conclusions;”<sup>4</sup>*

However, during a meeting on 24 October 2017 the Utility Regulator confirmed that while they had engaged industry specialists SMR to execute The Survey, the analysis and interpretation of the data provided would instead be carried out by the Utility Regulator.

We note that this change in approach has limited the ability of the Utility Regulator to make use of SMR’s market research expertise when undertaking the interpretation and analysis of results. It is imperative that the data interpretation and analysis is undertaken in accordance with best practice.

We note that splitting the responsibility in this way, with SMR conducting The Survey and the Utility Regulator undertaking the data interpretation and analysis, appears at odds with the guidance provided in the Market Research Society Guidelines for Questionnaire Design which firmus energy shared with the Utility Regulator on 2 October 2017. It states:

*“It is impossible to divorce good practice in questionnaire design – in terms of ethical and technical responsibilities – from the interpretation of the resulting data. As part of the questionnaire design process, researchers should consider how they expect to analyse and report the results.”<sup>5</sup>*

The conflicting definitions of non-additionality provided to SMR by the Utility Regulator, as noted above, served to negatively impact upon The Survey design and will therefore impact upon the ability to undertake robust analysis of The Survey results.

### **Confirmation Bias**

Having previously included a figure for non-additionality in the GD17 Final Determination, by choosing to undertake the analysis and interpretation of The Survey without the independence and expertise

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<sup>4</sup> Contract for FE CMA Survey – Invitation to Tender, Terms of reference for a survey services in connection with gas customer switching.

<sup>5</sup> Market Research Society, MRS Guidelines for Questionnaire Design, July 2011, Updated September 2014, Page 23, <https://www.mrs.org.uk/pdf/2014-09-01%20Questionnaire%20Design%20Guidelines.pdf>

of SMR, the Utility Regulator creates additional risk that the interpretation of the result becomes compromised by confirmation bias.

This risk is accentuated by the difficulties noted above regarding the definition of non-additionality and design, analysis and interpretation of The Survey.

If the data gathered by The Survey were interpreted inappropriately it could be used to support a wide range of opinion regarding the potential level of non-additionality, none of which is statistically robust.

### **Data Presentation**

We note the importance of ensuring that data is reported accurately following its analysis and interpretation. In line with best practice, it is important that The Survey data is not conflated in instances where questions permitted multiple customer responses, and that appropriate sample sizes are used. We welcome that SMR note this in section 2.7 of the Draft SMR Survey Report. It is imperative that this practice is continued by the Utility Regular as they interpret, analyse and present The Survey data.

### **Customer Recall**

In our 18 October 2017 correspondence regarding The Survey we noted that while we understood the necessity to question a large number of customers in order to provide a representative sample, the longer the time period since customers connected, the less likely their recall will be accurate.

As a considerable portion of the respondents interviewed had connected to natural gas several years ago (more than two years ago for 39% of the sample), it may have been difficult for them to recall spontaneously all of the influences on their decision to connect.

### **Customer Preferences**

In our 18 October 2017 correspondence regarding The Survey we noted the importance of assessing customers revealed preferences (what do people actually do) as opposed to their stated preference (what do people say they do). We noted that this was of particular importance when attempting to assess the effectiveness of advertising.

Consideration of non-additionality is not a test of the effectiveness of firmus energy advertising. Rather, non-additionality is an assessment of the number of customer connections firmus energy could achieve without any marketing, advertising or sales expenditure.

In attempting to quantify this number The Survey does not attempt to account for any predetermined views customers may hold in answering questions regarding whether they have been influenced by advertising.

We had suggested previously, that if asked whether or not sales or marketing had influenced their decision to connect to natural gas, a significant number of respondents may answer 'no', as they might not want to admit to, or be aware that, their decision making is affected by marketing activities.

There appears to be a disconnect between the responses to question 3.6 and the responses to the question in the Draft SMR Survey Report section 3.4 (most important reason for connecting to natural



gas). Although 58% of respondents claim that their decision to connect was not influenced by firmus energy marketing, many of the influences cited in the Draft SMR Survey Report section 3.4 are messages that have appeared frequently in firmus energy marketing campaigns.