

BGE (NI) Ltd Price Control 2012 – 2017

BGE (NI) Response to the Utility Regulator's Initial Proposals for Consultation

13th June 2012

1.0 Introduction

BGE (NI) is pleased to respond to this important consultation on the Utility Regulator's initial proposals in relation to our price control for the period 2012/13 to 2016/17.

BGE (NI) is a long established TSO which has made a considerable investment in the Northern Ireland gas industry. We have consistently delivered safe, reliable, efficient network performance and the five year price control process is critical to ensuring that we can continue to provide this level of service within the framework of our overarching regulatory contract.

Our comments below reiterate those previously made to the Utility Regulator in both verbal and written submissions. We are keen to engage further with both the Utility Regulator and its consultants to explore these issues and provide any further clarifications required.

2.0 Proposed Reductions to BGE (NI) Allowances

BGE (NI) is strongly of the view that the Utility Regulator's proposals in relation to reductions to our requested levels of opex and capex allowances are not appropriate. The level of cuts proposed will threaten the service and reliability levels to Shippers, Connected Distribution Systems and Consumers.

The Utility Regulator's current opex proposals are inadequate for the continued operation of the network at existing performance levels. For example, no allowance is currently proposed for key activities such as Asset Management; Detailed Design; Health, Safety, Quality and Environment; and Scheduling and Dispatch even though the Utility Regulator's consultants acknowledge that such activities are required.

Similarly, the Utility Regulator's position not to allow capital expenditure on key business and emergency systems is not sustainable and again conflicts with the recommendation of its own consultants' reports. The systems which BGE (NI) wish to maintain and upgrade will be c. 15 years old at the end of this price control period and include key areas such as gas station controls, and job maintenance and scheduling systems.

Failure to allow such expenditure combined with a continued focus by the regulator on the use of manual rather than automated systems will threaten reliability of gas supplies.

3.0 Approach to the Price Control Review

Throughout this Price Control review, BGE (NI) provided detailed submissions to the Utility Regulator and answered the limited number of questions raised.

BGE (NI) wishes to express its disappointment at the level of direct engagement from the Utility Regulator and its consultants over the course of the price control review period. Before the consultation paper was published, only two teleconference meetings were held to discuss our Opex and Capex submissions. These were followed by additional queries from the Utility Regulator and its consultants to which BGE (NI) submitted detailed responses. BGE (NI) also offered to host the Utility Regulator and its consultants on a site visit to inspect our systems and support facilities and were disappointed that this was not accepted. At no point following these interactions was BGE (NI) informed that the Utility Regulator considered certain information to be outstanding. As a result, BGE (NI) does not believe that 'absence of information' can be accepted as a valid rationale for the Utility Regulator's disallowance of a significant number of our proposals.

It was only post publication of the Utility Regulator's position and following several requests that BGE (NI) was granted sight of a version of the consultants' report on our price control submissions. The version provided has redacted sections and BGE (NI) continues to seek a full copy of the consultants' report. Had BGE (NI) been provided with a copy of the report at an earlier stage, we would have been in a position to address any required clarifications before the consultation paper was published. We urge the Utility Regulator to review its process for engagement with Licensees to ensure that these deficiencies are addressed for future price controls.

BGE (NI) also wishes to correct a factual inaccuracy in the consultation paper which states that we changed our reporting format with no prior discussion with the Utility Regulator. In fact, BGE (NI) informed the Utility Regulator in April 2011 of the requirement to update our detailed cost headings. We offered to answer any questions the Utility Regulator may have had and, before proceeding, we received confirmation from the Utility Regulator's office that this approach was acceptable. BGE (NI) advised the Utility Regulator of this sequence of events before the consultation paper was published and is disappointed that the inaccuracy was not corrected.

4.0 Benchmarking

Benchmarking is a key regulatory tool for ensuring a robust evidence base upon which efficiency levels can be reliably measured. Although the Utility Regulator states that it asked its consultants to consider benchmark comparisons of BGE (NI)'s operating expenditure costs against those of other energy/utility companies where appropriate, no evidence of such benchmarking is provided in the consultation paper.

The version of the consultants' report provided to BGE (NI) had various benchmarking sections redacted. The Utility Regulator has stated that it has not used benchmarking information to date in arriving at its

conclusions. BGE (NI) believes this position lacks credibility and we do not believe it is a valid reason for not publishing or sharing the outputs. We urge the Utility Regulator to reconsider this position and make a full copy of the consultants' report available to us. BGE (NI) reiterates our previous requests to the Utility Regulator to progress a benchmarking analysis of all 3 TSOs in Northern Ireland. In summary, BGE (NI) believes that the Utility Regulator has provided no evidence or rationale for further and continued efficiency cuts in our allowances.

5.0 Controllable Operating Expenditure

5.1 Maintenance

The Utility Regulator is proposing to reduce the ROI Maintenance and Operations cost line which includes maintenance of the portion of the South North pipeline which is located in the Republic of Ireland. The rationale for this reduction is partly based on the consultants' calculation that ROI maintenance costs are higher per kilometre than those for the NI sections of the pipeline. BGE (NI) has reviewed this calculation and has found it to be inaccurate. The correct analysis demonstrates that the ROI section is more cost effective per kilometre than the NI section of the network and this calculation has been provided to the Utility Regulator. This efficiency is made possible by the inclusion of this section of pipeline within the Bord Gais Network ROI maintenance programme and the leveraging of scale economies. BGE (NI) believes the tendering of this service to another provider would give rise to higher costs. We note that the Utility Regulator's consultants recommend that all of BGE (NI)'s maintenance submission be allowed and that benchmarking of direct maintenance related costs demonstrate that BGE (NI) is an efficient RPO compared to other gas TSOs in Northern Ireland.

5.2 Safety

BGE (NI) acknowledges the Utility Regulator's proposal to allow the submitted costs for PSSR and CIPS activities. However, for the remaining activities under 'Safety Campaign', the Utility Regulator is proposing to allow only £30k per annum even though the Utility Regulator's consultants recommended that all of BGE (NI)'s safety submission be allowed. While this approximately equates to the reported cost of the Safety Campaign in 10/11, it does not take account of integrity costs which were then reported under maintenance.

BGE (NI) requests the Utility Regulator to reconsider its proposed allowances for Safety related activities including those relating to public awareness of safety. An inadequate allowance would be counterproductive through potentially increasing the number of pipeline incidents.

5.3 Asset Management, Detailed Design, Scheduling and Dispatch and HSQE

The Utility Regulator is proposing to disallow BGE (NI)'s costs for Asset Management, Detailed Design, Scheduling and Dispatch, and Health, Safety, Quality and Environment on the basis that these were 'assumed' to have been factored in to BGE (NI)'s acceptance of the current price control allowances.

This assumption is completely incorrect. Only one element of Asset Management, i.e. the Joint Gas Capacity Statement, was covered in the 2007-2012 price control allowances. No allowance was provided for Detailed Design, Scheduling and Dispatch, or Health, Safety, Quality and Environment as at that time BGE (NI) had not sufficiently broken down the various operating elements across the constituent parts of its business. As a result, although these services were being provided, BGE (NI) did not receive any charge from 2007/08 to 2010/11. This is clearly evident from our opex returns over this period.

Both the Utility Regulator and its consultants agree that these activities are required for the safe and efficient operation of a network hence we can see no reasonable basis for the disallowance of the associated costs. We request the Utility Regulator to reconsider its position and allow the submitted costs. If allowances are not provided for these activities, BGE (NI) will not be able to continue to provide services such as the Joint Gas Capacity Statement etc.

It should also be noted that the allocated costs for these activities are minimal and serve to support day to day operational activities rather than capital development projects. As a result, there is no duplication with our capex proposals.

5.4 Transportation Services

The Utility Regulator is proposing to disallow BGE (NI)'s submission for a NI Affairs Manager on the basis that we should already have such a dedicated resource. BGE (NI) does not have a dedicated resource for NI affairs. This is very clear from the current price control out-turns whereby support costs are incurred on an allocations basis only. BGE (NI)'s submission for the individual elements of Transportation Services assumed that a new NI Affairs Management role would absorb a portion of the existing workload. However, in disallowing the role, the Utility Regulator has not made any corresponding cost adjustment to the other Transportation Services areas to compensate for the transferring workload.

As the Utility Regulator is aware, excluding Gas Transportation Management (GTMS) and Finance (which are now covered under Shared Services), the actual cost for Transportation Services in recent years has been (April 2011 monies):

08/09: £219k

09/10: £203K

10/11: £213k (*estimated).

It is therefore clear that the Utility Regulator's proposed average allowance of c. £153k pa will not be sufficient to cover costs.

Since the consultation paper was published, BGE (NI) has provided the Utility Regulator with a revised estimate for Transportation Services which:

1. Increases the cost of Regulatory Controls from £68k pa to £179k pa to account for the transference of workload from the NI Affairs Manager role.
2. Adds an additional cost of £40k pa as a modest allocation for routine code development work. This work was not included in the original submission as a code moratorium was in place at that time due to CAG. The Utility Regulator has written to advise that CAG is not certain to proceed and therefore we now seek an allowance for routine Code Modifications.

5.5 Shared Services

The Utility Regulator is proposing to roll over the current allowance of £268k as an aggregate amount for the Shared Services of IT, Finance, HR, Facilities, Secretariat and Group Recharge. BGE (NI) believes this is wholly insufficient for the following reasons:

- It does not take into account the direct impact of Third Directive unbundling on Shared Services. As the Utility Regulator is aware, the Third Directive prohibits the sharing of support functions by a TSO within a vertically integrated utility. As a result, Bord Gais Networks (as service provider to BGE (NI)) can no longer share services with BGE Group and must establish its own standalone support functions. Since the consultation paper was published, BGE (NI) has provided the Utility Regulator with an estimate of this cost impact.
- It does not make any allowance for the following costs which are included under Shared Services in our submission – Gas Transportation Management Systems (GTMS); Networks Finance; C&I Leased lines; Maps. Together these accounted for c. £127k in 09/10 (nominal).
- The current price control makes only very minor allowances for HR and Facilities.
- The current price control is not reflective of the level of shared services support currently provided to BGE (NI).

BGE (NI) also reiterates its request to the Utility Regulator to provide a breakdown of the proposed allowance into its constituent parts i.e. IT, Finance, HR, Facilities, Secretariat, and Group Recharge. BGE (NI)'s opex submission provided this level of cost detail and we fail to understand why the Utility Regulator has instead taken a consolidated approach to its draft proposals. BGE (NI) is firmly of the view that it is unreasonable of the Utility Regulator not to provide absolute clarity on the individual service

allowances. Such an approach is not at all transparent and serves to mask the inadequacy of the allowance for each service.

We request an urgent review of the proposed quantum of the allowances as well as a detailed breakdown of the individual service elements.

5.6 Insurance:

The Utility Regulator is proposing to reduce the insurance allowance to £195k pa versus BGE (NI)'s submission of an average £278k pa. The rationale provided is that actual insurance costs from 07/08 to 09/10 are lower than the BGE (NI) estimate.

BGE (NI) wishes to note that insurance costs are extremely difficult to forecast for a 5 year period given the complexity of the many factors which influence the market on an annual basis. BGE (NI) has benefited in recent years from multi-year deals which were available to utilities with a good claims record. Without these deals the cost of insurance would have been significantly greater than that which was actually achieved. This fact was reinforced prior to the 2010/11 renewal when underwriters with whom we had a long association exited our account as premiums fell below their accepted threshold.

There was a 10% increase in our liability premiums in 2012. We remain exposed to market fluctuations, and as the market is currently in a soft cycle, it is anticipated the rates will harden with associated premium increases in the next period. There is an increased level of uncertainty in the insurance market and there is a strong indication that insurers will push for premium increases.

5.7 Cost Apportionment

The Utility Regulator states that it will consider options for putting in place a basis for apportioning costs which cannot be changed without consent and will consider a licence modification as part of the price control review. BGE (NI) wishes to note that it does not engage in cost apportionment but rather receives services from Bord Gais Networks under the commercial terms of a services agreement between the parties. This Services Agreement offers BGE (NI) exceptional value for money as costs are allocated from BGN thus providing the benefit of significant economies of scale which would be extremely difficult to replicate with any other service provider.

As previously outlined, an example of this efficiency is maintenance of the section of South North Pipeline located in the Republic of Ireland. We believe tendering such areas of our activities to other providers would give rise to cost increases.

5.8 Additional Manual Work imposed by Infringements related activities

BGE (NI) wishes to note that the current solution selected by the Utility Regulator for the resolution of infringements with EU law will impose additional manual work requirements on BGE (NI) which will endure into the next price control period. These were not included in BGE (NI)'s original submission as the Infringements project had not commenced at that time. BGE (NI) requests that these manual activities be taken into account in the Utility Regulator's decision on opex allowances. BGE (NI) is happy to engage further with the Utility Regulator on this issue and to provide estimates of the costs involved.

6.0 Uncontrollable Operating Expenditure

6.1 Rates, Licence Fees and PSA fees

BGE (NI) agrees that rates, licence fees and PSA fees should be treated as uncontrollable pass through costs.

6.2 Non Routine Work

The Utility Regulator is proposing that any non routine work outside of CAG, EC 715 and ENTSG code implementation will need to be funded from the controllable operating allowance. BGE (NI) cannot accept this position. It is unreasonable of the Utility Regulator to expect that BGE (NI) will bear the risk of changes in law and other unforeseen factors.

The Utility Regulator is proposing to reduce BGE (NI)'s submission by c. 26% plus an additional compounding efficiency factor of 1.5% pa. These proposed allowances will not be sufficient to cover routine operating costs and will certainly not provide any capacity for non-routine work. BGE (NI) seeks clarity from the Utility Regulator on what specific proposed allowances could be used to support non-routine work such as security of supply or the impact of extended north south Network liaison etc.

BGE (NI) also wishes to note that our original submission of controllable operating costs only covered the then current routine operating costs. No costs associated with code development activities were included as there was a code moratorium in place at the time of submission. Since the consultation paper was published, BGE (NI) has submitted a cost estimate for routine code development work to the Utility Regulator.

BGE (NI) understands from discussions with the Utility Regulator that it agrees with the principle that all efficiently incurred costs are recoverable. BGE (NI) requests clarity in the Utility Regulator's price control decision paper on the methodology which will be followed to finalise scope and costs in relation to CAG, EC715, ENTSG codes and other uncontrollable costs.

In the current price control period the Utility Regulator has decided not to proceed with implementation of certain aspects of EC1775 (European Directive requirements) pending market demand for the services. BGE (NI) seeks to reduce risk by addressing legal requirements as they arise to avoid situations where parties are forced to install sub-optimal solutions. Accordingly, the development of proper and timely processes for planning, approving and implementing future legally binding development work is vital for the NI gas market. This is particularly so given the scale of such requirements from Europe. BGE (NI) also requests the Utility Regulator to confirm its proposals in relation to the scope, triggers and methodology for any 'reopeners' on uncontrollable costs.

6.2.1 IME3

The Utility Regulator is also proposing to not allow any BGE (NI) costs for IME3 restructuring. BGE (NI) requests the Utility Regulator to provide the rationale underlying this proposal as IME3 is a mandatory legal requirement with which BGE (NI) must comply. The NI consumer has reaped the benefits of economies of scale associated with receiving services from a larger BGE group entity over several years. It is therefore unreasonable of the Utility Regulator to deny any interest in BGE (NI)'s structure and the reality is that separation of service gives rise to cost increases.

6.2.2 Innovation

The Utility Regulator is proposing to disallow BGE (NI)'s submission on the development of innovation projects. BGE (NI) is disappointed that the Utility Regulator does not see the value to the NI consumer of investment in innovation and has not explicitly signalled its support for such activity through providing 'in principle' agreement to the concept pending more detailed proposals.

7.0 Capital Expenditure

7.1 General

The Utility Regulator states that the BGE (NI) capex submission *"appears to have been developed not from detailed project plans based on clear technical and operational requirements, but rather as broad conceptual estimates for requirements that may arise.....Allowances could only be considered at the time when functional requirements are clear, detailed design has been prepared and associated costs have been compiled"*.

BGE (NI) believes this statement portrays a lack of understanding of asset investment practices. Clearly in order to develop detailed functional requirements and designs, costs would have to be incurred. BGE (NI) would require confirmation from the Utility Regulator that such costs would be recoverable before committing to such expenditure. As such, in our capex submission, we are seeking approval in principle from the Utility Regulator to proceed to such activities. BGE (NI) is strongly of the view that the Utility Regulator should allocate an allowance for required capital investment. BGE (NI) will look to recover

expenditure based on actual outcome of the works. Since the consultation paper was published BGE (NI) met with both the Utility Regulator and its consultants to explain this process. We now seek clarity from the Utility Regulator on how it wishes to progress in relation to our capex proposals.

As an input into the setting of an efficiency factor, the Utility Regulator claims that “BGE (NI) does not have a single replacement and refurbishment policy...[and]...lacked a coherent approach to asset replacement and refurbishment”. BGE (NI) rejects this assertion completely and requests it to be withdrawn. As previously outlined to both the Utility Regulator and the consultants, BGE (NI) has specific asset management policies across the various asset classes in its network and has also put in place best practice asset replacement and refurbishment practices under a High Performance Utility Model. BGE (NI) invited the Utility Regulator and its consultants to visit, review in detail and question all our Asset Management policies, procedures and personnel at a site visit, however this was declined. BGE (NI) believes that it is inaccurate, misleading and inappropriate of the Utility Regulator to state that ‘BGE (NI) does not have a single replacement and refurbishment policy’.

BGE (NI) also wishes to highlight that the asset management and detailed design opex costs included in our submission relate to routine operating activity only. Any detailed design or asset management work associated with capital expenditure projects would be additional.

7.2 Online Inspection of NW Pipeline

In proposing to reduce the allowance for Online Inspection of the North West Pipeline to £411k from BGE (NI)’s submission of £588k, the Utility Regulator states that the temporary filtration and cleaning & inspection estimate was considered high. However, no meaningful evidence is provided for this assertion in the consultation paper.

Separately, the consultants’ report challenges the cost of cleaning but only on the basis of one high level estimate from a contractor. BGE (NI) does not believe this is a robust measurement of our estimates.

7.3 Pipeline Remediation Works and Code Compliance

The Utility Regulator states that it requires further information on Pipeline Remediation Works and Code Compliance before deciding on whether to allow this expenditure. Since the consultation paper was published, BGE (NI) has met again with the Utility Regulator and its consultants to further discuss these proposals. We request confirmation on whether any other clarifications are required.

7.4 Carrickfergus and Coolkeeragh projects

The Utility Regulator is proposing to not make any allowances for the following projects at this time on the basis that they are dependent on the requirements of CAG:

- Carrickfergus Automation
- Carrickfergus C&I Refurbishment
- Coolkeeragh Controls Upgrade
- Coolkeeragh C&I Refurbishment

These works are necessary to ensure the ongoing reliability of the BGE (NI) network irrespective of CAG. Since the consultation paper was published, BGE (NI) has met with the Utility Regulator and its consultants to explain this in further detail. The Coolkeeragh work in particular is of high importance. This AGI was commissioned in 2004 with a bespoke design installed to cater for low operating pressures dictated by the Utility Regulator. It is now suffering from aging equipment and obsolescence issues and the requested upgrades are of critical importance in ensuring the stability of NI electricity generation capability. The Carrickfergus automation is also key to delivering secure gas flows to Belfast in the event of disruptions to SNIP.

7.5 AGI Security System Upgrades

The Utility Regulator is proposing not to provide any allowance for AGI Security System Upgrades on the basis that “BGE (NI) has failed to provide sufficient evidence that these measures are required by the Centre for the Protection of National Infrastructure (CPNI)”. BGE (NI) believes this is misleading as at no point was BGE (NI) requested to seek an opinion on the upgrades from the CPNI. Instead, BGE (NI) was asked to provide any past information received from CPNI on this topic (of which there was none). To date, and to our knowledge, CPNI have not evaluated NI infrastructure. BGE (NI) seeks clarity from the Utility Regulator on whether it requires BGE (NI) to now seek a formal opinion on the upgrades from the CPNI.

7.6 Transmission Marker Posts

The Utility Regulator is proposing to disallow the project to replace Transmission Marker Posts on the basis that “the work should have been completed when the pipelines were constructed”. BGE (NI) wishes to state that Transmission Marker Posts were put in place to the required standard at the time of construction however because of degradation issues (due to the passing of time) together with the evolution of best practice and associated policy improvements, upgrades are now required.

7.7 C&I AGI Refurbishment

The Utility Regulator is disallowing the C&I AGI Refurbishment project on the basis that the assets will still be within expected life at the end of the control period and the refurbishment can therefore be delayed. BGE (NI) wishes to state that the existing equipment requires refurbishment not just because of age but also because of obsolescence. BGE (NI) reiterates its position that this project is required in the lifetime of the price control period.

7.8 Cathodic Protection

The Utility Regulator proposes a reduced allowance for general CP refurbishment and no allowance for the replacement of ground beds.

In relation to general refurbishment, the consultants' report suggests that the drawing office and design activities are duplicated in our opex submission. This is not the case as the opex submission only covers routine day to day operation and not any capital project activity.

In relation to ground beds, the consultants' report states that these should still be within design life in the price control period. This is incorrect. As clearly outlined in our capex clarification of January 2012, the ground beds in question will have exceeded their design life in the course of the price control period and therefore do require replacement or refurbishment.

7.9 IT Capex

The Utility Regulator has rejected BGE (NI)'s submission for IT capex on the basis that *"BGE (NI) failed to provide a detailed business case to justify the expenditure in IT proposed"*. BGE (NI) strongly rejects this assertion and, as outlined in our comments on the draft consultation paper, we believe it is misleading.

Following our initial capex submission, BGE (NI) was asked to provide details on the scope of IT work, costs, nature of the system upgrades, which projects would deliver opex benefits and which are required to deliver mandatory functional change. BGE (NI) provided this detail in full. At no point was BGE (NI) requested to provide a detailed business case on the IT capex proposals.

Since the consultation paper was published, BGE (NI) has met with the Utility Regulator and its consultants and has provided additional detail on our IT submission. We have also outlined details of the cost of IT capex projects which were undertaken in the current price control period and which benefited BGE (NI) but were not charged.

BGE (NI) has withdrawn its submission for GTMS NI modifications on the basis that these will be discussed with the Utility Regulator on a case by case basis under each project. BGE (NI) wishes to reiterate that its IT capex submission now only includes projects which are Run Mandatory i.e. necessary

upgrades/replacements to maintain existing service levels. If the Utility Regulator maintains its current position of making zero allowance for IT capex, this will result in no system refresh over a period of at least 10 to 14 years. Such a 'run to fail' model carries high levels of risk which, as a reasonable and prudent operator, BGE (NI) cannot support. We note that the consultants' report on the BGE (NI) submission acknowledges that "IT investment of the type identified is required" and we again request the Utility Regulator to provide an appropriate allowance.

8.0 Efficiency Factor

The Utility Regulator is proposing to apply a compounding efficiency factor of 1.5% per annum and referenced precedent from Ofgem in this regard.

BGE (NI) notes that the Ofgem determination of 1.5% was based on detailed analysis of potential efficiencies together with assumptions made by the regulated companies in their submissions. To simply apply this same efficiency factor to BGE (NI) without undertaking equivalent analysis is unreasonable. Application of an efficiency factor that is not supported by relevant data is totally arbitrary and does not represent good regulatory practice.

Independent benchmarking demonstrates that the BGE network is 14% more efficient than the average. This indicates that the capacity does not exist to achieve efficiency gains of the magnitude assumed by the Utility Regulator.

BGE (NI) is also strongly of the view that an efficiency factor should not be applied to the capex expenditure which the Utility Regulator is proposing to treat as opex (£472k). In particular, the application of an efficiency factor to the proposed Online Inspection allowance (£411k) which is already reduced from BGE (NI)'s submission, and which is non-recurring, has no sound basis.

9.0 Concluding Comments

BGE (NI) is very concerned by the Utility Regulator's proposed opex and capex allowances for the next 5 year period. We remain strongly of the view that they will not be sufficient to finance (a) the efficient operating costs of the business and (b) the level of capital expenditure required to adequately refurbish a network which will be c.15 years old by the end of the price control. For the reasons outlined in this document, we believe the proposals presented by the Utility Regulator are not well founded and the process followed in their determination was deficient.

We request the Utility Regulator to reconsider its position in light of the arguments presented by BGE (NI). We also request to be informed at the earliest possible opportunity of any perceived information gaps so that we may address these forthwith. We are of course available to meet with the Utility

Regulator and its consultants to discuss our submissions and subsequent clarifications and look forward to positive engagement in this respect.