



**Response to the UR Price Control for NI's Gas Distribution  
Networks GD17**

**May 2016**

## **1 Introduction**

- 1.1 The Consumer Council is a non-departmental public body (NDPB) established through the General Consumer Council (NI) Order 1984. Our principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland (NI).
- 1.2 The Consumer Council welcomes the opportunity to respond to the Utility Regulator (UR) Draft Determination (DD) on the Price Control for NI's Gas Distribution Networks GD17.
- 1.3 We acknowledge the complexity of this price control process given the number of Gas Distribution Networks (GDN) involved and the varying stages of maturity. We welcome the detailed information and analysis the UR has provided and the stakeholder engagement undertaken.

## **2 Executive Summary**

- 2.1 The Consumer Council supports the promotion and ongoing development of the natural gas network in NI. Natural gas offers consumers a choice of fuel that has been cheaper than oil for a sustained period of time<sup>1</sup>, provides consumer protection through its regulatory framework, is cleaner than other fossil fuels and provides payment methods that help consumers manage their spending on energy.
- 2.2 The GD17 Price Control is an opportunity for UR to continue to safeguard consumers and promote the development and maintenance of an efficient, economic and co-ordinated gas industry in NI. The interests of consumers must be at the heart of the Final Determination.

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<sup>1</sup> Over the last 5 years, home heating oil has been on average 7.22% more expensive than natural gas.  
[www.phoenixnaturalgas.com/why-natural-gas/gas-vs-oil/](http://www.phoenixnaturalgas.com/why-natural-gas/gas-vs-oil/) .

2.3 The GD 17 Price Control can benefit consumers by:

- Ensuring that the company delivers value for money for consumers;
- Increasing the take up of gas;
- Ensuring that there is sufficient investment to maintain a safe and resilient network;
- Balancing equitably the financial risks in the business between consumers and the company; and
- Creating an equitable balance of both the benefits and costs of investment between current and future gas users.

2.4 The Consumer Council welcomes UR's DD as we believe that it broadly delivers the benefits to consumers stated above. In particular it delivers considerable reductions immediately on tariffs. The effect to existing domestic gas customers is to reduce the typical Firmus Energy (FE) licence area bill by £46 per year and in the Phoenix Natural Gas (PNG) licence area by £15 per year compared to the GD14 Final Determination. In the case of Scotia Gas Networks (SGN) the opening tariff will be 14% lower than that in the SGN submission.

2.5 In order to prepare a response to this important series of Price Controls we asked Reckon LLP to analyse the DD from a consumer perspective. A copy of its report is submitted alongside this response at Annex 1 and 2.

2.6 The report by Reckon highlights some issues regarding the sustainability and potential costs to future consumers of the DD if forecasts of volume growth do not materialise. We would ask the UR to give consideration to this report as it develops its Final Determination and subsequent reviews of the industry.

### **3 Consumer Context**

- 3.1 Despite the welcome drop in domestic energy prices since 2015, fuel poverty in NI remains at the highest level in the UK<sup>2</sup>. Consumer Council research<sup>3</sup> in October 2015 showed home energy prices remain the biggest concern for the majority (33%) of consumers.
- 3.2 Research also highlights that disposable income levels in NI are nearly half that of the UK average<sup>4</sup>. Furthermore the report also found that average salaries in NI are lower, at £14,645 compared to £17,965, than in the UK as a whole<sup>5</sup>. NI also had the highest percentage of workers on or below the minimum wage at 10%.

### **4 What natural gas can do for NI consumers**

- 4.1 The Consumer Council supports the extension and infill of the natural gas network across NI, where it is financially viable to do so. Natural gas offers a clear range of benefits:
- The cost of oil is volatile compared to natural gas and on average over the last five years natural gas has been 7.2% cheaper than oil;
  - It is a regulated industry and offers protection for vulnerable consumers through Codes of Practice;
  - Due to a variety of payment methods such as prepayment meters, low income consumers are less likely to self disconnect;
  - Natural gas offers constant availability whereas oil requires delivery;
  - Modern natural gas boilers provide high levels of energy efficiency; and

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<sup>2</sup> Annual Fuel Poverty Statistics Report, DECC, 2015 show that 42% of households in NI are experiencing fuel poverty.

<sup>3</sup> MillwardBrown Ulster: Consumer Council NI Consumer Outlook Tracking - October 2015

<sup>4</sup> Asda Income Tracker, Centre for Economics and Business Research, January 2016

<sup>5</sup> Source: <http://www.bbc.co.uk/news/uk-northern-ireland-36386889> using ONS statistics.

- Natural gas is the most efficient and lowest carbon producer of the fossil fuels and can provide a stepping stone to a fossil free energy future. The Consumer Council acknowledges and supports the aim of achieving a carbon free renewable energy industry in NI.

4.2 The most recent figures published<sup>6</sup> indicate that home heating oil remains the most used heating source for homes in NI, with 68% of households using it as their primary heating source, compared to only 7% in GB.

4.3 Home heating oil volatility has seen prices for consumers peak at £329 for 500 litres in March 2012 and fall as low as £125 for 500 litres in January 2016<sup>7</sup>. The recent low prices are most welcome, especially for those with no alternative fuel choice and those experiencing fuel poverty. However, this clear volatility in cost is a concern compared to natural gas. Consumers want budget certainty.

4.4 Consumers that have converted to the gas network have expressed overall satisfaction with their experience of natural gas and in our 2012 survey, expressed real enthusiasm for it<sup>8</sup>.

## **5 Long Term (future consumers)**

5.1 The GD17 DD contains a number of proposals with potential cost implications for future consumers. In the Final Determination we would respectfully request that there is greater clarity around the allocation of risks between consumers and GDNs, and the allocation of costs between current and future gas consumers.

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<sup>6</sup> House Conditions Survey, NI Housing Executive, 2011.

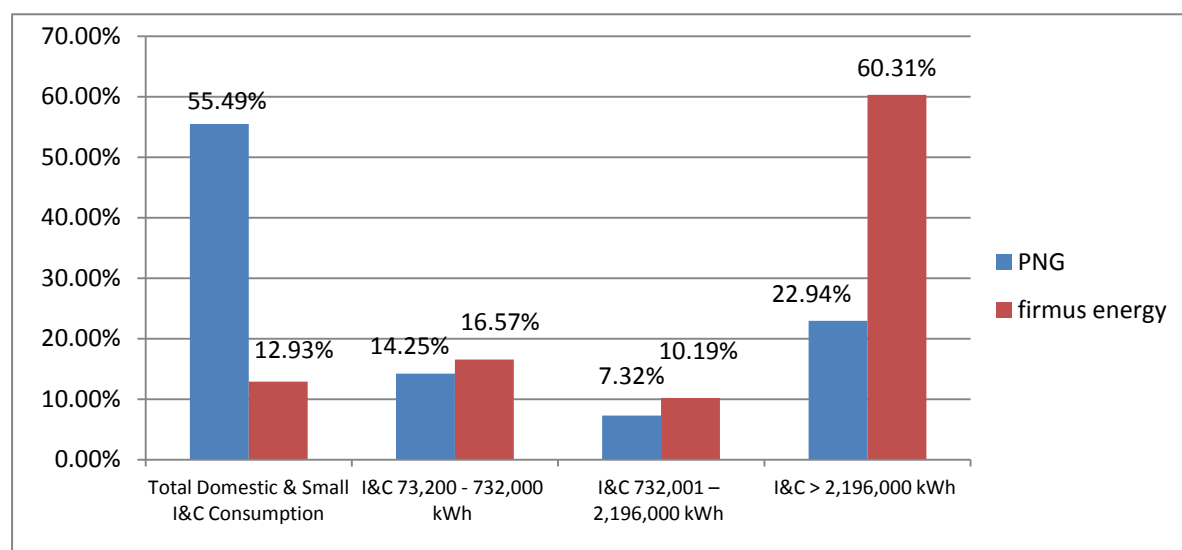
<sup>7</sup> Consumer Council weekly Home Heating Oil Survey.

<sup>8</sup> Customer's Experience of Natural Gas in NI – Consumer Council June 2012.

## **Form of control for FE**

- 5.2 The Consumer Council acknowledges UR's minded decision to move FE to a total revenue cap form price control. We recognise that a move away from a price cap is common regulatory practice when gas distribution companies reach a certain level of maturity. In the NI context the move will allow FE and PNG to be more comparable in terms of form of control.
- 5.3 However, with a revenue cap price control consumers in the future carry the risk of paying higher prices if volume or connections do not increase as forecast. This risk is heightened because of the possibility of a lower uptake of gas than expected during the GD17 period, due to the removal of the inherent incentive to increase volumes and customer numbers that a price cap price control provides. Further pressure would be applied if oil continues to remain lower than gas and other barriers to gas conversion highlighted elsewhere in our response are not addressed.
- 5.4 The situation could be even worse because of FE's disproportionately high reliance on large gas I&C customers - 60% compared to PNG's 23%, as shown in Chart 1. If any more of these large gas users were to stop burning gas, as has been seen with the recent closure of JTI and the proposed closure of Michelin, domestic gas consumers would be more vulnerable to price hikes under a total revenue cap price control.

**Chart 1. Consumption by Customer Type Comparison (% of total consumption)**



Source: Consumer Council calculation using data in UR Quarterly Transparency Report February 2016.

5.5 Therefore we would ask that mitigation measures are put in place for GD17 to counteract the potential risks that the loss of large I&C customers represents.

5.6 We would like to draw attention to proposals Reckon has made to help address some of the risks to consumers from a move to a revenue cap form of price control. These are outlined in points 2.a, 6.a and 7 to 11 within Annex 2 of this submission.

5.7 We would respectfully ask UR to address these points within the final Determination as this will have a material effect on both current and future consumers in the FE network area.

#### **Treatment of under-recoveries of revenue accumulated by FE**

5.8 The Consumer Council recognises that the inclusion of an under-recovery mechanism in FE's licence was aimed at supporting the uptake of gas at an early and critical stage of the network development.

5.9 We are concerned that as UR's DD sets out, FE appears to have benefited at the expense of consumers from the inclusion of under recoveries in its licence whereby:

- It received a 7.5% rate of return on its under recovery. A considerably higher return than the actual costs of capital; and
- Its decision to under recover has contributed to securing its volume target outperformance incentives.

5.10 This has overall been detrimental to gas consumers in the FE Network Area who face a £13m bill for the under recovery - £3m under recovery and £10.3m of interest due to the 7.5% rate of return. Therefore we welcome and support UR's proposals to:

- Amend the FE licence, in particular conditions 4.2.17 and 4.10.4; and
- Reduce the rate of return on the FE under recovery from 2017 by applying a rate of LIBOR +2%.

In principle we agree with UR's proposal at 11.81.a to keep the FE historic under recoveries outside the Total Regulatory Value. While this might cause upward pressure on gas prices until 2019, the overall reduction in gas distribution charges set out in UR's DD provides an opportunity to do without so without noticeable impact on consumers.

5.11 However, we would respectfully ask UR within the final Determination to quantify the financial impact these proposals would have on consumers up to 2019. We note that this information is provided for option 11.81.b and it is essential to provide an evidence based opinion.

5.12 We note the absence of any proposals or consideration by UR on whether and how part of the 7.5% interest element of FE's under recovery could be transferred to the company. On this point we acknowledge FE's licence sets



out the right of the company to recover any under recoveries. However, given UR's statutory responsibility to protect the interests of consumers, we believe this is a possibility that ought to be considered as part of the GD17 Final Determination.

5.13 Clearing the accumulated under recovery of £13 million over three years would add over £4.3 million a year to charges (on top of allowed revenues) up to 2019. This would increase FE's allowed revenue (and prices) in each of these years significantly compared to the headline numbers reported in the DD.

5.14 Therefore we would ask UR to consider whether this is a fair distribution of risk and reward between consumers and FE. From a consumer perspective transferring part of the under recovery to the company has two significant benefits:

- Minimising the financial impact of FE's historic under recovery on consumers; and
- It would act as an additional deterrent to GDNs from misusing the under recovery mechanism in the future.

5.15 We believe it is important also to introduce additional safeguards that provide a fairer share of financial risks associated with under recoveries between investors and consumers. We propose that UR considers introducing an efficiency test for assessing any future under recovery. Details of this test are provided in Annex 2. It would work as follows:

- Any GDN that wants to charge future consumers for past under recovery would have to justify that the deviation from cost-reflectivity and the profiling adjustment that this implies are part of an efficient scheme to manage take-up, and that the scheme operates in the interest of consumers; and

- Insofar as the company cannot justify the under recovery, then the under-recovery should be seen as a historical failure to collect revenues that could efficiently have been collected. In those cases it is legitimate for that cost to be borne by GDNs, not future consumers.

### **The Profile Adjustment Mechanism**

5.16 The Consumer Council notes UR proposals in relation to the profile adjustment. We recognise UR's assessment that the current arrangements may not be consistent with the standard regulatory model in the UK.

5.17 However, the removal of the profile adjustment could have the following negative impacts on consumers and the gas industry in NI based on the evidence contained in UR's GD17 DD:

- An immediate increase in domestic customer tariffs of 4% and 6% for FE and PNG respectively; and
- Higher forecasted gas prices until 2029-2030.

5.18 The evidence provided shows the removal of the Profile Adjustment Mechanism would cause a detriment to consumers in NI. Therefore the Consumer Council strongly opposes its removal. We ask UR to postpone any decision on the profile adjustment at least until the next price control.

5.19 Our concern about the Profile Adjustment Mechanism is that if volumes of gas sales fail to attain the current forecast, future consumers will experience price rises. We are given some comfort on this by the evidence presented in the GD17 DD that even at zero volume growth the price increase would not exceed between 1% and 2%.

5.20 A safeguard to protect future consumers is to require the GDNs and UR to monitor volume sales closely. This issue should therefore be kept closely

under review and adjustments made in future Price Control reviews if necessary.

### **The Extension of the Forecasting Horizon for FE from 2035 to 2045**

- 5.21 From a consumer perspective we appreciate that extending FE's forecasting horizon would have a downward impact on gas distribution charges for the GD17 period and until 2035.
- 5.22 However, we are deeply concerned about UR's statement in point 11.94 of the DD paper that "customers after 2035 will be much worse off" and the fact that this financial detriment is not quantified. We believe it is important that the GD17 FD strikes a fair balance between the interests of current and future gas consumers, provides clear evidence to quantify this statement and provide estimates of the financial impact to consumer's post 2035.
- 5.23 This is becoming an increasingly important issue given the long term risks associated with the still low uptake of gas among domestic consumers in the Ten Towns licence area, the reliance on a small number of large I&C customers and the need for increasing consumer trust in the gas industry. Consumers remain concerned that once they connect to gas, prices will be eventually "hiked up".
- 5.24 We have commented elsewhere on other mechanisms that UR already has in place transferring GDNs' revenue from current customers to future ones. These include the profile adjustment and in the case of FE the historic use of under recoveries. Given the reductions in gas distribution charges that those mechanisms provide for current gas consumers, we believe there is an argument to retain FE's current 30 year forecasting horizon. However, as stated already, in the absence of this information we cannot assess the impact this proposal would have on consumers throughout the period in question and therefore cannot take a firm position on it. We would

respectfully ask that UR remedies this data shortfall and provides a clear evidence based decision in its GD Final Determination.

## **6 Issues specific to the GD17 period (current consumers)**

- 6.1 There are a number of issues contained within the GD17 DD that are specific to the GD17 period. We comment on this within this section of our submission.

### **Rate of return**

- 6.2 The Consumer Council appreciates the level of detail provided in the DD for each element of the rate of return. We recognise also UR efforts to ensure robust calculations by procuring additional analysis as per Annex 7, and we welcome UR's transparency in submitting its calculations to peer review by the UK Regulators Network. We believe UR has conducted a thorough review of the rate of return.
- 6.3 However, working with Reckon we note that UR has provisionally applied an Asset Beta of 0.40 which sits at the highest point of the range of Asset Betas deemed appropriate for comparable low risk GB network utilities. The UR makes a strong argument that neither PNG nor FE are inherently more risky businesses than those used in the GB utilities Asset Beta range. Therefore on the basis of this rationale we would have expected to see at most the middle of the range (0.35) used.

### **Treatment of the cost of debt for FE and PNG**

- 6.4 The Consumer Council recognises PNG's need to refinance in 2017, and FE in 2019. This creates uncertainty about their actual costs of debt for GD17. This

is an important issue for consumers as any over estimation of GDNs' actual cost of debt could result in excess revenue for the companies for parts of the GD17 period.

- 6.5 We welcome the approach taken by the UR. This has been innovative and transparent. The UR approach aims to bring certainty to revenue streams and reduce the financial risk to consumers.
- 6.6 We see the benefit of UR's proposal to allow both GDNs to pass their actual costs of debt into their allowed revenue when these are known. However, we share UR's concerns that such a process in isolation does not protect consumers from the effects of under estimating GDNs' future interest payments.
- 6.7 Of the four options, the Consumer Council supports UR's preferred option 3 – target cost and pain/gain sharing. This option has the potential to deliver on the principles of certainty and reduction of risk and cost to consumers. It also aligns with the GDNs' borrowing arrangements. We will observe with interest how the actual mechanism to match GDNs' allowed costs of debt and actual borrowing costs works in practice.
- 6.8 Regarding the proposed 80:20 pain/gain adjustment mechanisms, we agree it provides GDNs with some incentive to secure debt at the lowest possible cost. This is particularly relevant to the GD17 period as both PNG and FE will be arranging refinance. The current historically low interest rates present GDNs with a unique opportunity to lock up their cost of debt at low levels. The Consumer Council would strongly request GDNs to ensure this is the case.
- 6.9 In addition to the above we would like to draw attention to the proposal made by Reckon as per points 2.e, 6.c and 17 to 19 in Annex 2 of our submission. Reckon suggests reversing the proposal to pass-through part of

the cost of debt, and instead using Ofgem datasets to index the cost of debt for FE and PNG.

- 6.10 We ask UR to fully consider whether such proposals would be a valid and viable alternative to those set out in Annex 7 of its DD paper as we believe they may ultimately be of benefit to consumers in NI.

### **Connection Incentive**

- 6.11 The connection incentive was never intended to be a long term allowance and with this in mind, both PNGL12 and GD14 proposed reducing the incentive allowance by 50% from 2017. It is therefore reasonable to expect GDNs to have implemented strategic measures to adequately manage this proposed reduction.
- 6.12 The Consumer Council is concerned that despite giving significant notice of this proposed reduction, UR has reviewed and subsequently suggested moving away from the proposed 50% reduction and allowing a glide path from £573 at present to £420 in 2022.
- 6.13 The Consumer Council broadly supports a form of incentive in order to maximise the potential for connection to the natural gas network if it can be shown to be necessary and effective. However under the current system, we can see no requirement for the GDN to demonstrate that the connections allowance it receives has actually contributed to achieving a connection. The only yardstick used is the performance against set targets of properties to be connected. We are concerned that without this transparency consumers may be paying a higher price than necessary and ultimately not receiving value for money from this incentive.

- 6.14 It is important for both companies and the UR to fully review the market conditions together to ascertain what level of connections allowance is needed to achieve the connections target. If this exercise is conducted independently by the GDN, there is an incentive for the company to emphasise the barriers in the market to justify a higher level of allowance. For example, throughout 2015, the price of home heating oil was below that of gas and we recognise that this provides a real challenge to GDNs to make new connections. However, a balance needs to be struck as energy prices are volatile and since January 2016 the price gap between oil and gas has begun to narrow.
- 6.15 It is also important that connections targets and the level of connections allowance are fair and challenging. In previous years GDNs have in the final analysis comfortably exceeded connections targets. However, if we look at the connections targets proposed for PNG in GD17 they appear to be based on a 2016 forecast that is well below the outturn for the previous four years. At this point in time we can see no firm evidence of what UR's GD17 targets are based on and we would respectfully ask that UR provides transparent detail in this regard. Ultimately the consumer needs to be assured of the validity of the target and the value for money of the proposed incentive which sets out to achieve this.
- 6.16 Furthermore, as far as we can see there is no requirement on the companies to show how the connections allowance is actually spent. Consumers therefore cannot see a direct correlation between the connections allowance and connections made. We would not expect the UR to micro-manage a company and instruct it in detail about how the allowance is spent. However, we believe there is an issue of trust and transparency in this regard and would argue consumers are paying the connections allowance in their bills and are entitled to

know that the money is being used for activity that creates new connections.

6.17 The cost of converting to natural gas is a significant barrier for consumers. Using the connection incentive to help reduce this cost for consumers would undoubtedly help them and achieve the goal of maximising connections.

6.18 As the current market is very dynamic with the relatively low cost of home heating oil, we believe an annual “light touch” review would be appropriate. This will ensure GD17 connection targets reflect market conditions and consumers are not paying over and above for a connection incentive.

#### **The inclusion of a “collar” in the connections incentive mechanism**

6.19 As previously set out, the Consumer Council believes that the maximisation of connections within existing infill areas is a key priority for GD17.

6.20 We support the concept of a connection allowance to incentivise the connection of owner occupied (OO) properties. We also welcome the inclusion of a risk-reward mechanism whereby GDNs would receive a 10% incentive for each connection above a set threshold, and a progressively lower allowance per property if they fail to meet their connection targets.

6.21 We see these incentives as key elements of this price control to help maximise the number of OO properties connected. However, we are not convinced by the inclusion of a 50% cap on the maximum reduction of the allowance that UR proposes. We believe that the reduction of the connection allowance should be allowed to drop below 50% if the GDNs fail to meet the relevant targets. In our view by removing the collar UR would be ensuring



that GDNs have sufficient incentive to connect as many OO properties as possible even when the maximisation targets are not met.

### **Economic Allowance**

6.22 The Consumer Council recognises the potential for variance when assessing fair and reasonable allowances for GDNs.

6.23 The Consumer Council agrees in principle that overall, gas mains should only be laid where there is a reasonable prospect that the initial outlay cost will be paid back by consumers connecting and burning gas within the useful economic period. We understand that GDNs strive to extend the gas mains network as widely as possible however we believe a balance between availability and cost must be achieved.

6.24 The UR has referenced the role of an economic assessment as being important in delivering a sustainable long term industry, whilst recognising a degree of judgement is required within GDN network areas to ensure that the overall consumer base benefits. That is to say that the benefits of an individual economically positive project should be used to potentially counterbalance an economically negative project and therefore in doing so, ensuring that gas is brought to as many consumers as possible. The Consumer Council recognises this approach as fair and reasonable for both GDNs and consumers.

6.25 We also fully support the necessary application of a separate economic assessment for consideration of the property passed determinations for SGN in the West and PNG in East Down.

6.26 The Consumer Council welcomes the application of a capped retrospective mechanism to adjust for the actual numbers and length

of properties passed to ensure consumers are not overpaying for the benefits received. This provides consumer protection by removing the risk of estimated lengths and focuses GDNs on the delivery of development within the parameters set out in GD17.

### **Customer Service / Ongoing Consumer Engagement**

6.27 Customer service delivery is at the heart of our work and we know through our complaints handling role the detrimental impact poor customer service has on consumers and their confidence in the overall industry. It is therefore imperative that when promoting natural gas, customer service is at the top of the GDN's priorities as it builds trust and a perception of value for money.

6.28 We welcome the customer service development objective requiring delivery of new customer service metrics and customer satisfaction surveys as an output of GD17. Identifying and addressing customer service issues when they arise should already be part of all GDN business models and ultimately it is a common sense approach to business.

6.29 The Consumer Council is pleased that the UR has a focussed timetable of delivery using its experience of development work across the water and electricity sectors. Excellence in customer service can only be achieved through shared learning and transparency therefore we would hope the GDNs embrace the UR's proposals:

- New consumer metrics and customer satisfaction survey to be trialled in Year 2 of GD17 or 2018;

- Introduction and incorporation of the above new measures within a revised Regulatory Instructions and Guidance pack; so that
- Performance in 2019 can be reported going forward in UR's Annual/Cost Reporting publication.

6.30 The Consumer Council would welcome the opportunity to work with the UR, GDNs and stakeholders to examine the criteria outlined in the DD and deliver an improved customer service strategy through the price control and beyond. Similar customer satisfaction measures that are being implemented for NI Water open up the possibility for developing metrics that allow comparability across all regulated companies in energy and water.

6.31 We welcome the proposal for future incentivised mechanisms for specific elements of the customer service experience in future price controls, arising from improved performance monitoring.

## **Benchmarking**

6.32 The Consumer Council welcomes the benchmarking exercise UR has undertaken in GD17. The Consumer Council has witnessed the clear advantages and improvements brought to the water sector in NI through benchmarking and comparative regulation.

6.33 The Regulator's success at benchmarking within the local water industry gives the Consumer Council confidence that it can bring similar benefits to the natural gas industry. As such we accept UR's view that its preferred Composite Scale Variable (CSV) model is appropriate. We note the UR has obtained an assessment of 11

models from Deloitte and has interpreted results from its two preferred models, namely Model 3 & Model 5.

- 6.34 UR has outlined its position that both models have advantages and disadvantages; however Model 5 is more sophisticated as it takes NI's gas network quality into consideration. We therefore believe that Model 5 is most appropriate to deliver the best benchmarking results.
- 6.35 Whilst the Consumer Council strongly supports wage parity for NI employees compared to the rest of the UK, we accept and understand the rationale applied by UR regarding a regional wage adjustment. We are conscious of the variance between average NI wages against the UK average. NI has some of the lowest wages of any UK region including the highest percentage of workers on or below the minimum wage at 10%.

#### **SGN – Request for additional funding**

- 6.36 We agree with the UR that the success of SGN's Gas to the West application was heavily weighted towards the figures submitted in its submission. Any changes to the figures set out within SGN's Gas to the West submission have the possibility of risking the integrity of the process.
- 6.37 We note the view of UR that SGN may not have correctly identified the appropriate opex figure from its Gas to the West application compared to its GD17 business plan submission. If this is the case it is a mistake which will most likely have financial implications. However, as this is within SGN's control, the Consumer Council is strong in its view that consumers should not have to bear the cost. Any proposals other than the minor adjustments outlined by UR in GD17 would be unacceptable.

## **Fuel poverty**

- 6.38 The Consumer Council's response to GD14 contained a strong focus on Fuel Poverty which reflected soaring energy prices at the time. It is therefore welcome that GD17 is being consulted on with consumers benefitting from significantly lower energy costs.
- 6.39 The Consumer Council supports initiatives that help alleviate fuel poverty in NI. We recognise and support key aspects of GD17 that we believe can deliver a high quality service at a reduced cost to existing and future gas consumers. Ideally all accessible NI consumers would have the option of connecting to the natural gas network and we welcome expansion into East Down and the West.
- 6.40 We would encourage innovation from GDNs, stakeholders and government to create opportunities to make natural gas available to households and suggest that UR is open and supportive of such innovation. We note that in the SGN Business Plan submission for Gas to the West it included a proposal for a £50 incentive payment to target fuel poor households. We would like to see such proposals explored by the UR, to see if they could help reduce fuel poverty without reducing the overall benefits of the Price Control to the wider consumer base.
- 6.41 In March 2016 the Consumer Council responded to the UR's consultation on its intention to impose a financial penalty on Gas Networks Ireland (UK) Ltd. Rather than imposing the fine of £0.5m which is returned directly to HMS Treasury, the Consumer Council sought the option of a voluntary financial contribution in lieu of a financial penalty that could be used to benefit NI customers.

6.42 Similarly, in 2015 Ofgem imposed a financial penalty of £5m on the power company Drax. It also ordered Drax to pay £20m in consumer redress to National Energy Action, ensuring GB consumers benefitted. In our view a similar approach could have been used to potentially help fuel poor consumers in NI. We would strongly advocate this form of approach should similar circumstances arise in the future. This could for example, be a charitable donation equal to the value of any proposed financial penalty. This option would still incentivise future compliance and contribute towards building consumer trust and confidence in the natural gas industry.

## **7 Conclusion**

7.1 Overall the Consumer Council would like to compliment UR on the level of detail and analysis provided in UR GD17 DD and annexes. We also appreciate UR's commitment to engage with the gas industry, the Consumer Council and other key stakeholders throughout the GD17 DD consultation period.

7.2 Having examined the DD and annexes, we believe UR's GD17 DD delivers an evidence based and fair package for consumers. In particular we welcome the proposed lower distribution charges for FE and PNG compared to GD14<sup>9</sup> - 25% or £45 less per year and 8% or £15 less per year respectively.

7.3 We are also satisfied based on the evidence UR has provided that the proposed allowed revenues should ensure there is sufficient investment to maintain and develop gas networks within each licence area and increase the take up of gas, particularly among the OO sector.

7.4 We have concern that the Rate of Return is a little higher than it need be and the Connections Incentive lacks the transparency required to deviate from the established policy line. We also raise some issues regarding the

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<sup>9</sup> In the case of SGN, UR's proposal would result in a 14%.

sustainability and potential costs to future consumers resulting from the GD17 DD if the forecast of volume growth does not materialise. We ask UR to give due consideration to these issues as it formulates its GD17 Final Determination and undertakes the proposed licence changes.

- 7.5 We look forward to continued working with UR and the gas industry to contribute to the development of a strong and efficient network that delivers for NI consumers.
- 7.6 If you require further information or you wish to discuss any aspect of this response please contact Richard Williams on 02890 251649 or [richard.williams@consumercouncil.org.uk](mailto:richard.williams@consumercouncil.org.uk).



Floor 3  
Seatem House  
28-32 Alfred Street  
Belfast  
BT2 8EN

Freephone:	0800 121 6022
Switchboard:	028 9025 1600
Fax:	028 9025 1663
E-mail:	<a href="mailto:info@consumercouncil.org.uk">info@consumercouncil.org.uk</a>





## **Annex 1**

### **Consumer harm from the GD17 proposals**

**9 May 2016, Reckon LLP**

#### Overview

1. This note seeks to identify aspects of the Utility Regulator's proposals for gas distribution price controls from 2017 that might be most harmful to the interests of consumers.
2. Table 1 lists some specific potential technical issues with the regulator's proposals. The purpose of this overview section is to highlight ways in which consumers might be harmed by these issues.
3. The main area of concern is about the potential impact on customers of lower-than-hoped-for take-up of mains gas in Northern Ireland. The probability of low take up is high since domestic heating oil is currently cheaper per kWh than mains gas, and there is political and environmental pressure towards energy efficiency improvements and the use of biomass.
4. Under the regulator's proposals for FE and PNGL, if take-up of mains gas is less than expected, then consumers suffer:
  - (a) The use of a total revenue control means that prices will be higher than expected, since the regulator would allow the companies to collect a fixed amount of revenue independent of how many customers they have or how much gas these customers use. The effect is that existing mains gas consumers are being made to bear the risk that few new customers switch to mains gas; investors in the gas distribution companies do not bear that risk. An average price control would have allocated that risk in a fairer way between consumers and investors.
  - (b) One of the consequences of low take-up in the past has been under-recovery against the price control formula. All the regulator's options in respect of the treatment of FE's past under-recovery amount to prioritising the protection of investors' interests at the expense of consumers. Whilst the proposal to reduce the interest paid to investors in respect of under-recoveries to LIBOR+2 is clearly

an improvement over the previous arrangements in this area, the regulator has failed to consider whether and how part of the shortfall in revenue could be transferred to investors, or to control or explain the impact on consumers of a rapid elimination of the historical under-recovery.

- (c) The regulator's proposal to retain the profile adjustment mechanism amounts to embedding in its regulatory regime the protection of investors from risk, at the expense of the interest of consumers. The regulator's proposal to extend the profile adjustment period for FE has two implications: it amounts to a recognition of the likelihood of a significant and sustained shortfall for that network; and it exposes consumers to the high risk of errors in very long term forecasts. There is nothing in the mechanism to ensure that investors in gas companies are exposed to a fair share of the risk of low take-up of mains gas.
- 5. In summary, a major strategic risk that the regulator's proposals fail to address is that of a death spiral for gas distribution in Northern Ireland, whereby the price advantages of oil and/or the environmental advantages of insulation and biomass would lead to low mains gas take-up, which (because of the regulator's unbalanced approach to allocating take-up risks between consumers and investors) would lead to higher gas prices, feeding the low take-up.
  - 6. The regulator's proposal for a partial pass-through of the cost of debt amount to a further transfer of risk from investors to consumers and compounds the harms to consumers outlined above. Whilst it might have been acceptable to follow Ofgem in linking the allowed return on capital to some economy-wide measure of borrowing costs, it is not in the interests of Northern Ireland mains gas consumers to be exposed to the specific borrowing costs incurred by Northern Ireland gas distribution companies. This proposal harms consumers in two ways:
    - (a) It exposes consumers to the cost of financing decisions by the gas distribution companies, and thereby encourages investors to choose financing structures that transfer residual risk from equity (where investors would bear all of it) to debt (where investors would only bear 20 per cent of it).

- (b) It exposes consumers to company-specific risks such as fluctuations in investors' perceptions about future mains gas take-up and about the stability of the Northern Ireland gas regulation system. Given the regulator's failure to date to establish a regime that gives a fair, sustainable and credible balance of risks between consumers and investors, and the regulator's failure to prevent the risk of a death spiral in the Northern Ireland gas sector, there is a risk that investors will demand a regulatory risk premium for lending to these companies.

#### Description of technical issues

**Table 1 Technical issues in the GD17 draft determinations**

Issue number	Description of the issue
1	<p><b>Title:</b> Form of control for firmus energy</p> <p><b>Summary:</b></p> <p>The Utility Regulator has proposed to move from a tariff control for firmus energy to a revenue control. This would transfer the risk of non-productive or under-utilised assets from the company onto customers.</p> <p><b>Full description:</b></p> <p>In its draft determination for firmus energy (FE), the regulator has stated its intention to move from a tariff control to a revenue control. Under a tariff control approach, the regulator restricts tariffs, i.e. the amount of money that can be recovered from each consumer or for unit volumes. Under a revenue control approach, the regulator restricts the amount of revenue the company can raise from customers through charges.</p> <p>Under a tariff control approach, company revenues depend on customer numbers or volumes of gas delivered. That is, the more customers use the network, the greater the revenue for the company. Under a revenue control approach, company revenues do not depend on the number of customers or volumes of gas delivered.</p> <p>A tariff control could therefore offer an incentive for the company to</p>

	<p>expand its network and get more customers to connect and use its network - but it also means that the company bears the risk associated with under-productive assets (i.e. newly built assets that are under-utilised). The company would only earn a reasonable return on investment in the network if it can generate sufficient revenue by getting new customers to connect (and existing ones to consume more gas).</p> <p>The draft determinations say that “as the [FE] business grows and matures, it may be more appropriate to switch to a revenue cap form of price control as new volumes become less important and external factors, such as temperatures, can have a bigger impact on overall volumes.”</p> <p>We don’t think that FE’s business is mature enough to justify a switch to revenue control. We note that, by the end of 2015, FE’s penetration rate remains at 19 per cent (10,200 connected properties out of almost 54 thousand properties passed). In comparison, PNGL’s penetration rate at the end of 2015 is 48 per cent (95 thousand connected properties out of 201 thousand properties passed).</p> <p>As FE’s network expands – the regulator expects it to pass an additional 68 thousand properties by the end of the GD17 period – retaining the tariff control approach would be a strong incentive for FE to connect new customers and increase its penetration and asset utilisation rates. Better utilisation rates would allow FE to recover reasonably incurred costs across a larger number of customers (and volumes) and mitigate the risk of excessive charges to customers.</p> <p><b>Document reference:</b></p> <p>GD17 Draft determinations, page 47</p>
2	<p><b>Title:</b> Treatment of the cost of debt for FE and PNGL</p> <p><b>Summary:</b></p> <p>The Utility Regulator has proposed a pass-through mechanism for the cost of debt of FE and PNGL. This mechanism transfers risk from the company to customers and might encourage inefficient financing arrangements, thereby making customers worse off.</p> <p><b>Full description:</b></p>

	<p>The Utility Regulator's draft determinations set out the allowed cost of debt for Phoenix Natural Gas (PNGL) (2.26 per cent) and FE (2.33 per cent) within the overall weighted average cost of capital (WACC).</p> <p>The draft determinations say that both PNGL and FE are due to refinance existing debt in 2017 and 2019 respectively. In addition, both companies could raise additional debt over the period to finance their activities. The document notes that there is uncertainty about the actual costs at which these companies would be able to borrow.</p> <p>This uncertainty about the actual costs of borrowing in the future does create some risks. The regulator has proposed a mechanism for sharing the cost of debt risk between customers and shareholders, whereby customers would pay 80 per cent of any debt cost under- and over-runs, and shareholders would pay the remaining 20 per cent. The regulator says that this risk-sharing mechanism provides strong incentives for the company to keep costs low.</p> <p>The details of the mechanism are not adequately specified in the draft determination.</p> <p>If the mechanism was to apply to interest costs as a £ number, then it would give rise to an undue loss to consumers if gearing is increased: customers would pay 80 per cent of the interest cost for the additional debt, but receive no credit in respect of the lower amount of equity employed in the business.</p> <p>If the mechanism applies to the cost of debt expressed as a percentage rate, then there is still a significant risk that customers could lose out unjustifiably. This would occur, for example, if the company was to refinance itself using a structured debt approach whereby part of the debt is low-risk, low-rate as the debt assumed in the determination; and a further tier of debt is higher risk, higher rate, and carries some of the risks that are attributed to equity in the regulator's determination. This could be a reasonable structure to adopt because it has some advantages in terms of corporate control (it can give debt holders powers to control management, which might be considered more effective than control through equity) and has some tax advantages.</p> <p>If such a structure is adopted in the context of a regulatory partial</p>
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	<p>pass-through of the cost of debt, then customers could end up paying twice for part of the remuneration that investors receive in respect of risk: the passed-through cost of debt would now reflect some financial risks that were included in the determination's cost of equity, but the cost of equity would not have been reduced.</p> <p>In both cases, customers would end up paying more – not because market conditions have changed but because of the particular way in which the company has chosen to structure its finances. This is not consistent with the stated objective of the scheme.</p> <p><b>Document reference:</b></p> <p>GD17 Draft determinations, pages 224 and 225</p>
3	<p><b>Title:</b> The inclusion of a “collar” in the connections incentive mechanism</p> <p><b>Summary:</b></p> <p>The Utility Regulator has included a connections incentive mechanism in its draft determinations. The mechanism involves a reward for each new owner occupied domestic property connected during the GD17 period. The design of the mechanism includes a “collar”, which could expose customers to the risk of paying excessive rewards for connections in the event that the company fails to meet its target by more than 50 per cent.</p> <p><b>Full description:</b></p> <p>The Utility Regulator's draft determinations for the three companies include a connections incentive scheme for owner occupied (OO) domestic properties. This incentive is meant to encourage the company to connect as many passed properties as feasible. The regulator has set a target for the number of OO properties to be connected in each year of the price control period. If the company achieves the target, it will receive a fixed amount per connected property (for FE and PNGL, this is £550 in 2017 and for SGN this is £520 in 2018, and this reduces for all three companies to £420 by 2022).</p> <p>The incentive is not payable on the first 25 per cent of the target in the FE area and 33 per cent of the target in the PNGL area, because the regulator believes that these would happen anyway without any</p>

	<p>marketing effort by the company.</p> <p>If the company fails to achieve the target, it will receive a progressively lower amount per property. For instance, the incentive amount per property would be reduced by 20 per cent if the company fails to meet its target by 20 per cent (and achieves 80 per cent), and by 30 per cent if it fails its target by 30 per cent, and so on. However, the maximum reduction in the incentive amount is set at 50 per cent (the “collar”). For instance, if the company fails to meet its target by 60 per cent (i.e. it achieves 40 per cent of its target), the incentive payment per property would not be reduced by more than 50 per cent.</p> <p>We see no rationale for the collar of 50 per cent to be applied. If the purpose of the scheme is to encourage as many new connections as feasible, the scheme should be recalibrated such that the amount is progressively reduced to zero up to the minimum number of connections (zero for SGN, 25 per cent of the target for FE, and 33 per cent for PNGL).</p> <p><b>Document reference:</b></p> <p>GD17 Draft determinations, pages 75 and 76 (FE), 105 (PNGL) and 142 (SGN)</p>
4	<p><b>Title:</b> Treatment of under-recoveries of revenue accumulated by FE</p> <p><b>Summary:</b></p> <p>The Utility Regulator has proposed a reduction in the rate of interest charged by FE in relation to accumulated under-recoveries. While this is an improvement, the regulator has not explained the possible near-term impact on customer charges nor does it appear to have considered measures to soften the blow to customers.</p> <p><b>Full description:</b></p> <p>FE has been applying charges that have recovered less than their allowed revenues in the past. This means that, by the end of 2016, FE is expected to have accumulated an amount of £13 million (in 2014 prices) that it could recover through charges to customers. For any amount that remains unrecovered, customers are liable to pay interest every year, either through their charges in that year or through additional liabilities in the future due to decisions made at</p>

	<p>previous price control reviews.</p> <p>Within the context of revenue controls, some under- or over-recoveries may be inevitable, because it is difficult to accurately forecast consumption volumes and customer numbers at the time of setting tariffs. In the event of an under-recovery, the company would need to set aside some capital to finance the shortfall until it can be made up through higher charges in the future (if that is permitted).</p> <p>The regulator had previously allowed FE to charge interest of 7.5 per cent plus RPI inflation (the WACC) on accumulated under-recoveries. This is likely to be higher than the short-term borrowing cost for a typical regulated network utility. The regulator now proposes to apply a rate of LIBOR plus 2 per cent for any new under- or over-recoveries in the GD17 period, which is likely to be less than 7.5 per cent plus RPI inflation.</p> <p>In relation to the historical accumulated under-recovery of £13 million, the draft determination has put forward two options.</p> <p><b>Option a</b> would allow FE to continue earning a rate of return on the old accumulated under-recovery until it is fully recovered. Although the draft determination document does not explicitly say so, we assume that the applicable rate of return would be LIBOR plus per cent.</p> <p><b>Option b</b> would incorporate the accumulate under-recovery into the regulatory asset value, effectively allowing FE to recover the under-recovery over an extended period (of 29 years), while earning the WACC applicable in each year on any outstanding amounts.</p> <p>Option a is the regulator's preferred approach. The draft determination says that the regulator expects the under-recovery to be fully cleared by 2019 (in three years).</p> <p>Clearing the accumulated under-recovery of £13 million over three years would add over £4.3 million a year to charges (on top of allowed revenues) up to 2019. This would increase FE's allowed revenue (and prices) in each of these years significantly compared to the headline numbers reported in the draft determination.</p> <p>Although we support the proposed reduction in the interest charged by FE, we do not think that the regulator has properly explained the possible adverse short-term consequences of this proposal for</p>
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	<p>customers or how these might be mitigated.</p> <p><b>Document reference:</b></p> <p>GD17 Draft determinations, pages 250-252</p>
5	<p><b>Title:</b> The profile adjustment mechanism</p> <p><b>Summary:</b></p> <p>The profile adjustment mechanism transfers revenue from current customers to future customers. The mechanism, along with the revenue control approach, leaves future customers unduly exposed to the risk of high charges if customer numbers in the future are lower than they are predicted.</p> <p><b>Full description:</b></p> <p>The Utility Regulator's draft determinations include a profile adjustment mechanism.</p> <p>This mechanism uses forecasts of various parameters (customer numbers, gas consumption volumes, capital expenditure, operating expenditure, depreciation and RPI inflation) up to 2045 for FE, 2046 for PNGL and 2057 for SGN to determine their allowed revenues for the current price control period. An effect of the mechanism is that future customers would pay a greater share of the cost of expenditure incurred by the companies today.</p> <p>As a consequence of this mechanism, prices at the start of the GD17 period would be lower than they would have been otherwise and prices in the future would be higher than they would have been otherwise.</p> <p>Lower prices today might encourage more customers to connect to the network, and increase consumption – spreading the costs associated with expanding the network across a greater number of (future) customers.</p> <p>This is fine as long as the forecasts of customer numbers and volumes are reasonably accurate. If actual customers numbers and volumes in the period between in the later years of the forecast horizon turn out to be lower than currently predicted, things could go wrong (as it has done in the past with PNGL).</p> <p>If actual connection numbers and volumes turn out to be lower than expected, deferred revenues will have to be recovered from a</p>

	<p>smaller pool of customers and volumes – making prices higher than they are predicted now (and they are already predicted to be higher than current prices). Higher prices might discourage connections and volumes, making the problem worse. In the worst case scenario, the mechanism would lead to a vicious spiral of increasing prices and lower volumes until the company is unable to recover its costs.</p> <p>We do not think that the profile adjustment acts in the interests of customers.</p> <p>We think that a tariff control (instead of a revenue control) approach would move some of the connection and volume risk from customers to the company – and provide sufficient incentive for companies to increase connections and volumes (but only when it is efficient and commercially viable to do so).</p> <p><b>Document reference:</b></p> <p>GD17 Draft determinations, Section 10 - Financial aspects</p>
6	<p><b>Title:</b> The extension of the forecasting horizon for FE from 2035 to 2045</p> <p><b>Summary:</b></p> <p>The draft determinations include a proposal to extend the profile adjustment period for FE by changing its forecasting horizon from 2035 to 2045. This increases the risk to customers from forecasting errors.</p> <p><b>Full description:</b></p> <p>The Utility Regulator proposes to extend the forecasting horizon for FE from 2035 to 2045. Under the profile adjustment mechanism, this has the effect of deferring FE's revenues over a longer period.</p> <p>The profile adjustment mechanism could encourage the take-up of gas today by shifting revenues into the future, thereby keeping prices today lower than they would have been otherwise.</p> <p>The profile adjustment mechanism is inherently risky because it relies on forecasts of customer numbers and volumes a long way into the future. If these forecasts turn out to have been too optimistic (too high), there is a risk that prices in the latter years of the forecast horizon would have to go up to unsustainable levels.</p> <p>As noted in the draft determinations, extending the forecasting</p>

	<p>horizon for FE reduces prices today compared to what they might have been otherwise. However this also increases the risk in the future to customers and the company from forecasts that turn out to have been too optimistic. It is hard enough to make good forecasts of volumes to 2035. Extending the period to 2045 increases the uncertainty around the forecast and exposes customers to additional risks.</p> <p><b>Document reference:</b></p> <p>GD17 Draft determinations, Section 10 Financial aspects</p>
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## **Annex 2**

### **Outline of possible solutions to consumer risk issues under the GD17 draft proposals**

**31 May 2016, Reckon LLP**

1. This note scopes the development of possible solutions to the risk allocation issues identified in our review of the Utility Regulator's GD17 draft proposals.

The issues

2. The issues that we identified include:
  - (a) The proposal to use a total revenue control has the effect that existing mains gas consumers are being made to bear the risk that few new customers switch to mains gas; investors in the gas distribution companies do not bear that risk.
  - (b) The regulator has failed to consider whether and how part of the historical shortfall in actual revenue relative to allowed revenue could be transferred to investors. The regulator has also failed to control or explain the impact on consumers of a rapid elimination of the historical under-recovery.
  - (c) The connections incentive mechanism fails to ensure that investors in gas companies are exposed to a fair share of the risk of low take-up of mains gas.
  - (d) The profile adjustment mechanism fails to make a fair allocation between investors and customers of the risks from inaccurate demand forecasts.
  - (e) The regulator's draft proposal for a pass-through of 80 per cent of debt costs exposes consumers to the cost of financing decisions by the gas distribution companies, and thereby encourages investors to choose financing structures that transfer residual risk from equity (where investors would bear all of it) to debt (where investors would only bear 20 per cent of it).
3. These issues are all manifestations of the unbalanced approach adopted by the Utility Regulator to the risks associated with mains gas take-up in

Northern Ireland: investors in gas distribution companies have their financial interests substantially insulated from those risks, at the expense of future mains gas customers.

4. The regulator's unbalanced approach is not in the interests of gas consumers. It could also give rise to a death spiral for gas distribution in Northern Ireland, whereby the price advantages of heating oil and/or the environmental advantages of home insulation improvement and biomass would lead to low mains gas take-up and consumption, leading to higher gas prices, feeding the low take-up and consumption.

Possible solutions to explore

5. The issues outlined above can probably be mitigated or solved by restoring balance in the allocation of risks, ensuring that investors in gas distribution companies carry some of the risks associated with mains gas take-up and consumption.
6. Particular routes to investigate to deliver this objective include:
  - (a) Reversing the proposal to use a total revenue form of control (with a connections incentive), and instead adopting either price controls or an average revenue control.
  - (b) Subjecting any application of historical under-recoveries to future customers to a form of efficiency test.
  - (c) Reversing the proposal to pass-through part of the cost of debt, and instead using information from other parts of the UK to index the cost of debt.

### **Form of control**

7. Under price controls, the regulator would set maximum levels for baskets of charges, which would be designed to reflect the costs and return on capital that an efficient network company would need to provide specific services such as new connections, the provision of a unit of network capacity, or the transport of a unit of gas.
8. A price control approach, whilst perhaps ideal in principle (as it ensures that each class of consumer is protected against overcharging, instead of merely protecting consumers as a group) would probably require the

regulator to make significant improvements to its understanding of the cost and charging structures in the gas distribution business. This might not be achievable within the timescales of GD17.

9. The option of an average revenue control would deliver some of the benefits of a price control approach in an easier to implement way. The practical mechanics of the price control do not need to be changed radically: the focus would still be on comparing actual revenue with the result of a formula. What would be changed is that the allowed revenue formula would be constructed to be directly proportional to measures of services actually delivered by the gas distribution network company: number of connected customers, exit capacity, volumes of gas delivered (and not just to properties passed).
10. The benefits of an average revenue form of control would be:
  - (a) It would remove the non-linearity and perverse effects of the connections incentive which we identified in our review: instead, there would be a single, cost-reflective, rate of income allowed to the gas network company for delivering each connection.
  - (b) It would share take-up and consumption risks between investors and future gas consumers, with investors being entitled to remuneration on a cost-reflective basis and only for gas distribution services that the company has actually provided.
  - (c) It would eliminate the absurd situation whereby a gas distribution company could benefit from deterring any forms of network use that are not captured by an incentive regime such as the connections incentive, on the basis that (under a total revenue control) the company can increase its profits by doing less work (as it saves some costs but the regulator protects its income). This would reduce the risk that future consumers would end up paying for such conduct by gas distributors who would have no incentive to encourage demand.
  - (d) It might be possible to calibrate the average revenue control parameters in such a way as to share the risk of volume forecast errors between customers and investors. If so, it would go some way towards addressing the unfairness in the current profile adjustment mechanism.

11. In other energy sector price controls, some regulators have argued that it was desirable to eliminate incentives for an energy company to encourage demand, even though that meant removing natural incentives to encourage demand by giving good service or providing helpful information. The rationale was that, on environmental or climate change grounds, it was inappropriate to encourage consumption. Even if it were valid elsewhere, this argument clearly does not apply to the situation of Northern Ireland where gas is the main cleaner, lower-CO2 alternative to heating oil.

### **Efficiency test for under-recoveries**

12. The Utility Regulator seems to be treating allowed revenues as if they were guaranteed revenues which companies are entitled to even if the customers that received the services in respect of which revenues were allowed were not charged the full amount.
13. This is wrong in principle: allowed revenue is a maximum, not an entitlement. There is no statutory duty to protect the interests of investors and no statutory powers to underpin any entitlements to investors.
14. It is also harmful in practice: it insulates companies from the natural impetus to serve their customers well in order to retain them or encourage take-up. And it transfers take-up and consumption risk to future consumers.
15. However, given the regulator's historical approach, it might be unfair and perhaps legally impossible to apply a blanket denial of the inclusion of historical under-recoveries in future allowed revenues. Furthermore, there are circumstances in which charging less than cost now and more than cost in the future could make sense: it might be commercially and economically efficient to give a short-term financial boost to new gas customers so as to offset the cost of conversion to gas, at least on the assumption that gas distribution companies have access to cheaper finance for this purpose than homeowners. Whilst such incentives should perhaps have been captured through the profile adjustment, it is not automatically unfair to use the under-recovery mechanism for this purpose.

16. Instead, a solution in this area has to be an efficiency test: any gas distribution company that wants to charge future consumers for past under-recovery would have to justify that the deviation from cost-reflectivity and the profiling adjustment that this implies are part of an efficient scheme to manage take-up and that that scheme operates in the interest of consumers. Insofar as the company cannot show that, then the under-recovery should be seen as either a historical failure to collect revenues that could efficiently have been collected, or just bad luck — and in those cases it is legitimate for that cost to be borne by investors, not future consumers.

### **Non-distortionary approach to the cost of debt**

17. Ofgem has established systems and datasets to index the cost of debt in its price controls. Although these systems have their defects, they work and they do not suffer from the perverse incentives that arise from linking a company's price control to the costs of that company's future borrowings.
18. It is true that Ofgem's allowed cost of debt could not be used unmodified: gas distribution is a different business in Northern Ireland and elsewhere in the UK, the companies are structured differently, and the regulatory risk is perceived to be higher in Northern Ireland.
19. But it would be perfectly feasible to set the GD17 cost of debt to be equal to the cost of debt allowed in Ofgem gas distribution price controls plus a fixed premium. This would be more transparent and have less risk of perverse incentives than the Utility Regulator's current proposal.

### **Impact on the cost of capital**

20. The companies, the Utility Regulator and their various consultants will undoubtedly argue that the proposals outlined above will lead to an increase in the cost of capital, to the detriment of consumers.
21. These arguments are likely to be fallacious:
  - (a) A depressed cost of capital coupled with overly generous incentive schemes (the Ofgem approach) is not in the interest of consumers. In fact it amounts to little more than a relabeling exercise, where profit allowances are moved to the calibration of incentive schemes instead of being shown transparently in the cost of equity or cost of



debt. Profits are still high and consumers still have to pay for them, nothing has been gained by the relabeling.

- (b) The regulator's failure to put in place arrangements that will prevent the risk of a death spiral likely contributes to higher cost of capital. Consumers are better off paying for an explicit transfer of demand risk in a regulatory regime that would explicitly leave commercial risks associated with take-up and consumption with commercial investors.

#### Next steps

- 22. Developing proposals to implement the ideas scoped in this paper would require more development work than what was scoped in our proposal to review the GD17 draft proposals. We would be happy to put forward a proposal to CCNI to deliver this development work.
- 23. We expect that £5,000 plus VAT would be sufficient to deliver a paper and a simple spreadsheet model setting out specific proposals and demonstrating their potential impact by comparison to the regulator's proposal (and the true impact of this proposals taking account of historical under-recoveries which the regulator wants to burden future consumers with).
- 24. Subject to a prompt start, this could be done by Thursday 26 May 2016 (ahead of the Utility Regulator's consultation deadline of noon on Tuesday 31 May 2016).