7th October 2014

Brian McHugh
Gas Branch
Utility Regulator
Queen's House
14 Queen Street
Belfast
BT1 6ER

Dear Brian,

Gas to the West Licence Applications – Consultation on Provisional Decisions

You will understand that firmus energy (FE) was very disappointed not to have been provisionally selected as the preferred applicant for the construction and operation of the Gas to the West (GTTW) natural gas network.

We hope the Utility Regulator (UR) will agree that our application demonstrated FE's ability to deliver the GTTW project to consumers in Northern Ireland (NI) safely and efficiently. In this regard, we note that:

- FE was the only applicant with proven experience of developing a "greenfield" rural gas distribution network in NI.
- FE is recognised for its highly motivated, locally-based workforce, strong customer and stakeholder relationships and its track record of delivering against agreed regulatory objectives.
- Our application also showed:
    - The lowest distribution WACC of all applicants at 5.47%;
    - The highest score for Operational Business Plan (OBP); and
    - The lowest mobilisation costs of all applicants.

We believe that the scoring criteria applied by UR in making its provisional decision placed undue weight on the fact that the preferred applicant's submission reported lower operating costs (opex) than other applicants. We understand that UR have not been afforded the opportunity to form any judgement on the operating costs included in the Data Input Workbook[1], accordingly, we believe UR's provisional decision carries with it a number of risks for customers in NI.

In this regard, we are concerned that a number of the assumptions underpinning the preferred applicant's estimates will prove to be optimistic relative to the true cost of delivering a safe and efficient rural gas distribution network in NI.

We believe there is a risk associated with the allocation of costs under joint venture arrangements proposed between the preferred applicant and the preferred applicant for the GTTW high pressure network.

[1] Consultation of Provisional Decisions, para 2.8.10 page 45

In the remainder of this response, we set out the basis for these concerns. We would urge UR to ensure, through its forthcoming discussions with the preferred applicants, that these risks are appropriately mitigated. As reserve applicant, we stand ready to engage with UR should it not prove possible to secure agreement to a licence on the basis of the preferred applicant's tender submission.

1. Operating Costs

We assume that UR has been provided with sufficient information to satisfy itself that the preferred applicant is capable of delivering GTTW safely and meeting its long term connections targets within its submitted opex budget. We would, for example, be extremely disappointed if the opex allowed for the preferred applicant in the initial GTTW price control period were to be materially higher than that identified in the submission on which UR's decision was based. Equally, we anticipate that UR will have made clear to the preferred applicant that material increases in opex in subsequent price control periods will need to be justified by reference to changes in the underlying costs of operation, rather than as a result of initial assumptions proving to have been ambitious.

In the following paragraphs, we identify for UR's assistance a number of areas in which the opex assumptions underpinning the appointment of the preferred applicant are at odds with our own experience of the costs associated with safely constructing and operating a rural gas distribution network. We have sought to quantify possible understatement of project costs based on our own evaluation of publicly available information. A summary of our initial findings is set out in the table below.

	£m
Understatement of costs required to meet GTTW connection targets	3.3
Erroneous classification of opex as capex (not in line with Accounting Standards)	1.3
Insufficient engineering resources to manage network build and operation	1.8
Understatement of insurance and establishment costs	1.1
Provision of apparent cross-subsidy from preferred applicant's activities outside Northern Ireland	2.2
TOTAL	**9.7**

With these additional costs the preferred applicant's Net Present Value as per Published Criteria 3.15 Applicant Determined Cost would increase from £121m to c.£149m – an increase of c.£28m.

2. Engineering

a) Engineering Resources

The preferred applicant's initial engineering headcount of 4 reducing to 2 direct team managers seems inadequate to manage mobilisation, construction and operation of the proposed GTTW network. For example, in relation to Public Reported Escapes (PREs), the preferred applicant proposes not to employ direct engineering resource to oversee the management of gas escapes. This runs counter to best practice and the current NI gas emergency protocol.

b) Emergency Call Centre

The preferred applicant's assumptions on emergency call costs appear to have been based on forecast customer numbers rather than the reality of operating a "greenfield" rural gas network in NI. In NI, National Grid charges a fixed monthly management fee for call handling services plus a fixed cost per call. Costs in FE's submission have been based on the actual emergency calls we receive in operating a similar rural network within FE's franchise area, but with a 33.3% efficiency saving assuming synergies between GTTW and Ten Towns. Fixed costs of £0.6m do not appear to be included in the preferred applicant's bid.

From our experience of operating a "greenfield" rural gas network in NI over the last 9 years, the reality is that customers in NI are still learning about natural gas and are much more cautious in their approach than their counterparts in GB. We do of course recognise that this will improve over time.

c) Emergency Response - First Calls

FE is concerned that only £31k has been submitted by the preferred applicant for all first response calls in Year 1 (£1.1m over 10 years). The preferred applicant appears to be planning to outsource the emergency response provision but has not included any details or costs of any retainer necessary for the provision of engineers on call within the OBP (which would be a material omission). FE pays an annual retainer of c.£60k for these services.

3. Ability to Meet Targets for Connections

Any successful bid should be capable of realistically achieving the target of 40,000 connected natural gas customers in Fermanagh and Tyrone.

The total owner-occupier incentive is £425 for 7,761 customers, or £3.3m over a ten year period. The preferred applicant has proposed that labour costs of c.£1.6m will be accounted for from this fund leaving c.£1.7m available for financial incentives and marketing activities for the owner-occupied sector.

For owner-occupier incentives the preferred applicant has proposed that;

- c.10% of connections will avail of a £250 up front incentive;
- c.50% of connections will avail of interest free loans. There is no detail of the cost of providing these loans, however we would very conservatively estimate that each loan will cost c.£250; and
- c.40% of connections will be fully funded by NISEP or similar schemes. Our experience is that these schemes typically require a contribution of £250+ per connection to secure sufficient levels of scheme funding.

Based on the above, we view the likely cost of providing incentives, interest free loans and NISEP schemes to be at least a further c.£1.9m. In total this would mean a potential £200k shortfall before any of the marketing activities within the preferred applicant's OBP are carried out.

In our own experience, (which has successfully achieved 49% more connections than our PCR02 regulatory target) a planned and continuous promotional activity (advertising, PR, sponsorship, events, development of installer networks, door-to-door activity, conversion incentives etc.) needs to be undertaken in the network area in order to develop a positive perception and experience of natural gas. Internal resource requires third party support in terms of sales collateral design and production, media planning and advertising, PR support and direct mail costs.

We are concerned that the preferred applicant's OBP narrative outlines basic marketing activity but provides no plan or detail on actual costs. We note that UR's own commentary states that: *“The application explains that much of these costs are covered by the owner occupier incentive but it is very difficult to follow the calculations with the tables presented and how the final figure was arrived at is not clear.”*

4. Other Cost Items

Certain assumptions within the preferred applicant’s submission appear to be based on customers or network km across a number of GB licence areas, rather than an analysis of the practicalities and logistics of constructing and operating a low pressure gas distribution network in Fermanagh and Tyrone. FE is concerned that the preferred applicant’s submission does not fully recognise the economic and market conditions prevailing in Northern Ireland *and* the costs associated with stimulating interest in and demand for connections to the network, nor the costs of maintaining the network and responding to emergencies.

a) Manpower

We have already highlighted our concerns as to the level of emergency manpower required to cover a large geographic area and to safely manage an evolving gas network. In addition, we note that £0.7m of manpower costs have been reclassified from Labour to Emergencies and Network maintenance costs (which further reduces cost capacity for third party support). We are concerned that this leaves insufficient contingency to safely manage the network.

Furthermore, we note that c.£1.3m of manpower costs relating to senior management including the Director for NI operations have been re-classified from opex to capex, taking these costs outside the scope of the workbook inputs. We assume that UR has been provided with sufficient information to satisfy itself that this classification meets the applicable accounting requirements to capitalise only costs directly attributable to the construction of an asset (IAS 16.17(a)) (and does not “displace” genuine capex that would otherwise be applied to network development).

We note that preferred applicant’s manpower costs (SGN OBP page 36) also include Management Service Agreement (MSA) charges for:

- Corporate Services – (Customer Services; Human Resource Management; Corporate Communications; Training Services; Fleet Services; Property and Facilities Management; Procurement; Legal Services; Audit Services; and Risk Management).
- Network Services – (Safe Control of Operations; Engineering Policy; Innovation; Network Strategy; Gas Control; Demand Forecasting; and Distribution Design).
- Finance Services – (Payroll; Accounts Payable; Insurance; and Tax)
- IT and Back Office Services – (IT help desk; and IT support).

Within the OBP (Figure 8, Section 8) the annual cost of these services range from nil in year 1 of operations to £0.1m in year 10. The preferred applicant’s 2013 Financial Statements show that the average FTE salary cost within the business is £48k. Therefore, given the significant number of services to be provided by the preferred applicant for GTTW the submitted manpower resource appears not to be reflected in submitted costs.

b) Office Costs

The preferred applicant has estimated office costs on the basis of accommodating 19 staff plus rates, utility bills, stationery, postage and telephony costs. Submitted costs include £5k per year for telephony and £34k per year for all other costs. Unless the preferred applicant's submission includes an element of cross-subsidisation from other facilities, we consider this assumption to be optimistic. Based on our own experience, rental of office space, before telephony or other any utility or establishment, stationery or postage costs will cost materially more, with our estimate being at least £0.4m higher over the ten year workbook period

c) Insurance

The preferred applicant's workbook includes insurance costs at £18k per annum. FE's submitted costs are c.£0.7m higher over ten years and cover: Property Damage/Business Interruption (excl. pipelines); Public & Products Liability (including pipelines); Employer's Liability; Personal Accident & Travel; Motor; Crime; Directors' & Officers' Liability; and Professional Indemnity. Therefore, we would question whether UR is satisfied with the validity of the costs submitted in the OBP and whether the proposed level of cover is sufficient to ensure that no risk will fall on consumers?

d) Synergies with FE's Distribution Network in the Ten Towns

FE's OBP (Paragraph 2.2.2, and Chapter 8 page 81 Miscellaneous Costs) indicates that operating costs attributable to GTTW would in part be due to allocation of time by staff operating across both the Ten Towns and GTTW networks. The grant of the GTTW low pressure licence to FE would therefore result in approximately £2.3m of savings in opex on the Ten Towns Network. The project scoring mechanism did not appear to give any credit to FE's submission for the savings available across NI (including existing customers in the Ten Towns).

5. Clarity as to Terms of Joint Venture

The preferred applicant proposes to enter into a Joint Venture (JV) with the provisional preferred applicant for the GTTW high pressure network. We understand that the JV arrangements contemplate that the low pressure operator will provide financing and construction services to the high pressure operator in construction of the GTTW high pressure network.

The form of the JV agreement has not been made publicly available, and so we are not able to comment on any specific issues that might arise under it. We would expect that JV arrangements of this kind will contain detailed provisions dealing with construction and financing costs and the allocation of construction and regulatory risk between the parties (being the GTTW high pressure operator and the GTTW low pressure operator). The balance of risk in such a JV arrangement will materially influence the actual costs and outcomes of the GTTW project. We therefore assume that:

- UR has been able to base its decisions on a fully documented and formalised JV arrangement (as opposed to a "heads of terms"), and with complete transparency on all material terms and conditions agreed between the parties.
- The JV agreements have been negotiated on arm's length terms, and that UR has been able to assess and take into account the extent of any cross-subsidy being provided by one party to another in the form of favourable risk allocation, terms of financing or other terms. For example, is the UR satisfied that there is no scope within the JV arrangements for costs associated with the low pressure network to be reallocated to the high pressure network, and

that the regulatory accounting for the JV arrangement will provide sufficient transparency?

- UR has been provided with adequate comfort that the JV arrangements have been formed in accordance with all applicable procurement legislation.
- UR has been provided with detail as to the basis on which the preferred applicant proposes to extend or renegotiate its existing contracts in order to accommodate the extension of its operations from GB to NI.

Conclusion

The worst possible outcome for NI consumers would be that a Licensee cannot meet its financial obligations and/or meet its development targets and/or construct and manage a network safely. We expect that UR will have been provided with sufficient information and clarity to ensure that this is not the case in making its provisional decision.

We reaffirm that we are confident in our ability in Northern Ireland to successfully undertake the Low Pressure Gas Conveyance Licence for GTTW should circumstances change.

Please feel free to contact me should you wish to discuss this in more detail.

Yours sincerely

John French
Director of Regulation and Pricing