



29th May 2013

Graham Craig
Gas Distribution
Utility Regulator
Queens House
14 Queen Street
BELFAST
BT1 6ER

Dear Graham,

Re: Consultation Paper on Gas Network Extensions in Northern Ireland

Thank-you for providing firmus energy with this opportunity to respond to the above consultation.

Since 2005, firmus energy has brought the benefits of natural gas to over 18,000 homes and businesses in its network area, and in doing so we are;

- Currently providing consumers with the lowest gas price in the United Kingdom;
- Maintaining the highest level of customer service of any regulated energy company in Northern Ireland¹;
- Developing a safe and robust gas distribution network; and
- Maximising the development of our network, whilst seeking additional regulatory permission to extend our network to areas and customers that were not included within our original business plan assumptions.

Since our licence was awarded, we have:

- Invested over £70 million building our network in Northern Ireland, and we continue

¹ Enquires and Complaints Report 2011-12, July 2012, Consumer Council.

to invest around £10m per annum locally on network development and circa £5m per annum into the local Northern Ireland economy through our business operations;

- Looked to increase the number of consumers who can benefit from natural gas. Our business model projected that we would be undertaking 2,000 connections per year. However, currently we are at a run rate of circa 4,000 connections per year;
- Grown our business in an economically viable and responsible manner by initially targeting large industrial and commercial loads, new housing estates and public housing where refurbishment was planned and to existing households;
- Maintained competitive pricing to encourage conversion to natural gas;
- Looked to extend the benefits of natural gas to as many consumers as possible. In addition to our original licence area we have negotiated with the Utility Regulator seven² additional extensions (Portstewart, Ballyclare, Warrenpoint, Craigadoo, Coleraine Quarries, Bushmills, and Bessbrook) over and above our original “Ten Towns” business plan; and
- Undertaken our network development against a backdrop of falling house prices and reduced economic confidence.

firmus energy is committed to working with the Utility Regulator, DETI, the Consumer Council and other stakeholders in order to maximise the benefits of natural gas to consumers and the local economy in Northern Ireland, in a socially responsible and consumer focused manner.

firmus energy operates its bundled distribution and supply businesses pursuant to an established regulatory framework, made up of the terms of the licences granted in March 2005, further to which there have been three price controls to date.

We set out our comments below, tracking the numbering used in your consultation.

² A further extension to Glenavy By-Products is also currently being discussed with the Utility Regulator, following a public consultation in March 2013.

Chapter 1

Q.1 Is the respondent actively considering making an application for either or both the necessary licence(s)?

In March 2005, firmus energy was formally awarded supply and distribution licenses for the “green field” development of a natural gas network outside Greater Belfast.

Since our licence was awarded, firmus energy in developing our network has looked to maximise the benefits of natural gas to as many customers as is economically viable. In addition, we have requested and gained regulatory approval to extend our network into new areas. To date firmus energy has developed its network to Antrim (inc. Ballyclare and Templepatrick), Armagh (Tandragee), Ballymena (Broughshane) Ballymoney, Banbridge, Coleraine (Portstewart & Bushmills), Craigavon (Moira, Lurgan and Portadown), Limavady, Londonderry~Derry (Newbuildings) and Newry (Warrenpoint).

firmus energy in developing the “Ten Towns” Distribution Network has been successful in providing:

- Employment (600-700 direct and indirect jobs);
- Support for Households in Fuel Poverty;
- Economic Benefits;
- Environmental Benefits; and
- A Safe Network that is operated in a responsible manner.

As we have been successful in the roll-out of the gas network in the “Ten Towns” development area we would consider making an application for the licence(s). However, before doing so we would require significantly more information about the tender process and award procedures, what guarantees will be afforded by Utility Regulator as part of any submission and the process under which the Utility Regulator plans to finalise licence terms. This is a significant process which requires absolute clarity from the outset before we could commit to tender costs of up to £1m in technical and legal fees.

Chapter 2

Q. 2 Do respondents require any additional information on possible Northern Ireland Executive Subvention in order to construct any potential licence application effectively?

Within firmus energy's current distribution licence the cost of all feeder mains up to the 5km point from each of the firmus energy network development areas are included in the transmission operator's asset base. firmus energy would therefore request further clarity in this regard from the Utility Regulator as to whether this will also be the case for this proposed extension to the West. This is a fundamental principle which must be established prior to application submission.

Additionally, firmus energy has worked very closely and successfully with the Transmission Operator in the development and opening up of the "Ten Towns" network areas. We have linked successfully to the nine AGI's³ on our network with no interruption to service and worked with the Transmission Operator to ensure that maintenance of both our distribution network and the transmission network operate efficiently.

The development of the distribution network is mutually dependent on the successful development of a transmission network out to the West. On that basis, firmus energy would request further clarity on the detailed processes surrounding the awarding of the Distribution Licence and the impact and timescales within any distribution network development plan if the Northern Ireland Executives Subvention is delayed or cancelled, which in turn causes the successful Transmission Licence applicant to change or cancel their implementation plans.

Chapter 4

Q.3. What are respondents views on the options presented on linking applications and price control allowances?

Whilst firmus energy understands the Utility Regulator's desire to link future price control allowances to licence applications, it will inevitably be the case that assumptions within the application may become quickly outdated such as changes in ground conditions (archaeology surveys, environmental surveys, engineering difficulties, DRD allowed road closures etc.), customer loads (particularly customers who reduce their energy consumption or close their business due to economic factors) turn out to be significantly different to what

³ Natural Gas Above Ground Installations (AGI).

was assumed in the original application.

firmus energy's experience in developing the "Ten Towns" network has shown that many things can and do change from what was assumed at the application stage. For example, economic conditions can change making it harder for customers to afford the conversion to natural gas, or there can be political changes and amendments to local and national government's budgets meaning that less public sector properties switch to natural gas than was originally assumed. On that basis, firmus energy would require further detailed clarification from the Utility Regulator on how changes to the economic, environmental and other data relating to the differences between application submission and licence start can be accommodated.

Q.4. What are respondents views on having a structured competition in which applicants are asked to construct their applications on the basis of an established regulatory model and development plan?

firmus energy understands why the Utility Regulator has asked applicants to construct their applications on the basis of an established regulatory model and development plan. However, we have serious reservations about the degree of flexibility it gives potential bidders to innovate and reflect the actual changes that have occurred since the FMA modelling was undertaken in 2009.

The disadvantage of this prescriptive method is that it may not be effective in revealing applicants actual costs as there is an "*air of unreality*" about the process. It is based on assumptions made in 2009 which are undoubtedly outdated and could significantly affect the development plans for the towns. For example, our initial examination of the details provided for Dungannon-Coalisland showed several of loads highlighted had already closed/mothballed e.g. Tyrone Brick.

On that basis, firmus energy would like further clarification from the Utility Regulator on an alternative approach to construct applications.

Q.5. What are respondents views on whether the transmission and distribution competitions should be constructed to allow applicants to apply for each licence separately or jointly?

From our experience, background and knowledge, firmus energy is of the opinion that the

disciplines involved in developing, constructing and operating transmission networks are very different to that of a distribution network operator and owner. The core competencies on building and operating transmission networks are very different to rolling out a distribution network across multiple rural towns with varying degrees of conurbation concentration.

A distribution network has by its nature has a greater end customer focus and looks to ensure the best possible service and price for its customers in a safe and responsible manner.

firmus energy also believes that it is important that the process provides the best possible outcome for consumers and Northern Ireland as a whole. Therefore, firmus energy believes that the Utility Regulator should view the process for transmission and distribution as two separate competitions in which the best applicant in either transmission or distribution would win the award. On this basis, we believe that the Utility Regulator will achieve the best possible deal for consumers.

Chapter 5

Q.6. We would welcome views on whether three months is sufficient to prepare a licence application.

Based on experience of developing previous licence applications, firmus energy believes a three month timescale is extremely ambitious, if not impossible. Based on our experience of the Ten Towns licence application, we believe that a six to nine month period is more realistic as it provides applicants the necessary time to prepare a fully considered application and seek the necessary approvals from shareholders. This is a significant strategic project for Northern Ireland and for potential applicants and should be afforded the correct timeframes for consideration and application.

Q.7. We would welcome views on our proposal to merge the pre-qualification and invitation to tender stages of the evaluation into a single evaluation stage.

We would favour two assessments being conducted separately, as they are essentially two separate exercises. Again, given the significance of the application process we see no reasons to short-circuit tried and tested processes.

Q.8. We would welcome views on the proposed timeline for the licence application process.

As set out in our response to Question Six, we believe that the proposed timescale for the application process is unrealistic. We believe that a six to nine month period will be necessary for applicants to develop a fully considered application.

Chapter 6

Q.9. We would welcome views on our proposed criteria and weightings for each criterion.

The Consultation asks for applicant's opinion/views regarding Para 6.20, namely:

6.20 Once the application is received the Utility Regulator could undertake a completeness / compliance check of the information received in order to identify any missing data. If this check identifies any omission(s) in the information required to be provided, we could notify the applicant and give them a period of time in which to rectify the omission(s). Alternatively, we could evaluate the application using only the information that is provided thus creating a clear incentive on applicants to submit a complete submission as there would be no opportunity to rectify any omissions. We would like to have stakeholder views on this point

firmus energy has no issue in being able to provide all the necessary information in any initial application, and would not anticipate leaving any relevant material out. However, the proposed timescales for application do not allow for firmus energy to satisfactorily complete the application process to the extent that we could take on any risk for omissions. Additionally, we would want to ensure that the process would allow for us to revise our application, without prejudice, if there was a material change to the licence, or licence conditions.

a) Views on Proposed Weightings –

The weightings for the two categories (D and T) are as follows:

Transmission:

- Applicant Determined Cost (70% of available marks)
- Operational Business Plan (20% of available marks)

- Innovation and Technology Transfer (10% of available marks)

Distribution:

- Applicant Determined Cost (60% of available marks)
- Operational Business Plan (20% of available marks)
- Maximising connections (10% of available marks)
- Innovation & Technology Transfer (10% of available marks)

firmus energy has concerns of the high weighting (up to 70%) for applicant determined cost. Under this weighting there is the potential for other applicants purposefully undercutting their submitted costs in the knowledge that they will be able amend their application costs later to retrieve any potential losses. firmus energy would require a level playing field for every applicant, with full clarity to all applicants in the event of changes or suggested changes to cost lines and cost descriptions. The Utility Regulator should have a mechanism in place to ensure that an unfair competitive cost advantage cannot be manipulated by any applicant. firmus energy believes that more weighting should be given to the operational business plan, including elements relating to the operational nuances of building and operating new networks in rural towns.

Q.10. In relation to the criterion “Economic and Financial Standing” do respondents agree that the appropriate capital value for the network extension against which applicants should be required to provide proof of net assets should equal the total costs of the network over 40 years?

We agree with what is being proposed in Para 6.13 of the consultation, and we believe that it is important that there is a level playing field and these criterion are consistently applied to all applicants.

Q.11. Should there be an opportunity to rectify any omissions from the application?

As previously mentioned in Question Six, we believe the proposed timescale for the application process is very tight; which increases the opportunity for omissions to be made.

In addition, as set out previously, as this competition is based on a model that was scoped out in 2009, it will be important before the project begins and indeed the licence is awarded

that the all assumptions are updated to take account customer and load profile over the last four years.

Therefore, as applicants are being asked to bid on what is now an outdated proposition, it will be important that they have the opportunity to bid on the basis of the latest data in the six towns.

Q.12 Do respondents consider that the proposed workbook is sufficient to capture the cost information necessary for the Utility Regulator to assess applicant determined costs effectively?

In general, firmus energy has no specific issue with the proposed workbook. However the detail relating to the application is critical and it will be important that cost category lines can be amended at time of application if it becomes clear that some data categories are missing or are "*light*".

Chapter 7

Q. 13. We would welcome respondent's views on whether 40 years is the appropriate period over which operating cost data is to be provided.

We fail to understand why 40 years is being proposed as the recovery period for the proposed licence award. firmus energy believes that there needs to be a consistent approach to licence periods within Northern Ireland.

In Belfast the distribution licence holder was initially awarded a twenty year licence period. This was subsequently extended for a further thirty years (i.e. 50 years in total). firmus energy in 2005 was awarded a thirty year licence for the development of the "Ten Towns" network area, and now it is being proposed that the successful licence applicant for the Gas to the West project will receive a forty year licence.

We believe that regulatory certainty is vitally important and there should be consistency, as much as possible, for gas network licence holders in Northern Ireland. We would value further clarity from the Utility Regulator on this issue.

Q. 14 Do respondents consider that the proposed controllable operating expenditure cost lines in the workbook are appropriate to capture this data effectively?

As set out in Question 12, In general, firmus energy have no issue with the proposed workbook; however the “*devil will be in the detail*” and it will be important that cost category lines can be amended at time of application if it becomes clear that some categories are indeed missing.

Q. 15 Do respondents consider that the proposed workbook notes are sufficiently detailed to allow applicants to complete the workbook effectively?

In principle, firmus energy does not have issues with the proposed workbook notes.

Q. 16 Do Respondents consider that the proposed definitions of Controllable Operating expenditure as set out in the notes accurately reflect the structure of costs and the cost divers a licence holder would expect to experience?

Generally, firmus energy does not have an issue with this.

Q. 17 Do respondents consider that the network design information as set out in the accompanying FMA documents is sufficient for applicants to develop a robust application?

Whilst these provide a good foundation on which to develop the network design, we believe that the FMA documents do not provide an optimum design solution. We believe there are critical technical specifications / documents that are missing such as details around the proximity to buildings (as per IGEM guidelines) and the large increase in cost due to traffic restrictions imposed on proposed routes. Therefore we believe it would be difficult to base an application on the current level of information that has been provided.

Since the FMA model was developed there has been significant change in the economic climate. There is a lack of detail of how the information was gathered, if the load information is current and/or accurate and whether existing boilers are suitable for conversion to natural gas. Additionally, key customer loads which are critical for network recovery have experienced significant economic changes in recent years; for example, in Dungannon it is known that some potential large gas users have closed or reduced their usage. Changes to

gas flows have a major impact on network modelling and renders the FMA information to some extent unreliable.

The lack of distribution mains shown on the maps to allow for the development of the existing housing market would be another concern. It has been noted there is an allowance for existing housing mains but there is an initial cost to bring the “spine” mains to the edge of housing developments which has not been included. These are the key differences within rural towns compared to Greater Belfast where conurbations are less dense. It would be a significant risk for any undertaker to rely on the information given unless a full model was developed to ensure that the “Feeder” main from the AGI and the “spine” mains throughout the town could support the expected load.

We note that there is a lack of allowance or detail on the SEDs (Special Engineering Difficulties) included in the FMA proposal. This may affect the routing of the gas network and therefore affect the network design of the town. In addition, there has been no proposed cost allowance of unknown SEDs that will undoubtedly occur when constructing a gas network from a rural to an urban environment.

firmus energy would request further clarity from the Utility Regulator regarding the use of FMA documents, and what protection is offered should the information provided turn out to be inaccurate or incomplete.

Chapter 8

Q. 18 We welcome respondents views on our proposals for the key features of the regulatory model to be used in the transmission “competition”.

It is firmus energy’s understanding from the consultation that, within the proposed regulatory model, for the transmission licence to be awarded for forty years and that the licence holder will:

- be subject to a revenue cap form of control and will receive a guaranteed income for a period of five years based on an ex-ante assessment of the capital, financing and operating costs; and
- will be subject to a price control review period of five years.

In addition, DETI will designate the transmission assets in the area of the network extension

as forming part of the Northern Ireland postalised transmission system and that indexation will be based on the Retail Prices Index and that the full opening asset value will be recovered over a period of 40 years.

Within the competition the Utility Regulator is also proposing that licence applicants are required to indicate the (real pre-tax) rate of return they will be required to own and operate the transmission system over the forty years of the project.

Q. 19 We welcome respondents views on the incentive proposed to ensure the pipeline is operational as quickly as possible.

firmus energy agrees, in principal, to the incentive proposed to ensure the pipeline is operational as quickly as possible. However, we believe the Utility Regulator would need to be cognisant of the fact that both transmission and distribution network developers are governed by the ground conditions and population density that they find in an area. Therefore the application of any incentive mechanism would need to be pragmatic in its approach and take account of ground conditions (archaeology surveys, environmental surveys, engineering difficulties, DRD allowed road closures etc.) turn out to be significantly different to what was assumed both in terms of cost and timescale of the original application.

Chapter 9

Q. 20 We welcome respondents views on our proposals for the key features of the regulatory model to be used in the distribution “competition”.

firmus energy's current network area covers a distance of 271km between Derry and Warrenpoint across what is now 18⁴ distinct provincial towns similar wide. This is a similar dispersed and provincial geographical area as to that which is being proposed for the extension of the Gas Network to the West. Our experience has shown that the complexity of developing a new “green field” gas network across such a wide area and within rural towns (with associated disparate services and meter fits) is a challenge both in terms of cost and operational effectiveness. However, firmus energy has, due to its economic based development model, managed to maintain a favourable price differential against the main competitor, namely, home heating oil. As the recent Utility Regulator report⁵ shows we have provided customers within the firmus energy network with the cheapest gas prices in the

⁴ Londonderry, Limavady, Portstewart, Coleraine, Ballymoney, Broughshane, Ballymena, Ballyclare, Antrim, Templepatrick, Moira, Lurgan, Craigavon, Portadown, Armagh, Tandragee, Banbridge, Newry and Warrenpoint.

⁵ Retail Market Monitoring, Quarterly Transparency Report, March 2013, Utility Regulator.

United Kingdom, the island of Ireland, and the EU15.

firmus energy has prudently built and rolled out its network based on an economically appraised development programme. As we have developed our network we have identified and targeted large industrial and commercial loads and focused domestic connections on households who are more likely to be in fuel poverty in cooperation with the Northern Ireland Housing Executive and by the use of NISEP funding. This has ensured that optimum load growth can be captured as soon as possible and that the regulated recovery model is de-risked.

Our understanding from the consultation document is that, within the proposed regulatory models for the distribution licence extension to the west will be awarded for forty years and that the licence holder will:

- be subject to a price cap form of control where it will be permitted to charge up to a certain level of distribution tariff based on an assessment of capital, financing and operating costs associated with forecast demand, and that the proposed measure of demand should be consumption;
- recover revenues dues solely from gas consumers in the area of the network extension (although there will be a common tariff across all the designated towns); and
- be subject to a price control review of five years.

In addition, the licence will contain a network development plan, which should reflect the model derived from the FMA study for the development of a “fat” business model and that indexation will be based on the Retail Prices Index.

It is also our understanding that the Utility Regulator proposes that applicants within the awards process are required to indicate the (real pre-tax) rate of return that they will require to own and operate the transmission system over the 40 years of the licence.

As set out in our response to the Consultation Questions; we believe that the proposed timeline for the process is overly ambitious; especially as the Utility Regulator has chosen not to follow a traditional bidding process, which relies on FMA modelling that took place in

2009.

Additionally, in relation to the nature of the model, firmus energy is concerned with the Utility Regulator view that the business model should be “*fat*”. The experience in Greater Belfast, and the resulting requirement to extend the licence period on the basis of non-recovery, is testament to the overly ambitious rollout of a network without the attainment of the necessary load to ensure the efficient economic payback. New networks cannot be speculative in nature (i.e. the maximisation of gas availability without guaranteed connections and resultant volume throughput) without exerting significant risks to the recovery period.

The experience of firmus energy within the Ten Towns, whereby early volume throughput was derived through the connection of large Industrial & Commercial and SME loads, has helped secure the long term economic viability of the network across a combination of largely rural towns. By taking this approach and combining it with then targeting of new build housing developments and social housing areas, firmus energy has been able to drive gas availability and penetration. This initial “*thin*” model has now been able to be adapted to a “*fatter*” model through initiatives to maximise gas penetration along the existing mains and targeted network extensions into suitable established owner-occupier areas. This has allowed firmus to grow connections to >4000 per annum in recent years. On the basis of this proven model for rural towns and cities, we would value clarification from the Utility Regulator on why a “*fat*” model has been proposed as the basis for the licence award.

In conclusion, in addition to the questions set out in the consultation, firmus energy would like further clarity from the Utility Regulator in regard to the following points:

1. What regulatory, legal and financial protection would there be for bidders receive if the 2009 FMA information provided turns out to be materially inaccurate?
2. What scrutiny will bidders face and how will the Utility Regulator ensure this is an equitable and transparent process?
3. Exactly how will any bid be scored and assessed and will full assessment criteria be published?
4. Will the assessment criteria be transparent and available to all bidders at the start of the process?

5. Shall the bid be deemed a “*best and final*” offer?
6. How will any bid be deemed as binding?

Please feel free to contact me direct on 028 9442 7835, should you wish to discuss further.

Yours sincerely

John

John French
Head of Regulation and Pricing