

SGN Natural Gas
3rd Floor,
83-85 Great Victoria Street,
Belfast,
BT2 7AF.

14th October 2016

Mr Paul Harland
Finance and Network Assets
NIAUR
Queens House,
14 Queen Street,
Belfast,
BT1 6ED.

Dear Paul,

GD17 Licence Modification Consultation

Thank you for the opportunity to respond to the GD17 licence modifications as outlined in your consultation document, published 15th September 2016. We have outlined our main issues within the body of this letter but other points are included in a separate supplement attached.

We would wish to specifically raise a number of licence issues where we consider changes are required. The areas we believe need to be addressed are given below:-

- i. Interpretation for the end of mobilisation (FOCD)
- ii. Design Changes to the HP system
- iii. Clarity of Reopener for HP delay
- iv. Post tax WACC calculation error
- v. P7 Conveyance Category
- vi. Capex Uncertainty Mechanism Adjustments

Interpretation for the end of mobilisation

Following a meeting with yourself in early September 2016 we wrote to confirm our understanding of the First Operational Commencement Date (FOCD). This was based on extracts from the Gas to the West: Applicant Information Pack and the associated clarifications issued by the Utility Regulator. The relevant extracts are also reproduced below for ease of reference. While we acknowledge that the Utility Regulator has addressed this issue within the Final Determination document, paragraphs 6.506 to 6.510, the qualifications provided are inconsistent with the references on which our understanding is based. We therefore request that the Utility Regulator address this inconsistency and ensure the Licence (and allowances) reflects the stated commitment within the Applicant Information Pack

Extract From the Gas to the West Application Pack

1. Gas to the West: Applicant Information Pack – 6 February 2014 (AIP)

Capital expenditure

- 3.38. As there will be no revenue recovery mechanism during the period before first operational commencement date (FOCD)¹¹ those costs allowed will be capitalised and included in the opening asset value. The interest rate used will be LIBOR + 0.5%.¹²

¹¹ This means the date when gas first flows on a commercial basis through the pipeline.

¹² The one year LIBOR rate will be used.

Extract from the clarifications questions issued by the Utility Regulator in response to specific issues raised regarding the application pack.

2. 2014-04-16_Updated_Gas_to_the_West_Clarifications_1_-_74.

28	3.38 of the application form notes states that the first operational commencement date (FOCD) is the date when gas first flows on a commercial basis through the pipeline. Could you clarify “on a commercial basis”? Does this relate to gas to any customer or to a large I&C customer?	<p>Regarding the low pressure licence</p> <p>The reference to gas flowing “on a commercial basis” is not intending to distinguish between categories of customer. It refers to the time when gas flows for commercial purposes (to any customers) as opposed to the use of the network for testing or commissioning in order to bring it into operational use.</p>
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This confirms that there was clear instruction given as to the definition to be applied to FOCD prior to the bid being submitted. It was based on this instruction that we developed our bid proposals and structured our mobilisation costs. We are also not aware of any subsequent consultations that have amended the guidance given. Based on the above it is therefore our understanding that for the low pressure licence FOCD is when gas flows on a commercial basis “to any customer”. For SGN Natural Gas this will be in November 2016 when the service to a major commercial customer is commissioned and their processes are converted to use natural gas. This is different to the date stated and we would request that the Utility Regulator gives consideration to amending their previous assumption before confirming the Licence terms.

Design Changes to the HP/IP system

Prior to the submission of our original business plan the design of the High Pressure transmission system was changed with some sections, totalling in excess of 130km, being redesigned for reduced Intermediate Pressure operation. The licence was written to ensure that the treatment of IP mains in both the HP and LP licence was clear with maintenance been the responsibility the LP licence holder. This design change amended one of the given parameters upon which our original bid was based. Whilst this has resulted in significant overall cost savings for the Northern Ireland consumer, this change has impacted on some elements of our costs that we had reflected in our business plan. The additional operating costs of maintaining this pipeline now sits with ourselves and we believe that this change should be recognised by the Utility Regulator. During our discussions with yourself following the publication of the draft determination we highlighted that these extra maintenance costs had not been recognised. At a meeting on the 1st September 2016 you confirmed that there had some movement in terms of the Opex proposals but you could not confirm the specifics of these changes. As there is no mention of these specific additions in the final determination it is not clear to SGN Natural Gas as to whether the Utility Regulator has overlooked or given consideration to our request. We would therefore request confirmation as to how this cost is to be treated and ensure allowances are consistent with the definitions in the licence.

Clarity on re-opener for HP/IP delay

We have provided amendments to the wording in clause 3.2.2(a)(i) to include for some examples that may trigger a change to the Annual Connection Type Target and also an application under 4.7 for a Special Review.

Post tax WACC calculation error

We strongly believe UREG’s calculation of our post tax GD17 WACC of 5.3%, in licence condition 4.11.1, is incorrect, as set out in previous correspondence and detailed in Annex 1. UREG’s calculation incorrectly applies tax to the whole 1.9% risk premium element of our 6.2% pre-tax WACC, which represents Start up and NI risks. This is a fundamental error as it was never specified in our bid that the risk premium is all equity and UREG incorrectly assumes the ED1 vanilla WACC, on which the risk premium is added, already factors in the additional costs of debt relating to start up and NI risks. By its very nature the ED1 WACC will only include the costs of debt for mature GB DNOs which have a proven track record of repaying loans, and the bid risk premium must include the extra costs of debt for start-up and NI risk which should be honoured. With this error corrected, as well as adjusting some more minor errors highlighted in Annex 1, we calculate the post-tax WACC for GttW to be 5.6%.

P7 conveyance Category

The SGN Natural Gas Conveyance Charging statement that was recently approved by the UR is different to that of the other NI GDN's in that we have an additional conveyance category. The category, P7, is described within section A of our Network Code as follows:

3 Supply Meter Points

- 3.1 A Supply Meter Point whose Annual Quantity is greater than 293,071,000 kWh (10,000,000 therms) shall be classified as a "Very Large DM Supply Meter Point".

To allow for consistency in interpretation we require that this should also be included within the modifications when they are applied to our Licence. Our suggested wording to ensure consistency with the existing conveyance category definitions (4.12.1) is as follows:

firm gas demand of over 10,000,000 therms per annum which is connected to the Network and which is not used in a combined heat and power generating station;

Capex Uncertainty Mechanism Adjustments

We are seeking clarity on some important areas relating to the Capex Uncertainty Adjustments. We seek confirmation as to whether all mains, including spine and feeder, are included in the mechanism, the actual mechanics of the capex risk sharing mechanism and how additional PRSs will be compensated for through the output adjustment mechanisms. Please refer to section 4.5.2 of the table below for more details.

Further detail on our comments can be found in the attached annexes.

Yours sincerely,

Mike Bedford

Director of Corporate Finance & Regulation
On behalf of SGN Natural Gas

SGN Natural Gas Licence Modification

We have included our comments on the proposed modifications to the SGN Natural Gas Conveyance Licence within the table below. Please note that the quoted page numbers refer to the pages within the tracked change version of the Licence that was issued as part of the consultation.

Page No	Reference	Comments
P.58	1.21.5	Reference has now been updated '1.12.5' to '1.21.5', etc. [Supported]
P.80	2.4.12(a)(i)	Updated wording [Supported]
P.130	2.25	Common Branding – updated clause [Supported]
P.131	2.26	Common network Tariff – updated clauses [Supported]
P.160	Annex 2	Revised Development Plan Table: The updated table is consistent, in total terms, with the revised build information submitted to the Utility Regulator in April 2016.
P.143	3.2.2(a)(i)	Could clause 3.2.2 (a)(i) be changed to include the examples of situations where UR would be minded to consider revising the Licensee's Obligations to Develop the Network. 3.2.2 Revising the Licensee's Obligations to Develop the Network (a) The Authority may, at the request of the Licensee and as reasonably appropriate in all the circumstances, revise any Annual Connection Type Target for any District where: (i) the Authority is reasonably satisfied that exceptional circumstances (not limited to delays to Planning or Construction affecting the HP/IP pipeline, excluding lack of funds), which could not have been reasonably avoided by the Licensee, have prevented, or could reasonably be expected to prevent the Licensee from complying with its obligations under Condition 3.2.1; or....
P.184	4.4.11	Wording added to end of clause Conditions 4.4.2 – 4.4.5 and condition 4.11.1 – Can confirmation be provided that 'm' is the last year of the previous price control (or 2017 in the case of GD17 for GttW) and 'n' is the last year of the current price control under review? There appears to be inconsistent use of the terms.
P.185	4.4.13	Wording amended, deleted part of clause [Supported]
	4.4.14	Amended and renumbered clause [Supported]
	4.4.17	Change 'allowed rate of return' to 'allowed rate of return plus RPI' to be consistent with the indexation of allowed returns in the rest of the licence.
P.187 – P.189	4.5	Best Available Uncertainty Mechanism – amended clause and term descriptions [Supported]

P.188	4.5.2	<p>We need clarity, with respect to the Capex Uncertainty Mechanism adjustment and para 9.30 of the FD,;</p> <ol style="list-style-type: none"> 1. that all mains, including spine and feeder, will be classified as infill or other mains for the purposes of the Uncertainty Mechanism adjustment? 2. how any additional PRS's will be fully compensated for (at an efficient cost) in the scenario of extra mains being laid above the determined level? 3. that the 75:25 capex risk sharing adjustment for company and consumer respectively is for unit costs, as intended in previous correspondence. Any efficient under or overspend relating to outputs is already covered, at a determined unit rate, by other capex uncertainty mechanisms? The current exception to this, notwithstanding our point 2 above, is PRSs which would have the sharing adjustment applied to the number and unit rate, i.e. total cost, as per condition 7.126 of the FD.' <p>For comments on the Tax Uncertainty Mechanism Adjustment please refer to Annex 2</p>
P.193	4.6.6	Amended wording and revised formula [Supported]
P.196	4.6.9	Amended wording and revised formula [Supported]
P.204	4.7.4 (c)	<p>Amend condition 4.7.4(c) to 'the Licensee's obligations under Condition 3.2.1 have not been or can reasonably be expected not to be, complied with. This special review would include the necessary changes to determined Values, impacted by a revision to the development plan, in current, future or preceding formula years. Determined values under consideration would include all determined values in condition 4.11.2 and extending the period the bid WACC in condition 4.11.1 is applied, by the duration any delay in the HP/IP build.'</p>
P.209	4.11	Updated designated parameters table [comments as per Annex 1]
	4.11.2	<p>Revised designated parameters table</p> <p>Suggest removing the redundant wording at the end of the table 'All Value(s) in £000's and indexed to RPI 2014'</p>
P.216	4.12	Various definitions have been added, removed or updated. [Supported]
	4.12.1	Suggest 'Final determination' 2017 needs to change to 2018
	4.12.1	"Revenue Per Unit" - means, in respect of each Conveyance Category I – should this be lower case "i"
P.221	4.12.3	Amendments to terms within the table , including new terms [Supported]
P.222	4.12.4	Table now includes a term for 'The Formula Year' [Supported]

Annex 1 – Post tax WACC Calculation Error

We strongly believe the calculation of the post-tax GD17 WACC of 5.3%, in licence condition 4.11.1, is incorrect and fundamentally flawed – as set out in previous correspondence and summarised below.

Our bid 6.2% pre-tax WACC was not calculated on a CAPM basis and thus there was not a Vanilla WACC stated in our bid. Instead the bottom end of a range of 6.2%-6.9% was chosen based on 1.9% start up and NI risk premium added to a CAPM based WACC of more mature networks in GB (RIIO-ED1 to RIIO-GD1). So although we did not deliberately select the ED1 WACC to add the risk premium to, instead selecting a WACC from a range of 6.2%-6.9%, a specific building block of a GD17 post tax WACC can be inferred (the 3.8% ED1 Vanilla WACC). However, as per the First Economics report for UREG 'SGN Years 1-5 Vanilla WACC', 'one could make all manner of assumptions about the split between additional return to lenders and additional returns to shareholders' of the risk premium in order to calculate its post-tax level. Indeed no attempt was made in the report to justify any split – apart from stating that a 50:50 split is extreme without any rationale behind this.

In their calculation UREG assume that the ED1 vanilla WACC factors in investment grade debt costs and thus 100% of the 1.9% risk premium uplift represents additional return to shareholders, i.e. cost of equity. Therefore UREG applies tax to all of the 1.9% risk premium. This is fundamentally flawed as it was never specified in our bid that the risk premium is all equity and the ED1 cost of debt will reflect the costs of debt for GB DNOs, not start up NI gas distribution companies. It is beyond any reasonable doubt that lenders would reflect the additional start up and NI risk - in their lending rates to start up NI GDNs versus GB DNOs. These extra costs of debt, which do not have tax applied in a Vanilla WACC calculation, would therefore be a significant part of the 1.9% risk premium and this cost of debt element of our bid WACC risk premium should be honoured. .

Indeed the NIE risk element of the premium, due to its derivation based on the 2014 CC NIE determination, has an explicit cost of debt element built in. This is shown in table 1.1 of the Oxera 'Gas to the West Cost of Capital' paper submitted with our bid, and detailed in section 2.8 of the paper. There is no logic as to why if the NI risk is deemed to fall on both the shareholders and lenders the start-up risk, which used the premium of the previous comparable start up GDN's WACC (Firmus in 2006) to the closest GDN WACC (GDPCR1), should not also manifest itself in the same way. It stands to reason that due to the significant uncertainty surrounding a start-up company - lenders will increase their rates as compared to a mature business with a proven track record of repaying loans.

In the absence of a definitive split of debt and equity in the risk premium – there are two options. Firstly acknowledge the significant computational difficulties in calculating a post-tax WACC, as per the difficulties UREG quote in switching Firmus and Phoenix to a post-tax WACC in section 10.97 of the Final Determination, and retain a pre-tax WACC for GttW. Or, recognise that the risk premium needs to have an equitable cost of equity: cost of debt split and that there must be a significant cost of debt element as highlighted above, and thus assume a 50:50 split in the absence of any other rationale. This would leave a vanilla WACC of 5.5% for GD17 based on UREG's assumption of the ED1 Vanilla WACC, as shown in cell F30 of the tab 'UREG's calculations' in the attached spreadsheet 'Cost of Capital Amendments'.

Making the following further corrections to UREG's calculations, as per the tab 'Amended UREG calculations' would leave a vanilla WACC of 5.6% for GD17 as shown in cell F30;

1. Correcting the ED1 risk free rate to 1.30, in cell C7, as per table 1.3 of the Oxera Report. The calculated risk premium would need to be retained at 1.90 in cell C21; and
2. correcting the uplift to the cost of debt to 1.90, in cell F27, to reflect that it is pre tax – and uplift the cost of equity to 1.52 in cell F28 to reflect that it is post tax.

Annex 2 – Tax Uncertainty Mechanism Adjustment

We also note the introduction of a tax uncertainty mechanism adjustment for the tax allowance in para 6.3 and that para 9.46 of the FD states an adjustment will only take place to reflect statutory corporation tax rates. They should also be adjusted to take account of the following;

1. changes in GD17 determined opex, capex, revenue and volume via uncertainty mechanisms and re-openers
2. changes in assumed interest rates and RPI
3. changes in capital allowances
4. changes to applicable legislation
5. setting of legal precedents through case law
6. changes to the HMRC interpretation of legislation
7. changes to accounting standards

Examples would include;

1. implementation of proposed limits on the amount of tax relief that companies can claim for interest in April 2017
2. reform on the amount of losses that can be carried forward from earlier periods, from April 2017. It is proposed the amount of profit that can be offset against losses carried forward will be restricted to 50% of the amount of group/company profits in excess of £5m.

There are also specific modelling issues with the calculation of the final determination tax allowance, which were raised re: the Draft Determination Pi model;

1. the split of the general and special rate pools does not appear to have been updated for the Final Determination
2. the model appears to be carrying forward a total tax pool balance each year, and then splitting this based on the allocation of capex spend in the current year. There should be 2 separate tax pools as once expenditure is allocated to a specific pool it will be carried forward in that pool only.
3. the pre 2018 capex spend needs to be updated to the Final Determination in the Capital Allowance calculations, and the pre 2018 taxable losses and 'Profits Attributable to Corporation Tax' calculations need to be updated for the Final Determination.'