

13th August 2015

Linda Beirne
The Utility Regulator
14 Queens Street
Belfast
BT1 6ED

Dear Linda,

Consultation on modifications to the price control conditions of the firmus energy (Distribution) Limited licence

Thank you for the opportunity to respond to this consultation on the principles of changing the form of firmus energy's price control from a price cap to a revenue cap.

While we accept that there may be arguments for moving firmus energy to a revenue cap model at the appropriate time, we would urge the Utility Regulator (UR) to ensure that it is taking all relevant factors into account in reaching its determination. In that spirit, we have noted in this response a number of issues that will require detailed consideration and consultation before a determination is reached. We believe this is essential if any move to a revenue cap can be implemented successfully and without negatively impacting on the UR's objective of supporting the continued growth and development of an economic natural gas network in our licence area.

- First, we have concerns as to whether now is the right time to implement the move to a revenue cap based on the maturity of our network compared to that of Phoenix Natural Gas Ltd (PNGL) at the time of its own transition to a revenue cap.
- Second, we have significant concerns as to the interaction of this consultation with the GD17 price control process, and the risk that a lack of clarity on the terms of our price control could impact on the success of the GD17 process as a whole.
- Third, while a revenue cap would go some way to aligning the regulation of firmus and PNGL, the UR's objective of achieving true comparability will not be met unless the significant number of other differences in the way in which PNGL and firmus energy are regulated are also eliminated. This implies a number of changes to the firmus energy licence and price control conditions that go beyond a mere "move to revenue cap".
- Finally, we note that the UR has not included in this consultation a consideration of the technical licence changes required to implement a revenue cap for firmus energy. However, we do not consider that the principles can be separated from the practicalities of implementation and so have also included a number of observations as to the technical challenges associated with implementing a revenue cap for firmus energy, which we believe should be taken into account as part of the UR's decision-making process.

Timing of transition a revenue cap

As we noted at the outset of this response, we agree that there will come a point in time at which it will be appropriate to transition firmus energy to a revenue cap form of control. However, we would question whether now is that time having regard for the current stage of our development and the UR's objective of supporting the continued growth and development of an economic natural gas network in our licence area.

The UR considers that "as the firmus business is over 10 years old, it is appropriate to move firmus from a price cap to a revenue cap form of control."¹ We do not believe that the move from a price cap to a revenue cap should be determined solely by the passage of an arbitrary length of time since the granting of our licence. Instead, the UR should also consider the maturity of the network in light of the scale and type of opportunities that exist for further network development. For example, when PNGL was transitioned to a revenue cap from January 2007, much of its infill network mains had been completed and it already had 100,000 customers.² By contrast, firmus energy's current level of 25,000 connections represents a small proportion of the approximately 230,000 households in our Towns Development Area.

As the UR will be aware, we are proposing to embark on a significant infill programme as part of GD17, in order to increase the reach of our network. Having regard for the point on the long-term development curve at which firmus energy is currently positioned, our network cannot be referred to as "mature" or "steady state" by any reasonable measure.

Interaction with GD17 price control

We appreciate that the UR may view the GD17 price control as providing a window of opportunity to align the form of our price control (price cap vs revenue cap) with the price control process itself.

As we noted in our GD17 Supplementary Paper on the Connections Incentive, any decision to change the form of price control needs to address the issue of how appropriate levels of incentive will be maintained to facilitate future economic network growth, including in the form of the existing connections incentive, as well as capex allowances designed to facilitate economic network development.

The UR intends to run GD17 almost exactly concurrently with the process contemplated by this consultation, with publication of its determination on the move to a revenue cap occurring in September 2015, in the same month as submission of final business plans for GD17. Finalisation of any licence modifications in connection with implementation of the revenue cap is expected to coincide with publication of the GD17 final determination in September 2016.

It will be clear that there is significant interaction between the price control conditions of our licence that are the subject of this consultation, and the GD17 price control itself. As such, we believe the fact that the two processes are intended to take place simultaneously creates significant risks for the success of both.

¹ Consultation on modifications to the price control conditions of the firmus energy licence, UR, 18 June 2015.

² Kellen Group Annual Report & Accounts 2007.

For so long as there is uncertainty as to the precise form of our price control, there will be doubt as to the basis on which we should complete our GD17 business plan submission. The UR requires the latter to be submitted in September 2015, while the former will not be resolved until mid-2016 at the earliest on the current timetable. Therefore as we note in further detail below, there is limited clarity as to the precise licence changes that would be made as part of implementation of a revenue cap. Changes of this nature will inevitably directly impact on the data we include in our GD17 business plan and, in the absence of clarity on these issues, we will be forced to make a number of assumptions in the business plan as to the outcome of this consultation (with the risk of subsequent revision to the business plan being required as the process develops).

In this regard, we note that we have received no response to our letter of 5 June 2015 requesting confirmation as to the appropriateness of our proposed approach to the submission of our Business Plan Template.

We believe it is vitally important to the success of GD17 that the UR's determination in this process is published well in advance of the date for submission of our GD17 business plan and that the determination contains a precise and detailed elucidation of the changes to our price control conditions that are proposed as part of the move to a revenue cap.

The fact that this level of clarity may not be possible to achieve in the timescale available may indicate in favour of a pragmatic delay to the move to a revenue cap so that the risk of disruption to GD17 is eliminated. If the UR nonetheless determines to proceed with implementation of a revenue cap simultaneously with pursuing GD17, we believe that successful delivery will require full, detailed and open engagement and co-operation between firmus energy and UR on the form of the price control and licence changes in advance of GD17 business plan submissions. We would emphasise that we remain ready and willing to engage constructively on this basis.

Comparability with other distribution network operators

We note that UR considers that a move to a revenue cap would increase comparability with PNGL and the GB Gas Distribution Network operators (GB GDNs). However, other differences between the licences of firmus energy and these other operators remain, implying that the businesses cannot be considered truly comparable unless further licence modifications are also implemented.

For example, material differences between firmus energy's and PNGL's licences include:

- revenue recovery period—licence parameter 'q' is 2035 for firmus energy, or 30 years from our first connection, compared with 2046 for PNG, which is 50 years from its first connection;
- inclusion of accumulated under-recoveries in a simplified RAB for PNGL;
- treating the Profile Adjustment as capitalised opex in the RAB for PNGL; and
- allowed revenue to be calculated from the RAB, cost of capital and allowed expenditure for PNGL.

Unless these differences are removed, there will remain the risk that over the long term the conveyance charges applied to customers of the same type across network areas could

diverge further. Moreover, without comparable licence conditions the UR's ability to carry out meaningful cost or price benchmarking analyses in future could be undermined.

These outcomes could arise due to the impact of firmus energy moving to a revenue cap before it had the opportunity to build out its network and connect a similar number of customers as PNGL. In turn this would reduce firmus energy's ability to benefit from similar economies of scale and density as PNGL over the long-term. Furthermore, any benchmarking comparisons that relied on RAB-based normalisations would be problematic without a consistent definition of firmus energy's and PNGL's 'asset base'.

We believe that taking the opportunity to align the firmus energy and PNGL licence conditions as they relate to price controls would have significant benefits for all stakeholders in the form of increased transparency, stability and comparability between network operators.

Implementation challenges

If the absence of alignment of the price control conditions between PNGL and firmus energy, a number of detailed implementation issues will arise as to how a revenue cap can be implemented in practice. For example, no detail has been provided as to how the price control mechanism would correct for the inevitable differences between expected and actual volumes with respect to both determined revenue and accumulated under-recoveries.

The terms of firmus energy's licence and the anticipated growth in connections (and therefore volumes) would significantly complicate the implementation of a revenue cap as compared to PNGL and the GB GDNs (which are much closer to steady state). Consequently, the transition to a revenue cap could increase the risk of unintended, adverse consequences for customers due to underdevelopment of firmus energy's network where it would otherwise have been economically beneficial to do so.

For example, the current calculation of movements in the value of under-recoveries depends on the difference between determined and actual prices multiplied by actual volumes. The UR also considers firmus energy's accumulated under-recovery balance before giving approval to the content of our annual conveyance charge statement under condition 2.2.3 of our licence.

Under a revenue cap, a separate mechanism would be needed to adjust determined prices in future control periods to comply with the revenue cap (i.e. a 'true-up' mechanism). However, if the true-up adjustment were to be based on actual revenues as opposed to 'counterfactual' revenues (i.e. to account for the fact that actual prices are greater than determined prices to remunerate past under-recoveries) then this could result in systematic under-recovery of firmus energy's economic costs.

Indeed, if outturn volume is lower than forecast then the movement in under-recoveries could also be lower than planned, potentially increasing the risk that these could not be recovered within the time frame established by firmus energy's licence. This would potentially also require a separate adjustment to determined prices in future control periods.

Put differently, in order to allow firmus energy to recover its costs—including remuneration of past under-recoveries and the allowed rate of return on the TRV— the UR would need to develop an appropriate true-up mechanism to comply with the revenue cap that accounted for the potential overlaps between volume and price outturns relative to forecast and determined levels, respectively. Specifically, this would require UR to calculate counterfactual revenues based on actual volumes and determined prices which would then be used to calculate an appropriate true-up adjustment. In addition, a separate adjustment could be needed to ensure full remuneration of past under-recoveries.

The complexity of implementing a revenue cap for firmus energy would be exacerbated still further given that connections and volumes are expected to continue to grow significantly, which reflects the relatively immature state of development of the network. The implication of this would be that the counterfactual revenues would be more difficult to determine, particularly if UR were to attempt to determine whether any element of volume underperformance is 'inefficient'.

Furthermore, the UR would need to consider how quickly and frequently prices could be adjusted in response to volumes deviating from forecast, and over what time period any shortfalls would be recovered. Correcting for volume variances over too short a time period could lead to unstable prices.

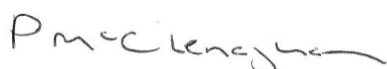
The implication of this analysis is that the easiest way to remove the complexity associated with the move to a revenue cap would be to include accumulated under-recoveries in a simplified RAB. As mentioned above, this would also have the benefit of greater comparability between firmus energy's and PNGL's licences and transparency for consumers.

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Firmus energy considers agreement on the issues of the length of the recovery period, a broadly and consistently defined RAB, and the detailed operation of the revenue cap model are essential to the successful implementation of a revenue cap. We also believe that a clear path to resolution of these issues needs to be in place before our GD17 business plan is submitted if we are to avoid the risk that our business plan requires later revision to reflect the outcome of this consultation, jeopardising the integrity of the GD17 process as a whole.

We look forward to working with your office on these issues.

Yours sincerely,



Peter McClenaghan
Regulatory Affairs Manager