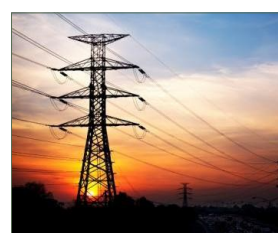


firmus energy (Distribution) Limited Licence

Outcome of Consultation paper on moving to revenue cap regime

16 September 2015



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference

Act with integrity.

Abstract

This Outcome of Consultation paper relates to the principle of changing the firmus Energy (Distribution) Limited (firmus) Licence from a price cap form of control to a revenue cap.

Audience

This document is likely to be of interest to the licensee affected, other regulated companies in the energy industry, government and other statutory bodies and consumer groups with an interest in the energy industry.

Consumer impact

The firmus licence requires updating to reflect regulatory decisions and to ensure it remains up-to-date and fit for purpose.

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1.Introduction

Purpose of this paper

- 1.1. On 18 June 2015, the UR consulted on the principle of changing the firmus energy (Distribution) Limited (firmus) Licence from a price cap form of control to a revenue cap.
- 1.2. Having considered the consultation responses, this Outcome of Consultation paper outlines the changes consulted upon. The final modification to the firmus licence will be consulted on in September 2016 using the PNGL licence as a starting point.

Background and Summary of Changes Proposed

Price Control Context

- 1.3. firmus currently has a price cap form of control and this provides strong financial incentives to outperform on volumes in the start-up phases of the business. We set allowed tariffs for firmus in each year. The capping of tariffs rather than revenue is more appropriate for a company in the early stage of its development as it provides strong incentives to increase volumes and to develop the gas industry. The firmus price cap form of control means that the maximum tariffs are fixed based on determined volumes (volume incentive control). The price cap provides an incentive to outperform on volumes as the revenue derived from outperformance can be retained.
- 1.4. PNGL had operated under a price cap in the period 1996-2006, when it was at a similar stage of development to firmus and therefore the focus was on providing incentives to grow the gas market. As the network matured, the strong volume incentive was no longer needed.

Consequently, PNGL's control was changed to a cap on revenues in 2007¹. The modifications to the PNGL's licence were made to Part 2; Condition 2.3; Conveyance Charges, other Terms for the Conveyance of Gas and the provision of Conveyance service².

1.5. Scotia Gas Networks Northern Ireland Ltd (SGN) was awarded its conveyance licence in February 2015 with first customers scheduled to be on from late 2016. SGN also has a price cap form of control.

¹ http://www.uregni.gov.uk/publications/phoenix_natural_gas_limited_conveyance_licence_modification_to_price_control

² http://www.uregni.gov.uk/uploads/licenses/2014-03-28_PNGL_Conveyance_Licence_-_final.pdf

2. Summary of responses received

- 2.1 Three responses were received to the firmus consultation. All three responses are summarised below. A confidential response was one of the responses received and has been included in the Utility Regulator's consideration of this decision however we have only published two responses alongside this outcome paper.
- 2.2 There are three main issues to consider regarding changing firmus from a price cap form of control to a revenue cap; Volumes, WACC comparability and Growth. Each are addressed below.

Volumes

- 2.3 In 2007, 59% of firmus volumes were made up of gaining new customers. This was mainly due to circa 100 new contract I&C customers and therefore highlights that firmus could have a big impact on volumes by getting additional new customers. Following the connection of the contract customers, firmus' networks development has been directed toward small customers. In 2016 only 3% of firmus volumes are forecast to be made up of gaining new customers. Therefore the impact of new customers is much less and the incentive of the price cap is much reduced.
- 2.4 One respondent noted that 3% of firmus volumes are forecast to be made up of gaining new customers and queried if this takes into account the subsequent extension to include Benburb and Moy Electoral Wards.
- 2.5 The 3% does not include Benburb and Moy Electoral Wards. However

these are small towns and would only change the figure to 4%. It does not change the fact firmus has very little ability to increase its volume figure and its over or under performance in any given year is much more likely to be dependent on winter temperatures than its connection level.

WACC

- 2.6 Both firmus and PNGL currently have a fixed rate of return of 7.5% pre-tax until the end of 2016. Under a revenue cap form of control the rate of returns would be set on the same basis both firmus and PNGL and therefore the WACCs would be more comparable within the NI market and with the GB GDNs.
- 2.7 One of the respondents stated that they were not opposed to the change in the control methodology. However, they are concerned that there is consideration given to the differences in the energy businesses in Northern Ireland. They are concerned that UR has assumed that companies covered by the same form of control face the same risk, cost of equity and debt.
- 2.8 One respondent stated that they are concerned that UR suggest that under a revenue cap WACC would be more comparable within the NI market and with the GB GDNs. They note that a revenue cap does not necessarily result in less risk and therefore a lower WACC.
- 2.9 UR acknowledge that a revenue cap does not necessarily result in firmus having the same overall risk as other companies with a revenue cap. However moving firmus from a price cap to a revenue cap will allow them to be more comparable in terms of form of control.

Growth

- 2.10 Under a revenue cap form of control, firmus would be slightly less incentivised to grow the market although this can be dealt with through the connections incentive.
- 2.11 Our experience with PNGL following a change to revenue cap in 2007 was that large I&C and domestics customers continued to grow. PNGL connected a number of large I&Cs including Coca Cola, Larsen Ltd, Precision Liquids, Bombardier and Kilwaughter Chemical Co Ltd. Therefore, there is still an incentive to grow the market.
- 2.12 One of the respondents stated that they were interested to see how the connections incentives would be addressed as part of GD17.
- 2.13 We have stated in our April approach document to GD17 that we will use the existing connection incentive mechanism, review any assumptions considered necessary and assess its appropriateness for the future.

General Comments

- 2.14 Aside from the three main issues addressed above; Volumes, WACC comparability and Growth; we received some general comments regarding the change in the form of control, the process and the timescale. These are addressed below.

Timescales

- 2.15 All respondents raised concerns regarding the appropriateness of the move from price cap to a revenue cap being linked to the age of the business i.e. the firmus business will be 12 years old in 2017.

Respondents do not believe that the change of form of control should be determined by the passage of time since the granting of the licence.

- 2.16 UR consider that as the firmus business is currently 10 years old it is an appropriate timeframe to review the form of control rather than specifically linking the age of the business to a time period in which the form of control should change.

Interaction with GD17 price control

- 2.17 One of the respondents raised concerns regarding running GD17 price control concurrently with the process of changing the form of the price control.
- 2.18 UR regard the GD17 price control process as an appropriate place to consider the type of control for firmus and raised this issue in GD14 and our April approach document to GD17. We do not believe running the price control concurrently with the form of price control will cause any problems.

Technical Licence changes

- 2.19 One respondent noted that UR has not included in the consultation the technical licence changes required to implement a revenue cap and have included a number of observations as to the technical challenges associated with implementing a revenue cap for firmus.
- 2.20 UR note the observation and will take them into account when we consult on the licence modification in September 2016 as part of the GD17 price control. The technical licence changes will form part of this consultation.

3.Outcome of the Consultation on the principles of Licence Changes

3.1. Following due consideration of the responses the Utility Regulator has decided that it approves the principle of changing firmus from a price cap to a revenue cap form of control. This will be the basis on which we progress GD17.

3.2. The section within the firmus licence that will require most of the changes will be Part 4: The Price Control Conditions and we will use the PNGL Licence as a starting point. Marked-up extracts detailing the proposed changes to the firmus energy (Distribution) Limited licence will be consulted on in September 2016 as part of the GD17 Final Determination.