

Aligning the Price Control Reviews of Northern Ireland's Gas Distribution Networks

January 2010

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1 Introduction

Background

- 1.1 Northern Ireland has two Gas Distribution Networks (GDNs). Phoenix Natural Gas Limited (PNGL) own and operate the distribution network in the Greater Belfast and Larne areas, and firmus energy Limited own and operate the distribution network off the North-West and South-North transmission pipelines.
- 1.2 Both companies are price controlled by the Utility Regulator. PNGL's current price control commenced in 2007 and will continue until the end of 2011, so a new price control is needed for PNGL to take effect in 2012. The current price control period for firmus runs from 2009 to the end of 2013, so new price control is needed for firmus to take effect in 2014.
- 1.3 Towards the end of last year we began scoping and planning the work necessary to ensure a price control determination will be in place before 31 December 2011 for PNGL. In considering the issues involved, we also considered the merits of aligning the timing of the price controls of the two companies and how we might go about this.
- 1.4 The merits of aligning the price controls and the potential options we could pursue to achieve this are the focus of this paper.

Consultation Process

- 1.5 This is an open consultation. If you wish to express a view on the contents of this paper or any related matter, we would welcome your response. Responses should be received by 5 pm on **Friday 26 February** and should be addressed to:

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- 1.6 Our preference would be for responses to be submitted by e-mail.

- 1.7 Individual respondents may ask for their responses in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.
- 1.8 As a public body and non-ministerial Government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1 January 2005. According to the remit of FOIA, it is possible that certain recorded information contained in consultation responses can be put into the public domain. Hence, it is now possible that all responses made to consultations will be discoverable under FOIA – even if respondents ask the Utility Regulator to treat responses as confidential. It is therefore important that respondents note these developments and in particular, when marking responses as confidential or asking the Utility Regulator to treat responses as confidential, should specify why they consider the information in question to be confidential.

2 Aligning the Price Controls

Current Position

- 2.1 As stated earlier in paragraph 1.2, PNGL's existing price control period covers 2007 to 2011 whilst firmus' existing price control period covers 2009 to 2013.
- 2.2 The Utility Regulator carries out price controls for a five year period, a standard regulatory practice for price controlling utilities. If we do not make any adjustments to the timetable that results from current practice and the existing control periods, the next price control periods would cover 2012 to 2016 for PNGL and 2014 to 2018 for firmus.
- 2.3 Below we consider the various general advantages and disadvantages of aligning the control periods. Later in Chapter 3 we look a range of options that would achieve alignment, and the associated advantages and disadvantages of each.

Advantages of Alignment

- 2.4 General advantages of alignment include:

- **Greater Economies of Scope**

We anticipate two main efficiencies in carrying out both price controls simultaneously instead of separately: (1) internal efficiencies; and (2) efficiencies in consultancy procurement.

Internal efficiencies will result from having to consider particular issues only once and apply our findings to both companies, instead of the current situation which would be to consider the same issues twice but at different points in time. We do anticipate that the resource commitment required to develop two price controls simultaneously will be greater than to develop just one, but also expect this commitment to be considerably less than to develop two price controls separately.

With respect to consultancy procurement, the Utility Regulator often procures specialist consultancy support to assist with particular aspects of price controls. For example, engineering consultants are often used to appraise the proposed capital programme over the control period. Under the current arrangements we would need to procure consultants in two separate exercises for each price control.

However, if the price controls are aligned we could commission consultancy support to include reviews of both companies in a single contract. We anticipate

that the cost of this might exceed the cost of reviewing just one company, but expect it will be significantly less than the combined cost of the two separate procurements necessary under the current arrangements.

A further efficiency of alignment will accrue to external stakeholders who have an interest in our price controls, in terms of only having to review and comment on one set of price control consultations and publications.

- **Ability to Benchmark in Real Time**

In carrying out previous price controls, we have made limited use of benchmarking to inform our decision making. However it is our intention to make much greater use of benchmarking as a method for determining appropriate allowances in future price controls.

Under the current arrangements, benchmarking the two companies against one another would involve comparing data from different years. This runs of the risk that changes in market circumstances make comparisons less meaningful. Aligning the price controls would overcome this problem and allow for real-time comparisons to be made.

- **Creation of Time in Between Control Periods to Innovate**

A price control is a resource intensive exercise to which we would plan to spend around two years developing, beginning with the planning phase and concluding with our final determination. If we do not change the current arrangements, then our Gas Directorate will at any point in time always be working on developing a price control.

Aligning the control periods would however create a number of years in between controls that could be spent innovating (meaning that time and energy could be given to consider ways to better regulate the gas industry). For example, we could devote resources to consider if and/ or how to implement any findings that emerge from the Ofgem RPI-X@20 project.

Time in between control periods would also free resources to focus on issues particular to the development of the industry in Northern Ireland.

2.5 Further advantages may arise depending on how we time the alignment of the price controls.

- **Annual Cost Reporting**

We are currently in the process of developing a similar annual cost reporting regime to that which Ofgem recently developed for the GDNs in GB¹. Like Ofgem, we will be developing a purpose-built reporting template to be populated by Northern Ireland's gas distribution and supply companies using detailed guidance that we will issue. The use of a template and accompanying guidance will ensure greater consistency of data, and thus allow for more immediate and meaningful comparison of the companies against each other (and the GDNs in GB).

The project is currently in its later stages of development, and we expect to have a draft reporting template and guidance document ready sometime in early 2010.

Whilst we anticipate the regime will be fully rolled out and implemented in 2010, it may take some time for the companies to become fully proficient at populating the reporting template. Therefore any option we pursue to align the price controls that allows more time for the regime to bed in would prove advantageous from a data quality perspective.

- **Ofgem GDPGR 2013 to 2017**

Ofgem will be carrying out their next price control for the GDNs in GB, to take effect in March 2013. Ofgem will be publishing various documents throughout 2012, such as their approach to the price control, initial findings etc. Therefore any option we pursue to align our own price controls that would also allow us to make best use of Ofgem's findings would prove advantageous in developing our eventual determinations.

Disadvantages of Alignment

2.6 The main disadvantage is the additional pressure on internal resources that carrying out two price controls simultaneously will create. We do recognise however that to carry out two at once will not necessarily mean doubling the effort required to carry out one.

¹ In 2007, Ofgem began developing an annual cost reporting regime for the GDNs in GB. The regime (now fully in place) requires the GDNs to deliver on an annual basis, information pertinent to the GDN price control. Annual cost reporting in the electricity distribution industry and gas and electricity transmission industries in GB has proved itself successful in forcing regulated utilities to ensure their reporting systems are robust. The process has also improved Ofgem's understanding of costs and allowed more accurate reporting on progress against price control allowances. Ofgem expects that the annual cost reporting regime for the GDNs will yield similar benefits.

- 2.7 In addition, there may be some disadvantages associated with the way we move to align the price control periods. This is considered further in Chapter 3.

Impact on the Regulated Companies

- 2.8 At this stage we would not consider there to be any significant impact on either PNGL or firmus, in terms of what we would require from them if or when the price controls were eventually aligned.
- 2.9 However, depending on how we move to align the price controls – considered further in Chapter 3 – there may be resource implications for the companies (in terms of when to begin preparing for a price control, and the level of detail required in the preparation). Furthermore, a change in the existing timetable may lead to a temporary increase in perceived regulatory uncertainty for the companies' investors.
- 2.10 However, we believe that these issues can be suitably managed and mitigated, through close working with the companies and by maintaining an open and transparent dialogue of our intentions, plans and decisions.

Summary

- 2.11 On balance we consider that the advantages of alignment outweigh the disadvantages, and are therefore minded that we align the price controls.

3 Options for Alignment

Developing the Options

3.1 There a number of actions we can take which alone or in conjunction with another action would successfully result in alignment. These are:

- **Delay the Full Five Year PNGL Price Control**

This would involve either rolling over the existing price control for one or two years, or alternatively carrying out a “mini price control”.

A rollover would mean simply allowing PNGL costs and revenues as determined in the current price control for a further one or two years, which implicitly means doing minimal or no work. This of course would be simple for all parties but runs of the risk of delaying any remedial action, where necessary, to correct for deviations between forecast and actual outturns (i.e. underspend or outperformance), be it to the benefit of customers or PNGL.

A “mini price control” would involve looking at a few select areas, for example just capex (or even selective areas of capex).

- **Pull Forward the Firmus Price Control**

Instead of delaying the full five year PNGL price control we could potentially pull forward the firmus price control by two years. Alternatively we could delay the full five year PNGL price control by just one year, and pull forward the firmus price control by one year.

- **Set Control Periods of Different Durations**

A final possibility is to set price control periods of different durations, in order the price controls align in the next-plus-one control period. For example, we could continue with the current timetable but set a six year control period for PNGL and a four year control period for firmus, thereby aligning the next control periods in 2018.

3.2 These actions could be combined into many different permutations but we have considered three main options, set out below. The advantages and disadvantages associated with each option in the table below are in addition to the general advantages and disadvantages set out in paragraph 2.4 and 2.6 respectively.

Option 1	Description	Delay the full five year PNGL price control by one year and pull forward the firmus price control, thereby aligning both price controls in 2013.
	Advantages	<ul style="list-style-type: none"> ▪ Delay of the full five year PNGL price control by one year will be less involved than delaying for two years. ▪ Allows additional time for cost reporting to bed in. ▪ Quickest achievement of alignment.
	Disadvantages	<ul style="list-style-type: none"> ▪ firmus likely to object to pulling price control forward. ▪ Next Ofgem GDN price control takes effect in 2013; developing our price controls in conjunction with (or before) Ofgem will limit our ability to use their findings.
Option 2	Description	Delay the full five year PNGL price control by two years, thereby aligning both price controls in 2014.
	Advantages	<ul style="list-style-type: none"> ▪ No need to pull forward firmus price control. ▪ Allows additional time for cost reporting to bed in. ▪ Will be able to use Ofgem GDN price controls (for benchmarking etc).
	Disadvantages	<ul style="list-style-type: none"> ▪ Delaying the full five year PNGL price control by two years will be more involved than for one.
Option 3	Description	Delay the full five year PNGL price control by one year, then carry out a full price control from 2013; carry out a four year price control for firmus from 2014, thereby aligning both in 2018.
	Advantages	<ul style="list-style-type: none"> ▪ Delaying the full five year PNGL price control by one year will be less involved than for two years. ▪ Allows additional time for cost reporting to bed in. ▪ No need to pull forward firmus price control.
	Disadvantages	<ul style="list-style-type: none"> ▪ Alignment not achieved until 2018. ▪ Will not be able to use Ofgem GDN price controls for PNGL control.

Options Assessment

- 3.3 All of the above options involve delaying the full five year PNGL price control. There are disadvantages inherent with any delay, the primary one being the lost opportunity to claw back and return to gas customers sooner than later any underspend or share of outperformance.
- 3.4 The alternative to a delay is either to pull forward the firmus price control by two years, or to set control periods of different durations for both companies such that alignment is achieved in the next-plus-one control period. However, arguments against these alternatives are as follows:
- Pulling forward the next price control for firmus by two years will require consent from firmus, which they may not wish to grant;
 - We wish to allow sufficient time for the annual cost reporting regime to bed in, which supports a delay in carrying out any price controls;

- We wish to use the findings from the Ofgem GDN price control as far as possible to improve our own, further supporting a delay to at least 2013; and
- We wish to align the price controls and realise the cited advantages as soon as practicable.

3.5 We are therefore minded to conclude that Option 2 – to delay the full five year PNGL price control by two years, thus achieving alignment in 2014 – emerges as the preferred option.

Preferred Option Implications

3.6 As the existing price control expires at the end of 2011 and a new full five year price control would not be in place until 2014 if we pursue Option 2, we would need to determine appropriate allowances for PNGL in the interim period. Our options, as discussed in paragraph 3.1, are to rollover the existing price control or carry out a “mini price control”.

3.7 A rollover may be suitable for a one year delay, but for a two year delay we would not be comfortable that the current price control determination – which was set several years ago – would accurately reflect circumstances in 2012 to 2014. Instead we would expect that at least some areas of the PNGL business would need to be reviewed to determine more appropriate allowances. Therefore, at this early stage of thinking, we are minded to carry out a “mini price control”.

3.8 We plan to engage with PNGL to develop a more comprehensive work plan for this exercise.

4 Next Steps

Call for Responses

- 4.1 Given the issues and selection criteria discussed in the previous chapter, we are minded to delay the full five year PNG price control for two years, and carry out a “mini price control” during the interim period (subject to the outcome of this consultation).
- 4.2 We welcome all views on our “minded to” position and also invite interested stakeholders to comment on any other aspect of this paper.

Next Steps

- 4.3 This consultation closes on **Friday 26 February**. Once responses are received and fully considered, we will decide on the appropriate way forward. In the meantime we will give more thought as to what might be involved in our “mini price control”.

END