



Paul Harland  
Finance and Network Assets  
Utility Regulator  
Queens House  
10-14 Queen Street  
BELFAST  
BT1 6ED

14 October 2016

Dear Paul,

**Re: Licence Modifications Pursuant to the GD17 Final Determination and Other Regulatory Decisions, Consultation Paper, 15 September 2016**

Firmus energy welcomes the opportunity to respond to the consultation on the Utility Regulator's Licence Modifications pursuant to the GD17 Final Determination (the "Licence Modifications").

Please note, however, that this response is without prejudice to firmus energy's right to make further representations and comments (which may potentially include comments on issues not set out below) prior to the publication by the Utility Regulator of its decision to proceed with the Licence Modifications.

**Outcome of the Final Determination**

Cognisant of the Utility Regulator's, consumers' and our own ambitions, firmus energy developed a GD17 Business Plan that set out an ambitious but deliverable business and network development proposal. This, in our view, met the Utility Regulator's objectives of promoting the natural gas industry while realising efficiencies, in order to deliver significant real-terms reductions in costs for Northern Ireland consumers.

Whilst we recognise the Utility Regulator's movement in allowances from the GD17 Draft Determination to Final Determination, the outcome nevertheless represents a significant negative movement in all aspects compared with our submitted Business Plan.

The Final Determination, as published, places at significant risk our ability to finance our licensed activities on an investment grade basis. This situation is compounded by the material downside risk resultant from unjustified increases to owner occupied connection targets and reductions to opex allowances.

As a consequence we now face significant challenges to our ability to deliver the network development outputs required within the Final Determination.

Therefore, firmus energy requests the opportunity for further dialogue with the Utility Regulator prior to a decision to proceed on the Licence Modifications.

### **Designated Parameters and Determination Values**

As noted above, the Final Determination proposals result in a stressed financeability package, against a background of significant cuts to our allowed costs and increases to our output targets.

The compounding effect of the proposed modifications to the designated parameters and determination values pursuant to the Final Determination results in a package which fails to ensure that firmus energy is able to finance its activities, potentially causing the Utility Regulator to be in breach of its statutory duties pursuant to Article 14 of the Energy (Northern Ireland) Order 2003.

The impact of the Final Determination for rate of return (designated parameter  $r_t$ ) and the determination values for operating expenditure are of key concern in this regard. We remain of the view that a number of previously communicated technical errors, as well as the Utility Regulator's overall underestimation of the systemic risk faced by our business, result in our cost of capital being materially understated by the Final Determination.

### **Cost of Debt**

In January 2016, the Utility Regulator first introduced the concept of a cost of debt adjustment mechanism with GDNs, publishing an indicative view of the format of such a mechanism in the GD17 Draft Determination (March 2017). Of note, the cost of debt mechanism had not been raised in the Utility Regulator's "Discussion Document on our Overall Approach" (December 2014), nor in the "Update on Our Overall Approach" (April 2015).

Within the Draft Determination, the Utility Regulator acknowledged the further engagement which would be necessary to implement this mechanism from January 2017, and accordingly, firmus energy sought to provide constructive input to both inform and assist the Utility Regulator in this regard.

We were therefore disappointed to note that the mechanism included within the Final Determination disregarded many of our representations (particularly in relation to the treatment of inflation). We also note that no meaningful opportunity was provided to third party stakeholders to provide input into the design of the mechanism. What results is a mechanism that is out of line with existing and developing UK regulatory precedent, creates significant further downside risk for firmus energy and has the potential to reduce incentives to implement efficient financing.

At the time of writing, the prevailing iBoxx reference rates that the Utility Regulator proposes to use to reset our allowed cost of capital are between 1.7% for 1-3 years and 3.1% for 10-15 years<sup>1</sup>. When combined with the Utility Regulator's assumed static inflation rate of 3.07%, the Final Determination sets a target with an in-built assumption that firmus energy will be able to secure new debt financing at a real rate of between -0.6% and 0.6%, before transaction costs. Unfortunately, a midpoint real new cost of borrowing of 0.0% is simply not achievable by firmus energy, particularly given the financeability challenge created by other aspects of the Final Determination.

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<sup>1</sup> Based on iBoxx £ BBB corporate non-financials spot rates as at 14 October 2016.

Furthermore, the figures quoted above do not account for the costs of maintaining the substantial committed capital expenditure and working capital facilities required to support financing of the c. £91 million GD17 capex programme anticipated for the GD17 Price Control Period.

As a result, the WACC figure of 4.32% stated in the Final Determination significantly overstates the Utility Regulator's own assessment of firmus energy's expected outturn allowed cost of capital for GD17 Price Control Period. It is therefore misleading in the extreme to use that headline cost of capital for the purposes of (purportedly favourable) comparison to other UK regulated networks.

Prevailing iBoxx rates are materially (up to 2.7%) below the out-of-date 10 year rate of 4.4% presented in the Final Determination. In addition, current RPI inflation has been running at 1.3% on a year-average basis<sup>2</sup> compared with the Utility Regulator's assumed 3.07% and thus transfers inflation risk at an extremely high bar. The Utility Regulator's approach is inconsistent with recent observed rates and translates to a shortfall for firmus energy on embedded debt cost of 1.8% per annum versus allowances for the first two and a half years of the GD17 Price Control Period.

The Final Determination (including the proposed cost of debt adjustment mechanism) results in an allowed pre-tax WACC of 3.8% in first two and a half years of the GD17 Price Control Period, which will reduce to 3.2% pre-tax for the final three and a half years of the GD17 Price Control Period assuming that firmus energy borrows at the short end of the maturity curve based on current iBoxx rates.

For firmus energy to achieve even this allowed cost of capital assumes performance consistent with all other Final Determination allowances (including capex, opex, the all-in cost of funding the business and connections targets) in every review year, which, as noted elsewhere in this letter, is implausible.

In addition, as we have previously noted, the current drafting of the Licence Modifications to implement the new cost of debt mechanism is not sufficiently detailed. We therefore request that the Licence Modifications specify how the benchmark will be matched to maturity, and detail the steps involved in 'truing up' on an NPV-neutral basis through an adjustment to the TRV as part of the GD23 review (including the interaction of the rate of return adjustment with our other uncertainty mechanisms). We believe it is imperative in the interests of preserving transparency and maintaining stakeholder confidence that our licence conditions provide no scope for ambiguity as to the precise methodology that will be adopted to adjust our TRV at the end of the GD17 Price Control Period.

### **Treatment of Under-recoveries**

We must reiterate our strong objection to the proposal to reduce the nominal rate of return on accumulated "Z" under-recovered revenues to a level below our real allowed cost of capital. This decision confounds our legitimate expectations and the glide path introduced in the Final Determination does not negate the fact that this decision is entirely arbitrary, disproportionate, and retrospective in effect.

The unwinding of the accumulated (retrospective) under-recoveries will marginally improve the financial position of firmus energy in the short term, somewhat mitigating the impact of the Final Determination. However, the impact would be temporary in nature and substantially offset by the Utility Regulator's decision to reduce the rate of return on accumulated under-recoveries to a level

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<sup>2</sup> Source: ONS

below our current cost of debt. Based on the Utility Regulator’s own analysis, the under-recoveries should be fully unwound by 2019/2020. As such, they will not support the financial position of the company beyond this point when the financial metrics remain consistently weak.

### **Comment on the GD17 Review Process and Subsequent Allowances**

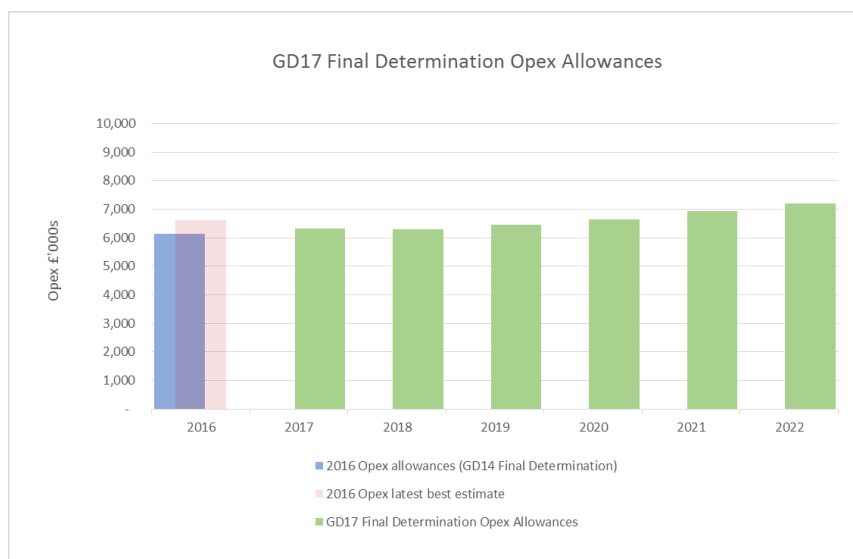
Throughout the GD17 Price Control review process firmus energy has endeavoured to engage positively and constructively in order to identify, where possible, common ground between our own view and the Utility Regulator’s perspective and to offer alternative solutions where areas of difference have arisen.

The level of granularity required in the GD17 review process was substantially greater than previously requested by the Utility Regulator and required significant input to ensure accurate and appropriate cost capture. This level of complex detail required by the Utility Regulator was at odds with ‘light touch’ and proportionate regulation.

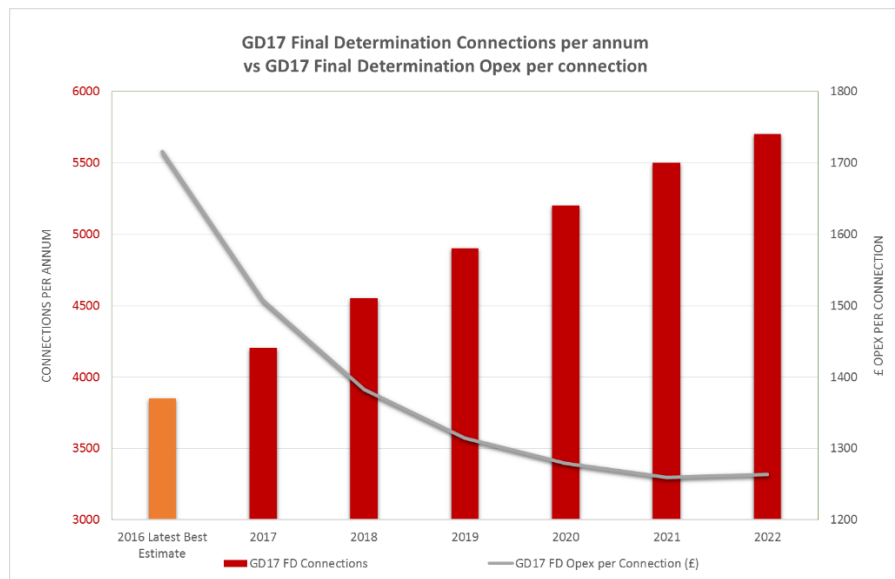
Despite the volume and granularity of data provided, the Utility Regulator relied almost exclusively on 2014 actuals. This practice of considering a single year in isolation fails to take due account of business growth or the productivity increases already built into our Business Plan.

As a result of the Final Determination firmus energy will be subject to a c. 15% year-on-year reduction in opex at the start of the GD17 Price Control Period (2017 allowed opex compared to 2016 actuals) followed by an opex allowance which remains flat in real terms over the six years (See Figure 1. Below). This is despite recognition in regulatory precedent for increased costs as a result of growth in scale such as that forecast for firmus energy during the GD17 Price Control Period (demonstrated by Figure 2. below). Moreover, where efficiencies are legitimately sought, regulatory precedent points to the introduction of an efficiency glide path.

**Figure 1.**



**Figure 2.**



The benchmarking undertaken by the Utility Regulator does not appear to have accounted for the fundamental differential between firmus energy and GB GDNs, most notably the impact of network scale, maturity and sparsity upon costs to firmus energy.

With the intention of ensuring greater clarity and reduced complexity for all parties participating in future processes firmus energy requests that the appropriateness of the complex and onerous GD17 data submission requirements is considered as part of the planned lessons learnt process.

Furthermore, consideration should be given to the benefit that would be derived by all stakeholders from early regulatory notification of, and commencement of consultation on, prospective material changes to price control conditions. In this regard we note the significant difference in approach between the Utility Regulator and Ofwat in the proposed introduction of a cost of debt adjustment mechanism, where the latter has commenced a detailed consultation process on the mechanism two years in advance of the launch of the PR19 price control.

### **Drafting Changes to the Capex and Opex Uncertainty Mechanisms**

Firmus energy note that the 15 September 2016 Licence Modifications, subject to this consultation, propose that the review period for the uncertainty mechanisms will be the three year period immediately preceding the first year of a future price control.

This is an alteration to the draft Licence shared by the Utility Regulator on 29 July 2016 (1 year) and also differs from the time period (2 years) proposed in further correspondence from the Utility Regulator on 12 October 2016 (2 days ago).

Having assessed the various options proposed firmus energy recommend adoption of the 3 year proposal contained within the formal Licence Modification consultation of 15 September 2016 as the most appropriate method to forecast the uncertainty mechanism.

Similarly, more than one iteration regarding how the 'applicable rate of return' will be applied has been shared with firmus energy. It is important to note that no iteration provides clarity that the rate of return would include the Rate of Return Adjustment (RORA).

Clarity and certainty in regard to these issues is imperative.

#### **Additional Items of Note**

As highlighted in recent correspondence, legal and professional fees (to the value of c. £200k p.a.) have been inadvertently removed from the Final Determination. We would welcome your recognition of these costs within the opex costs outlined in the Designated Values set out in the proposed Licence Modifications.

We note that, despite recognition in the Final Determination of the new connection challenges faced by GDNs, the unsupported assumption that 25% of customer connections are non-additional (i.e. not requiring any form of marketing to make the decision to connect) has been retained, thereby compounding the challenge presented by the unduly onerous increase to our connections target.

Finally, as outlined in our meeting of 12 October 2016 there exist a number of typographical errors and inconsistencies in our Licence in addition to those noted in Chapter 11 of the Consultation Paper. The attached appendix provides further comment in this regard and has been provided with the intention of assisting the Utility Regulator in achieving their objective of improving Licence clarity, as noted in the Consultation document, paragraph 1.6.

\* \* \*

We trust that you will give the contents of this letter due consideration before making a decision to implement the GD17 Final Determination.

As ever, we would welcome the opportunity to continue our engagement with you regarding the issues outlined in this consultation response, and in any case, prior to any decision to proceed by the Utility Regulator.

Yours sincerely,



Niall Martindale  
**Director of Regulation and Pricing**

Cc: Brian McHugh, Director of Finance and Network Assets

**Appendix Comment to Assist in the Correction of Licence Errors and Inconsistencies**

Condition	Comment
4.1.2	<p>The modification states that firmus energy should:</p> <p><i>"use all reasonable endeavours to set the Controlled Charges..."</i></p> <p>However, we note that the 15 September 2016 Consultation Paper states that firmus energy shall use "reasonable endeavours".</p> <p>We note there may be a distinction between the two concepts in terms of the commercial sacrifice that has to be borne by the company and therefore request that the final Modification state:</p> <p><i>"use reasonable endeavours to set the Controlled Charges..."</i></p>
4.1.3 and throughout	Some cross-references no longer relate to the correct Conditions.
4.2.11 and throughout	Certain terms such as "Charging Methodology Condition" are undefined within the Licence.
4.1.12  4.3.2	<p>Condition 4.1.12 refers to a formula set out in the licence in effect on 31 December 2016.</p> <p>Condition 4.3.2 refers to principles and methodology published in the Final Determination.</p> <p>We believe that any formulae or methodologies to be used to calculate parameters within the Licence should all be contained within the Licence.</p> <p>The Licence should be a standalone document and anyone undertaking calculations should not have to refer to other documents to carry out same.</p>