Gas Distribution Networks GD23 Price Control

Our Approach to GD23

November 2020

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, Markets and Networks. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our mission

To protect the short- and long-term interests of consumers of electricity, gas and water.

Our vision

To ensure value and sustainability in energy and water.

Our values

- Be a best practice regulator: transparent, consistent, proportionate, accountable and targeted.
- Be professional – listening, explaining and acting with integrity.
- Be a collaborative, co-operative and learning team.
- Be motivated and empowered to make a difference.

Abstract

We are publishing our Approach to GD23, the next price control for the gas distribution companies Phoenix Natural Gas Ltd (PNGL), firmus energy and Scotia Gas Networks (SGN) for the calendar years January 2023 – December 2028.

We published a consultation on the approach to GD23 in June 2020 and this Approach document takes account of the responses we received. It sets how the price control will determine a package of measures and funding to continue the efficient development of the gas industry in NI through increased connections and good stewardship of the existing assets. Consumers remain at the centre of our consideration and we look to the GDNs to further develop existing engagement with consumers and stakeholders to ensure the consumer is at the heart of GD23 business plan submissions; including consumers' views and expectations over service and future investment decisions.

Audience

Industry, consumers & statutory bodies.

Consumer impact

The price control will set out the allowed distribution charges for the gas distribution companies. Distribution charges make around 40-45% of the total domestic customer bill presently. The price control approach detailed in this document will set out the basis on which we will determine the allowed distribution charges.

As part of our approach for the GD23 price control, we will consider a range of measures designed to increase the number of consumers that can connect to the natural gas network, improve customer service and improve the environmental sustainability of our world.

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Foreword

The Utility Regulator's primary objective in respect of the Northern Ireland gas sector is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry. In doing so, we have regard to the need to ensure a high level of protection of the interests of consumers of gas generally and also the particular needs of vulnerable consumers.

Price Controls are one part of the work we do to deliver this objective. Through our price controls we establish a regulatory contract with service providers which sets the framework for the delivery of network development, consumer service and efficient levels of costs so that consumers receive value for money.

The gas industry is made up of a number of component parts. Transmission companies own and operate the high pressure transmission network which provides for the bulk transport of gas, including the undersea interconnectors from GB. The Gas Distribution Network (GDNs) operators provide the local distribution networks which all consumers (with the exception of power stations) connect to. Shippers and suppliers purchase the gas conveyed on the network with supply companies serving as the intermediaries which supply and bill consumers.

The GD23 Price Control will consider the plans of the three Gas Distribution Network operators i.e. Phoenix Natural Gas Limited, firmus energy and SGN Natural Gas.

These companies currently operate under the GD17 Price Control which runs to the end of 2022. GD23 will begin on the 1 January 2023 and run for a 6 year duration.

GD23 will follow the established processes and procedures used in GD17 Price Control, amended where necessary to improve outcomes for consumers. The objective of the industry remains as outlined above. The role of the GDNs in developing, maintaining, and operating the network and connecting new consumers continues.

This is not to underestimate the challenge and impact of a future energy strategy focused on decarbonisation which will develop in parallel with GD23. The Department for the Economy is currently leading the development of an energy strategy that will enable new and challenging decarbonisation targets which move towards a net zero target by 2050. Within this, it is considering whether decarbonisation of the gas grid is a viable option and what evidence can be provided on both the speed and affordability of decarbonising the gas grid. We cannot anticipate the outcome of this work and we will build sufficient flexibility into the development of the GD23 Price Control and its delivery to accommodate changes in policy as they arise.

Consumers remain at the centre of our consideration and we look to the GDNs to develop consumer engagement to ensure that consumers' views inform and influence expectations for service and future investment decisions.

1. Introduction

1.1 This document sets out the approach to the GD23 Price Control. The price control will regulate the outputs and costs of the three gas distribution network companies in Northern Ireland, Firmus Energy (Distribution) Ltd (“firmus”), Phoenix Natural Gas Ltd (“PNGL”) and Scotia Gas Networks Ltd (“SGN”) from 1 January 2023. It includes a timetable for the delivery of company Business Plans, our determinations and the changes to the company licences necessary to give effect to our decisions.

1.2 We set out our proposed approach to GD23 in a consultation published in June 2020 and this approach takes account of the responses to the consultation.

1.3 It sets out the approach to GD23 in the following chapters:

- Chapter 1, this chapter, provides an introduction to the approach document.
- Chapter 2 provides background and context, covering the economic regulation of gas distribution networks and price controls.
- Chapter 3 provides an overview of the lessons learnt from the previous gas distribution price control (GD17).
- Chapter 4 set out the summary of the Consultation Responses.
- Chapter 5 sets out the aims for the next price control, GD23.
- Chapter 6 sets out the approach to some key areas which must be addressed as we develop and deliver GD23.
- Chapter 7 considers the stakeholder and consumer engagement of all parties throughout the price control process.
- Chapter 8 discusses the principles surrounding efficiency targets and how they are applied to the GDNs.
- Chapter 9 introduces the treatment of operational costs associated with the price control.
- Chapter 10 introduces the treatment of capital costs associated with the price control.
- Chapter 11 discusses the incentives that have been in place during previous price controls and how we will incentivise the GDNs in GD23.

- Chapter 12 discusses the uncertainty mechanism, designed to limit the risk to both GDNs and consumers throughout GD23.
- Chapter 13 introduces the financial issues of the price control.
- Chapter 14 discusses the desired outputs of the price control.
- Chapter 15 sets out the GD23 timeline.
- Appendix 1 shows the current Gas Distribution Map of Northern Ireland highlighting the main gas lines and the GDN areas.
- Appendix 2 provides a Glossary of terms used in the document.
- Appendix 3 shows the Consultation Responses received on the approach document.

2. Background and Context

Background

2.1 The Utility Regulator is a non-ministerial government department, accountable to the NI Assembly, which is responsible for the setting of our statutory remit and objectives. Our principal objective in relation to the gas industry is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland. In doing so, we have regard to the need to ensure a high level of protection of the interests of consumers of gas generally and also the particular needs of vulnerable consumers. We do so in a manner consistent with the fulfilment of the objectives set out in the European Gas Directive, and more fully in the Energy (Northern Ireland) Order 2003.

2.2 Price Controls are one part of the work we do to deliver this objective. Through our price controls we establish a regulatory contract with service providers which sets the framework for the delivery of network development, consumer service and efficient levels of costs so that consumers receive value for money. In doing so we safeguard the industry by securing that the GDNs are able to finance the activities they carry out to serve consumers.

2.3 We do not direct regulated companies in how they run their businesses or where to develop their network. Instead we scrutinise and critique their plans and their justification for the outcomes they intend to deliver and the efficiency of the expenditure necessary to deliver those outcomes. Therefore a key element in the price control process is the submission of business plans by the licenced companies in which they set out their proposals for outputs and costs going forward. We review and challenge these plans to determine appropriate targets and funding mechanisms for the Price Control period.

2.4 In carrying out price controls we follow the five principles of better regulation which underpin our values. These are accountability, consistency, proportionality, targeting and transparency. We will continue to listen to consumers, stakeholders and the GDNs and explain our decisions.

Development of the gas industry to date

2.5 Northern Ireland currently has three gas distribution networks:

- Phoenix Natural Gas Limited (PNGL) own and operate the distribution network in the Greater Belfast and Larne areas and East Down.

- Firmus energy (Distribution) Limited (firmus) own and operate the distribution network, normally called the ten towns area.

- Scotia Gas Networks Ltd (SGN) own and operate the network mains laid as part of the 'Gas to the West' project.

2.6 The operating areas of these three companies is shown in Appendix 1.

2.7 The current development of the network is summarised in Table 2.1. It shows the number of properties passed and the number of properties connected to the end of 2019. In this context a 'property passed' is one which is typically located within 50m of a gas main, subject to certain practical limitations, and is referred to as 'readily connectable'. The number of connections covers all property types including domestic and industrial / commercial. There was 56% of properties passed connected at the end of 2019. A total of over 200,000 properties which could connect remained to be connected. There is significant potential to connect further properties to the existing network.

Network Operator	Licence Awarded	Properties passed	Properties connected	Potential connections
PNGL	Sept 1996	342,633	227,191	115,442
firmus	Mar 2005	142,948	49,037	93,911
SGN	Feb 2015	9,374	568	8,806
Total		494,955	276,796	218,159

Figures are correct up to the 31 December 2019

Table 2.1: Development of the gas network

2.8 Once GDNs complete the network development in GD17 and that already identified in the GD17 Price Control for completion in GD23, approximately 65% of properties in Northern Ireland will have access to natural gas should they choose to connect to the network. A high proportion of the remaining properties not passed by a gas main are in rural locations or in smaller villages and communities of less than 200 properties. For these locations the cost to serve (to allow connection) will increase the networks costs to existing consumers.

Economic Regulation of Gas Distribution Networks

2.9 A key function and purpose of economic regulation is to ensure that natural monopoly service providers continue to act in the interest of consumers. Where a monopoly exists, as it does in the distribution of natural gas, consumers are not able to change their network operator in order to receive better prices or service levels elsewhere. In the absence of these competitive pressures, natural monopolies may act against consumer interests by:

- Becoming or remaining inefficient, passing higher costs on to consumers than would otherwise be necessary.

- Delivering poor levels of service rather than seeking innovative or challenging ways to improve performance while reducing costs.

2.10 By subjecting monopoly service providers to external scrutiny, independent economic regulation brings an element of competition to the industry and helps ensure that the companies continue to act in the interest of consumers. This includes:

- Ensuring that the voice of the consumer informs both the company business plans and the determinations we make of expenditure and outcomes.

- Imposing limitations on the costs paid by consumers for the service provided by the regulated company or companies (while at the same time making sure that they are adequately financed). These constraints are based on direct challenge of the company's proposals, supported by external benchmarking of cost and service to establish the company's relative efficiency and performance.

- Ensuring that a strong regulatory framework is in place which includes clearly defined outputs that the GDNs must deliver, with delivery monitored regularly through cost and performance reporting. When selecting these outputs we aim to strike a balance between outputs that are clearly defined while allowing the GDNs the flexibility they need to deliver them in the most effective way.

The Price Control Process

2.11 Within a regulatory regime, the determination of a defined budget to deliver a defined set of outcomes over a set period is achieved through the price control process.

2.12 We also challenge the GDNs to improve their efficiency and performance relative to the gas distribution companies in Great Britain.

2.13 The wide-ranging price control process includes a number of distinct stages:

- GDNs prepare a business plan (including actual data for previous years), that sets out their assessment of the funding necessary to deliver the target outcomes during the price control period.

- We consider the business plan and benchmark efficiency and performance in order to set cost allowances necessary to allow the GDNs to operate in an efficient manner.

- We issue a draft determination for public consultation. We encourage stakeholders to provide their views by commenting on the draft proposals.

- We then carefully consider all responses received from the draft determination consultation to arrive at a final determination of a challenging and achievable level of funding. This process ensures the final determination is fair, balanced and proportionate for the GDNs.

- We consult on any licence modifications required as a result of the final determination. Such licence modifications will comprise modifications to designated parameters and determination values.

- We then assess the responses received to the consultation on licence modifications and carefully consider all responses received before publishing our licence modifications decision.

- If a GDN considers that the UR has made an error in its final determination and licence modifications it may seek permission from the Competition and Markets Authority (CMA) to appeal against our decision. If the CMA grants permission for the appeal to proceed the CMA will invite submissions from the relevant parties. The appeal process can take around 6 months at the end of which the CMA publishes its final determination and may remitted matters back to the UR for reconsideration and determination.

2.14 The timelines for GD23 are set out in Chapter 15.

3. Lessons Learnt from the Current Price Control (GD17)

3.1 A review of the lessons learnt takes place following each price control process. This includes both an internal review and an external request for feedback.

3.2 Lessons learnt from our internal review of the GD17 price control included:

- The overall form of the price control was effective given the relative maturity levels of the GDNs, however it was difficult to effectively benchmark the three GDNs given their different stages of development.

- Improvements to the transparency of the GD17 timetable were effective in ensuring that all parties had clarity on timescales and expectations for the GD17 approach.

- All reports and submissions from the GDNs (both in the price control determination stages and during the RIGS and Cost Performance Report submissions) should be in a consistent price base.

3.3 Some of the review points raised by the GDNs included:

- The introduction of a structured information request process allowed the GDNs to better understand our requirements and effectively allocate time and resources to the relevant queries.

- The GDNs welcomed our standard cost reporting template for the entire duration of GD17 to enable consistency.

- The GDNs felt that GD17 offered few incentives for outperformance and would welcome greater incentives moving forward into the next price controls.

- The GDNs would welcome greater transparency throughout the process and increased communication with ourselves to aid a smoother determination process.

- There was a recognition of the potential to improve customer engagement and learn from the Consumer Council of Northern Ireland (CCNI), and the GDNs stressed the importance of understanding consumers not yet connected to the gas network as well as those who are already customers.

3.4 We will seek to address these issues in the GD23 price control process.

4. Consultation on our Approach to GD23

Consultation process

4.1 We set out our proposed approach to GD23 in a consultation published in June 2020. We received five responses to the consultation in August 2020. This section provides an overview of key issues raised in the consultation responses and how they have been addressed in the Approach to GD23. We will continue to consider the detailed points raised in the consultation responses as we develop GD23.

Summary of Responses

4.2 We received five responses to our consultation. A list of who responded is contained in Appendix 3. The responses are published along with this document.

4.3 In general there was support at a broad level to continue with the tried and tested framework of GD17, including support for a 6 year duration for the price control. More clarity was sought on key areas of our proposed approach and the impact these might have on the preparation of Business Plans and our determinations.

4.4 The responses to our consultation Approach Document were focused on the following main areas:

- Energy Strategy.
- Innovation.
- Reopeners.
- Materiality Threshold.
- Business Plan Assessments.
- Benchmarking Top Down.
- Metering.
- Consumer Engagement.
- Market Structure.

4.5 Further detail is given below on these key topic areas.

Energy Strategy

4.6 This is with reference to the future Energy Strategy that is presently being formulated by the Department of the Economy. As there is uncertainty of the outcome and direction of travel in this area, the GDNs expressed similar concern and the effect it may have on the Business Plan submissions, which would be submitted largely before the outcome was known.

4.7 Whilst we recognise this issue and the unknown nature on the scope and scale of changes, more certainty may arise over the course of the price control process, before the Final Determination is published in June 2022.

4.8 As the timing to review changes or proposals will be limited we propose an Uncertainty Mechanism. This will be ring fenced to specifically dealing with any outcome of the Energy Strategy. This provides some certainty for all and allow a more complete review on any implementation of strategies that are appropriate for the Industry.

Innovation

4.9 This was largely considered in the wider context, that this area would not follow the normal rules of a business case to have a cost neutral basis. Creativity, outside of the box thinking and the use of local trails was also mentioned.

4.10 As this area still is evolving, we are minded to keep any Energy Strategy projects separate from this area, but willing to consider some additional funding if a business case could be presented in such a way, that would offer holistic benefits, such as specific projects or areas and personnel that could be of use to the whole of Northern Ireland. Any proposals for innovation funding should focus on the benefits to consumers and should take account of opportunities to apply learning from other gas distribution companies and other sectors.

Reopeners

4.11 Views were raised about the context of this, due to the prospect of the introduction of risk and uncertainty, during a price control that may arise, but recognised that due to unforeseen events, that in some exceptional circumstances that this may be appropriate.

4.12 Leaving aside the Energy Strategy, that is discussed separately we may consider reopeners if an exceptional event or process occurred that had a detrimental effect (both positive and / or negative) to the GDN on the running of its business and it had taken all reasonable steps to manage the issue arising. This would likely be done on a case by case basis, which would depend on the circumstances.

Materiality Threshold

4.13 The GDN's had varied comments on the current materiality threshold for of £100k for additional approvals. Some proposed a value based upon the size and scale of the respective GDN's, highlighting the fact that GDN's are of different sizes and the materiality threshold carrying different levels of risk. We are aware that OFGEM use a percentage of annual turnover for their materiality threshold. Comment was also made that this threshold should not be applicable to the new Energy Strategy.

4.14 We will consider this area further and consult on proposals within our Draft Determination.

Business Plan Assessments

4.15 Responses recognised the importance of Business Plans, but did require further clarification on how assessments will be undertaken, so the necessary steps can be taken in advance of the submissions.

4.16 The approach document outlined the following 3 key themes as follows, along with a number of tests:

- Delivering value for money.
- Services and costs.
- Trust in delivery.

4.17 The SONI price control draft determination sets out criteria, tests and assessment made for their price control business plan submission and we plan to discuss with Industry the type of assessment that is appropriate for GDN's considering the 3 key themes identified. We will expect companies to provide their own self-evaluation/assessment as part of their business plan submission.

4.18 We consider a proportional approach is appropriate and we plan to proceed with a Business Plan Assessment process as outlined in Section 6.

Benchmarking – Top Down

4.19 Some points were raised in terms of the dataset and modelling analysis to be used, the differences in respective networks, applying real price effects, productivity assumptions and catch up efficiency.

4.20 While we recognise these issues, we have yet to decide on whether a top down approach or bottom up analysis is appropriate.

4.21 We will consider based on the data and the Business Plan submissions the most appropriate course of action and may apply both approaches to arrive at an appropriate outcome.

Metering

4.22 A number of issues have been raised on Metering. This ranges from the type of meter in use, dealing with prepayment meter issues such as top up facilities and the responsibility for meter reading, which is currently dealt with by supply side companies.

4.23 As this sector covers a wide range of stakeholders, it is important to consider all issues before finding a co-ordinated approach for the Industry.

4.24 The Gas Metering Solutions Group has been recently set up with both network companies and suppliers to consider future metering needs meet the reasonable expectations of consumers. The outcome of this work will be embedded within the Price Control.

4.25 In addition we are aware that additional risk can be created due to the current roles relating to meters and meter reading of suppliers and network companies. These could act as a deterrent to new suppliers considering entering into the market. Further clarity and consistency with electricity roles could also been seen to facilitate future energy strategy that is currently being developed. Therefore we are minded to transfer responsibility for meter reading from supply companies to the GDNs and add greater clarity on roles and responsibilities.

4.26 This work might not be complete before submissions of the Business Plan submissions and allowances will be made for the possibility of the timeline for this work not aligning within the Price Control process.

Consumer Engagement

4.27 All respondents recognised the importance of meaningful consumer engagement, in terms of dialogue with existing and future customers and with the encouragement of introducing customer performance indicators, to help shape future outcomes and drive continuous improvement.

4.28 Reference was made to re-commence the work of the Consumer Engagement Working Group (CEWG). This working group includes all the key stakeholders (CCNI, DfE and GDNs) to facilitate the sharing of their respective experience, lessons learnt and also, through visiting other

Utilities, to see how more established operations run and mange there businesses from a consumer engagement perspective.

4.29 This group has now reconvened and will deal directly with key stakeholders, in developing a new GD23 Terms of Reference, including the identification of actionable data and new consumer metrics to help move this workstream forward on a shared, or partnership basis.

4.30 The latter will assist the progression of consumer and stakeholder engagement for GD23 and beyond, adopting VFM approaches to help:

- Maximise consistency of regulation across all three network GDNs as well as supply companies; alongside
- Cross-utility delivery of Best Practice under the Consumer Protection Programme, including enhanced provision for vulnerable consumers.

Market Structure

4.31 This was raised by one respondent, who expressed a desire for a single network code across Northern Ireland and for further resources to be provided to enable IT harmonisation.

4.32 We will consider standardisation adds value where appropriate and will continue to seek further standardisation in the future.

5. Aims for GD23

General Aims for GD23

5.1 In line with our principal objective, the overarching aim of GD23 is to contribute to the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland.

5.2 We aim to build on the process, approaches and information requirements developed through GD17, amending them where necessary to deliver improvements in service to consumers and taking account of changing circumstances.

5.3 The development of GD23 will run in parallel with work on the future Energy Strategy led by the Department of the Economy. This will assess the potential pathways to reach a net zero 2050 target for the energy sector in NI while meeting the energy needs of the population sustainably and cost-effectively. We aim to develop GD23 in a way which does not pre-empt the outcome of this work but provides the flexibility to address new policy objectives arising from the strategy.

5.4 Our other aims of the GD23 price control are that:

- GDNs should produce high quality, well evidenced business plans which can be accepted following limited scrutiny.
- GDNs should continue to improve their efficiency and performance at a sustainable rate.
- Economic development of the network should be carried out in a way which is resilient in the long term taking account of future decarbonisation.
- Long term planning is promoted to secure continuity of investment across years and between price control periods.
- GDNs engage with consumers to enable them to inform the level of service which the GDNs provide.
- GDNs continue to be able to finance their operations and receive a reasonable return on their investment.

5.5 At an operational level we will:

- Set out clear timeframes and deadlines for all elements of the determination process.

- Build on, and refine the previous GD17 business plan template to ensure consistency with the latest Annual Cost Reporting templates.

- Provide determinations which have sufficient flexibility to accommodate the development of the DfE Energy Strategy.

6. Update on Our Approach to Key Areas

General Approach

6.1 Through the GD23 price control we will determine a package of outputs and revenue and/or price limits for gas distribution networks. We will do so in a way that ensures that the GDNs efficient operational and investment costs can be met and their objectives delivered, providing best value for money to consumers.

6.2 As part of the price control we will consider all aspects of the GDNs business and the objectives of the price control will be tailored to take into account the needs, and associated costs, of the gas industry in Northern Ireland. While we will focus on the price control period, we will also consider the planning work necessary to support the effective and efficient delivery of service in the longer term.

6.3 We will carefully consider the impact of any price control decisions on consumers.

6.4 The provision of relevant and robust information in a timely manner by the GDNs is a pre-requisite for a successful price control. We will clearly set out our information requirements and timeframes and liaise with the GDNs on an ongoing basis as appropriate. We may also consider licence modifications, where relevant and appropriate, to ensure relevant information will be provided to us in the timescales, format and quality required.

6.5 Regulatory Instructions and Guidance (RIGS), which provide the structure and definition of regulatory reports, were introduced in GD14 and continued in GD17. We will continue the use of RIGs into GD23 and refine the templates to ensure that the level of information requested is appropriate and the reporting method as clear and concise as practicable.

6.6 In Chapter 15 of this paper we provide a timeline of the key milestones which will be followed throughout the price control process.

A Proportionate Approach

6.7 In addressing the key areas of this price control, we are mindful of the need to keep the regulatory burden to a minimum while addressing the information asymmetry that exists between us and the GDNs.

6.8 We will adopt and apply a number of principles to ensure that our approach is proportionate. These principles are:

- The GDNs complete the business plan templates. We will discuss these with industry in the latter part of 2020, with a view to circulating the final version for population in January 2021.

- Any atypical costs and special cost factors will be identified separately in GDN submissions.

- Areas of high expenditure will receive substantially more scrutiny and analysis than low value items. New, additional, opex and capex will also be challenged and scrutinised and we expect GDNs to identify and account for changes which reduce costs as well as changes which increase costs.

- Benchmarking will be used where possible and a triangulated approach will be adopted to ensure that allowances are efficient and that efficiency targets are reasonable but challenging.

- Where possible, any allowances set shall be closely aligned to clearly defined outputs and relevant drivers.

- We will continue to utilise the 'uncertainty mechanism', which is described in more detail in Chapter 12, adapting it as necessary to accommodate new areas of uncertainty such as the development of a new energy strategy.

- Efforts will be made to minimise the number of re-openers during the Price Control period. However we may allow for re-openers where insufficient information is available to make an informed determination, either regarding whether the costs will or will not materialise, or an absence of any firm estimate if they do materialise.

- We intend to continue using RPI for the GD23 Price Control and make provision for any changes which may be necessary if there is a material change in the methodology used to calculate RPI during the course of the Price Control.

- Allowances will not be given for costs that the GDNs can recover through other channels, such as (but not necessarily limited to) third parties causing damages to the network, customers or suppliers.

- Allowances will not be given for profit margins for any related third parties performing services for the GDNs.

6.9 We would expect GDNs to develop the data necessary to support a robust assessment of expenditure and outputs. Where it is necessary to adopt a light touch approach because there is insufficient data, we would adopt an approach to funding which is prudent but conservative until the company can develop a robust approach based on sound data.

Developing the network

6.10 Information on the current extension of the network is provided in Section 2, starting at paragraph 2.7. This shows that gas is already available to nearly ½ million properties, of which over a ¼ million properties have connected. Once all currently identified works are completed by the end of GD23, approximately 65% of properties in Northern Ireland will have access to natural gas should they choose to connect. These plans already include the completion of infill within the natural boundaries of all large towns and cities. A high proportion of the remaining properties not passed by a gas main are in rural locations or in smaller villages and communities of less than 200 properties, where the cost to serve will be higher than the cost per property to date. For these locations, the cost to serve (i.e. to allow connection) will increase the networks costs to existing consumers.

6.11 In line with our principal objective to promote the development and maintenance of an efficient, economic and co-ordinated gas industry, we consider the economics of further extensions of the gas network on a case by case basis. The key principle we apply when assessing economic development, is that the gas mains should only be laid where there is a reasonable prospect that the initial outlay cost will be paid back in the useful economic period at current tariff levels. This ensures that tariffs for existing customer do not increase to subsidise future extensions.

6.12 Based upon work done in GD17, we expect the network to reach its economic development limit following the completion of the extensions already planned for GD17 and GD23. This means that once these planned extensions are complete, it is unlikely that further extensions of the network would be considered economic.

6.13 The GDNs have informed us of their intention to submit a collective view of all remaining areas that they feel may be economically viable. We will consider the economic rationale of these proposals in parallel with the outcome of the future Energy Strategy on the role of gas networks as we move towards a net zero target by 2050. Without further policy intervention from government, it is unlikely that we will approve network extensions which increase tariffs.

6.14 There is always the potential of further economic development of the network supported by new 'large load' customers. Where these opportunities arise, we will consider the GDNs proposals on the optimum gas route from the existing network to connect them, including the potential for connecting local domestic and small I&C properties.

6.15 In GD17 we introduced an Economic Project Mechanism. This allows GDNs to seek approval for further network extensions (and other work deemed to be economic) which had not been identified at the time the Price Control was determined. We will continue this mechanism in GD23.

Environmental Impact, Decarbonisation and Energy Efficiency

6.16 GD23 will be developed in parallel with the preparation of a new Energy Strategy for Northern Ireland. This new strategy will enable new and challenging decarbonisation targets, which move towards a net zero target by 2050.

6.17 While natural gas is a carbon fuel, it has and can continue to, make a contribution to carbon reduction by connecting properties which currently using oil to gas mains which have already been laid and are in service. Circumstances in Northern Ireland are such that many homes continue to use oil for heat. Gas continues to provide a lower carbon alternative to oil and the continued conversion from gas to oil will reduce carbon emissions. In the longer term, options to decarbonise gas such as biogas and hydrogen may become viable at scale. In the meantime the supply of natural gas will be necessary until alternatives supplies of bulk heat to homes and industry become available.

6.18 We cannot pre-empt the outcome of the Energy Strategy. For this reason we will develop GD23 within our current vires and practice, but with sufficient flexibility to change as the outcome and impact of the Energy Strategy becomes clear.

6.19 Based on consultation responses, and the issues raised on the timing of events, we will consider creating a specific category in the Uncertainty Mechanism to address changes arising from the implementation of the future Energy Strategy. Before doing so we will consider whether the Economic Project Mechanism introduced in GD17 is sufficiently broad in scope to allow for changes which might arise as a result of the Energy Strategy.

Treatment of inflation

6.20 The values, revenues, prices or costs agreed as part of a price control determination must remain relevant for the whole of that price control. To achieve this, inflation indices are applied and future costs and revenues are adjusted to reflect actual inflation.

6.21 The current gas distribution licences use the Retail Price Index (RPI) to address inflation in the determination of tariffs and regulated asset value. However, RPI is no longer recognised as a national statistic and the use of the Consumer Price Index (CPI) or Consumer Price Index including Housing (CPIH) is becoming increasingly common in regulation. For example: OFWAT and OFGEM have moved or shortly will move from RPI to CPI/CPIH.

6.22 The UK National Statistics chairman has sent proposals to the Chancellor of the Exchequer in March 2019. He proposed that the publication of RPI should cease and, in the meantime, RPI should be incrementally adjusted to align to CPIH. The Chancellor (in September 2019) ruled out any alignment beginning until at least 2025 but agreed with further consultations on this subject, before coming to a final decision, expected in 2020-2021.

6.23 Pending the outcome of this work we intend to continue using RPI for the GD23 Price Control and make provision for any changes which may be necessary if there is a material change in the methodology used to calculate RPI during the course of the Price Control.

Asset Maintenance

6.24 We expect the monopoly service providers we regulate to demonstrate effective long term stewardship of the asset base which has been, and continues to be, funded by consumers.

6.25 For GD17 we asked each GDN to submit a Plan for Asset Maintenance detailing its approach to asset maintenance planning and how it had assessed the changes in operational practice and the investment required to maintain or enhance serviceability to consumers during the GD17 period. Each GDN was asked to prepare its plan in the context of their current stage of development and the long term needs for information and processes which would deliver asset management excellence over the life of its assets.

6.26 Our GD17 final determination advised that we expected the GDNs to continue to review and develop their plans for asset management during the price control period, as this is an integral part of service delivery. In doing so we specifically asked the GDNs to:

- Focus on the information and processes necessary to inform decisions on asset investment and asset maintenance expenditure, during GD17 and in future price controls, to deliver the necessary level of service at a least whole life cost.

- Look forward to key decisions they expected the Utility Regulator to make in the GD23 price control and ensure that the information necessary to inform such decisions, has been collected and analysed over the GD17 period to provide robust information in the business planning process that all parties are familiar with in a timely way.

6.27 We introduced asset management development reporting into the Annual Cost Report to monitor delivery on this objective during GD17. This required GDNs to update their Asset Management Capability Assessment and Plans for Asset Maintenance and report on progress against the delivery of these plans, with a particular focus on the needs of the GD23 price control.

6.28 For GD23, we require GDNs to provide an update on their Capability Assessment and plans for Asset Management, including the steps they have taken, and plan to take, to achieve excellence in asset maintenance planning. We expect the submissions to provide confidence in the company's ability to assess the optimum range of medium term interventions and the level of investment required to maintain serviceability and to target future investment effectively. They should demonstrate that robust asset management processes are in place to inform business decisions and incorporate, as a minimum, an update of the information requested for GD17:

- A self-assessment of asset management capability against a recognised asset management methodology, identifying any further work required to achieve excellence in asset management planning.
- An assessment of the data used to prioritise current interventions and to estimate future levels of capital and operational investment in the medium to long term.
- A plan to improve asset management capability, which sets out how the company will address any weaknesses in its current methodologies and data necessary to improve asset maintenance planning, and the timescale over which this will be achieved.
- Evidence of how a range of top-down and bottom up techniques have been applied during the preparation of the company's business plan to assess the optimum level of asset interventions and investment over the GD23 period.

6.29 We will review and update our approach to asset maintenance planning as we complete our information requirements for GD23, taking account of the information submitted by the GDNs in their Annual Cost Reports.

Volumes

6.30 A robust assessment of future customer numbers and volumes of gas consumed is important in determining reasonable tariffs for the Price Control period and ensuring a consistent level of tariffs between Price Controls.

6.31 In relation to volumes of gas and connections, we consider it appropriate to use a bottom up approach similar to that of GD17, where we:

- Review the targeted number of connections by customer category and associated average burn volume assumptions (for domestic and tariff customer categories) and monthly volume usages (for contract customer categories).
- Review the assumptions around customer additions and closures over the period of GD23 in relation to all customer categories.
- Benchmark against actual output data from previous years, where applicable.

Duration of the Price Control

6.32 Over time we have extended the duration of price controls to provide greater freedom to network companies to plan and deliver efficiently. GD14 was of a 3 year duration, ending in 2016. GD17 has a 6 year duration. A longer price control duration has allowed us to:

- Reduce the burden on companies of more frequent price controls and provide more space to plan the efficient delivery of investment.
- Enable GD23 to follow the recent OFGEMs RIIO price controls, allowing the UR to draw on OFGEM data to benchmark the GDNs against their GB counterparts.

6.33 Due to the amount of uncertainty that currently exists in the energy sector, OFGEM has reduced the duration of its latest price control (RIIO-2) from an 8 year to a 5 year duration.

6.34 Industry supported a 6 year duration for GD23. We believe that this provides a reasonable balance between the risk to consumers and GDNs of material changes in circumstances over the price control and while providing a framework which promotes stable long term delivery.

Introduction of Business Plan Assessments

6.35 One of our aims for the GD23 is that GDNs should produce high quality, well evidenced business plans which can be accepted following limited scrutiny.

6.36 In our recent price control for SONI we introduced a process of Business Plan Assessment. This was structured around 8 test questions which we would ask when we assess the quality of the business plan submission. These are grouped under 3 key themes which are set out below:

- Service contribution to good outcomes.
  - Test 1: Delivering value for money.
- Services and costs.
  - Test 2: Delivering services and outcomes.
  - Test 3: Securing cost efficiency and managing uncertainty.
  - Test 4: Aligning risk and return.
- Trust in delivery.
  - Test 5: Engaging customers, consumers and other stakeholders.
  - Test 6: Ensuring resilience and governance.
  - Test 7: Accounting for past delivery.
  - Test 8: Securing confidence and assurance.

6.37 The test areas above will be discussed further with GDN's and then we will provide more detailed guidance on our expectations for the Business Plan submissions including a list of test questions. We would expect the test areas for GDN's will reflect their business context and we will consider the need for test questions, for example, relating to how exactly consumers' needs are met given our drive to introduce best practice consumer service delivery across the industry. We will consult on our information requirements including guidance on the potential features of an exceptional plan, before finalising in line with the Business Plan Templates.

6.38 We will ask GDNs to complete a self-assessment of their Business Plan submissions. This should include:

- A statement setting out how the GDN has approached delivering an exceptional Business Plan in each test area, in line with the 3 key theme areas.
- A reference to the key documentation in the Business Plan which provides the supporting evidence to these statements.

6.39 When we receive the GDN's business plan we will assess how each has performed against each Test area and provide feedback to the company of our assessment of its business plan. This categorisation will be built up from an assessment of each of the test areas. It is not our intention to publish this detailed assessment but engage with each individual company on the areas where improvement can be made for future submissions.

6.40 GDN's business role, services and activities should be well aligned with the interests of customers, consumers, other stakeholders and the wider energy system. We feel that this assessment when coupled with our framework and other expectations/guidance on business plan:

- Allows GDN's to take ownership of its plan. It should also be answerable to stakeholders for what follows from it.
- Clarifies that lesser regulatory intervention can be expected in the GDN's business plan if it is of higher quality.
- Gives GDN's greater opportunity to shape its role over the price control period, what activities and level of service is funded through the price control, and aspects of the regulatory framework.
- Clarifies that there will be a higher degree of trust in GDN's if its business plan is of higher quality.

6.41 Based upon learning through this process we expect to continue to extend this approach to other network sectors providing a consistent comparative assessment of all network companies.

6.42 A high-level view of our findings as part of this process will be provided within the draft determination.

7. Stakeholder and Customer Engagement

General Stakeholder Engagement

7.1 Consumers remain at the centre of our consideration and we look to the GDNs to further develop existing engagement with consumers and stakeholders to ensure the consumer is at the heart of GD23 business plan submissions; including consumers' views and expectations over service and future investment decisions.

7.2 In advance of publishing this Approach for consultation we undertook initial engagement with the following stakeholders:

- PNGL;
- firmus energy;
- SGN;
- Consumer Council for Northern Ireland (CCNI); and
- Department for the Economy (DfE).

7.3 During the GD23 price control process, we have continued to engage with these key stakeholders to ensure they understand our approach and can provide feedback on the key components of the price control. This will allow us to take full account of stakeholders' views in making a final determination and secure a successful outcome.

7.4 We may take on board the views of credit agencies and investors through ongoing liaison work.

7.5 We aim to ensure that the level of engagement level between stakeholders is sufficient to secure an effective working approach to the price control. However in the event that stakeholders seek further interaction and engagement, where possible, we will aim to accommodate and facilitate this in the interest of collaborative working and enabling a smoother price control process.

Working with CCNI and DfE

7.6 CCNI and DfE have a key role to play in the price control, in line with their statutory roles. We already engaged with both CCNI and DfE on the general development of our approach and the key issues which will be considered in GD23.

7.7 We will continue our engagement with CCNI and DfE, including their active participation at CEWG and other Consumer Protection Programme related work streams and consumer research into:

- Consumer priorities; and
- Setting new consumer and customer satisfaction measures.

Working with the GDNs

7.8 We have, and will continue to engage with the GDNs on an ongoing basis throughout all phases of the price control process, especially those related to queries between parties.

7.9 This engagement will include, in addition to consideration of GDNs' price control submissions and price control consultation responses, requests for additional information or clarification, where required, as well as bi-lateral meetings with the GDNs. Where appropriate, joint meetings with all GDNs may also be arranged. The timing and frequency of the meetings may vary during the different phases of the price control and will be agreed with the GDNs on an ongoing basis.

7.10 As for the CCNI and DfE, we will continue our engagement with the GDNs, including their active participation at CEWG and other Consumer Protection Programme related workstreams and consumer research into:

- Consumer priorities; and
- Setting new consumer and customer satisfaction measures

Consumer Impact and Engagement

7.11 We will expect the GDNs to consider how they will use existing and additional channels of consumer engagement to find out what consumers expect the GDNs to deliver in GD23. GDNs should:

- Demonstrate how they have taken account of the views of consumers stakeholders in developing their plan, setting out what engagement was undertaken and how the engagement informed the business plan;
- Include details of any customer satisfaction surveys they have undertaken in their business plan submissions; and
- Provide a public facing business plan which explains, in a way that can be understood by consumers, the impact and cost of their business plan.

7.12 In the first instance we expect GDNs to:

- Prepare an inventory of their consumer contact by type of contact and communication channel;

- Show how they currently use structured and unstructured consumer contact information and follow up surveys to monitor consumer satisfaction and identify issues which are then addressed to improve consumer service; and

- Set out the steps they are currently taking to address the Consumer Protection Programme's (CPP) Best Practice project, including the development of best practice in their engagement and day to day contact with vulnerable consumers.

7.13 We currently work with a Consumer Vulnerability Working Group which is chaired by CCNI to improve the way vulnerable consumers are served by water, gas and electricity utility providers. We believe that there is merit in the GDNs presenting their proposals in respect of vulnerable consumers to this group which includes representatives from bodies with an understanding of the needs of a wide range of vulnerable consumers. This cannot be superficial engagement and GDNs will be encouraged to continue to work with, and develop relationships with these organisations outside the CVWG.

7.14 We will work with the GDNs, CCNI and DfE through a joint Consumer Engagement Working Group (CEWG) which we Chair to:

- Progress the gas equivalent of the water and electricity collective consumer engagement working groups. Such working groups have helped support NI Water and NIE Networks formulate their Business Plans and deliver against price control determinations.

- Identify new and emerging high-priority consumer expectations and needs for consideration at GD23. Other price controls, through equivalent research programmes, have identified new consumer issues through engagement with consumers and stakeholders.

- Share learnings / joint research at GD23. Joint or partnership working provides an opportunity to develop a richer understanding of consumer needs in a more cost effective way by sharing information, techniques and progressing a common research agenda.

- Agree new Terms of Reference for the CEWG at GD23 and beyond, including development of new consumer focused metrics. Whilst any metric should provide ‘actionable data’ for the GDNs there is also an important consideration in aligning metrics across regulated sectors and utilities to enable even more meaningful benchmarking of the GDNs' customer service delivery over time.

7.15 Consumer engagement, as with any consumer research, must provide a company with the 'actionable data' with which it can respond to the consumer voice and meet consumers' needs through continuous service improvement, since data which provides no insight is of no real value.

7.16 At the time of publication of this GD23 Approach Document the CEWG are finalising their agreed Terms of Reference. We will work to clarify the specific areas of focus with them that are required going forward taking account of the development within the UR of our key flagship project the CPP.

7.17 In light of known current CPP priorities and the initial work on the best-practice project the DNOs will be expected to provide plans of how consumer protection will feature in their business plans, ethos, training, etc. We consider this a necessary part of their Business Planning process (as is already the case with Gas DNOs in GB).

7.18 We expect an effective engagement process with a range of stakeholders to be a pre-requisite to the submission of a well-justified business plan. As part of the development of GD23 we will require that the GDNs demonstrate that their plans are based on a sound understanding of consumer needs and stakeholder interests. One potential area of focus for our Business Plan Assessment of the GDNs Business Plan will likely then include test questions on, for example, "Meeting consumers' needs; best practice customer service delivery which is value for money".

Customer Service

7.19 During GD23 we will review the measures in place to ensure ongoing focus of the GDNs on consumer needs and expectations. This may include the following:

- Increased focus on complaints data, especially complaints escalated to CCNI and ourselves and lessons learnt that can be derived from same.
- Review of serviceability metrics used in NI and GB and, where relevant and appropriate, standardisation of such metrics across the GDNs. This may involve introduction of customer satisfaction surveys to be conducted by the GDNs on a regular basis. These surveys could be based on those in place in GB, they could be different surveys designed specifically for local utility consumers to support benchmarking across local utility providers, or they could be a combination of both.

7.20 This will, over time, facilitate better monitoring of GDN performance and may form the foundation for additional incentive mechanisms such as specific customer service incentives in future price controls.

7.21 In order to achieve these aims we may introduce GDN consumer focussed development objectives which may be linked to new incentives.

7.22 Similar developmental objectives in our other price controls have a proven ability to progress new metrics through formulation stage, to trialling and subsequent definitional adjustment & refinement, to their introduction as new metrics and annual monitoring by companies as part of the normal submission of RIGs.

Impact of Distribution Costs on Consumer Tariff

7.23 The average gas distribution charge for a domestic property is circa £180. The regulated revenues of the gas GDNs in 2020 is circa £90m.

7.24 The regulated tariffs for gas customers are comprised of the following main elements:

- Wholesale gas cost;
- Transmission network cost;
- Distribution network cost; and
- Operating cost of the supply business and supply margin.

7.25 The below chart shows how each of these elements have combined to form the overall customer bill for SSE Airtricity in the Phoenix Natural Gas area of Northern Ireland in 2020.

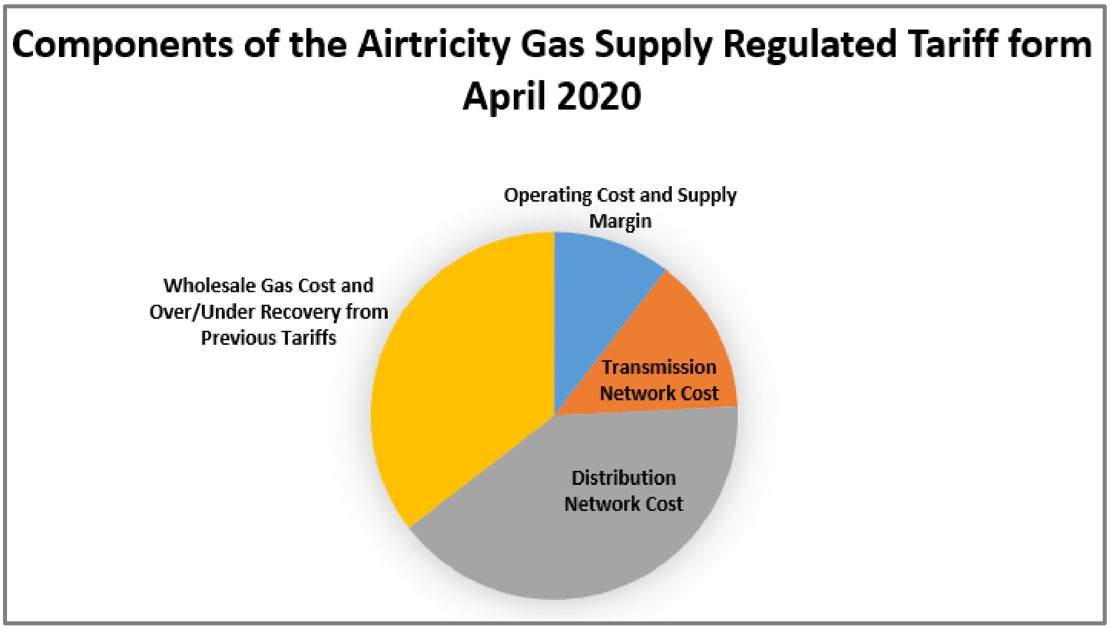


Figure 1: Components of a regulated tariff

7.26 Distribution network costs form the second largest cost component following the wholesale cost.

8. Efficiency Target

Overview

8.1 When setting an efficiency target, two effects need to be considered: catch-up efficiency toward the frontier and continued movement of the frontier over time or frontier shift.

8.2 ***Catch-up efficiency*** can be calculated in a number of ways including:

- A bottom-up approach which challenges company costs with a view to assessing what we consider to be an efficient allowance for each category.
- A top-down approach to opex and capex analysis which benchmarks the total costs or parts of the costs of a GDN against comparable companies.
- A combination of top-down and bottom-up analysis and benchmarking providing complementary assessments which we can use to triangulate to a robust view of an efficient level of costs.

8.3 In GD17 our determination of costs was based on a combination of bottom up analysis and targeted inter-company benchmarking which are outlined in our sections on operational and capital expenditure below. In GD23 we will continue to use these approaches and explore new top-down and bottom up techniques.

8.4 ***Frontier shift*** describes the efficiency gains resulting from companies becoming more efficient over time, e.g. through technological progress. The frontier shift in real terms can be calculated as follows in real terms:

- Nominal input price increase, minus
- Forecast inflation index, minus
- Continuing productivity increase.

Catch-up with the industry frontier

8.5 In order to establish the efficiency gains a company can achieve by moving closer to the efficient frontier, it is necessary to establish the gap that exists between the performance of the company and the efficient frontier. The quality of any such analysis will depend on the availability and quality of comparator data, as well as on consideration of any special factors and identification of atypical expenditure that may be materially relevant to the modelling.

8.6 It is important to note that the gap between the GDNs and the efficient frontier cannot be established until we receive the GDNs' GD23 submissions and our determination. Prior modelling data analyses will be required, as is normal with any modelling, and we will consider GDNs current data alignment to any new comparator data we might obtain in time to inform GD23.

8.7 Although no final decisions are made in this approach document, we set out below some key techniques which we will consider incorporating in our modelling to assess catch-up efficiency.

8.8 We will consider using a combined top-down and bottom-up approach for the assessment of the efficiency gains the GDNs can achieve through catching-up with the efficient frontier. No one method can provide a single estimate of the required efficiencies with absolute accuracy, we would prefer to combine a variety of approaches and therefore estimate from a triangulated viewpoint.

8.9 We then compare our efficiency targets with experience of efficiencies delivery from similar industries and arrive at our efficiency view and targets 'in the round'. This means, any additional or reduced cost pressures which a company is likely to face over the price control period must also be counterbalanced against any efficiency gap to the frontier, the size of such efficiency gap and how long we determine is reasonable to remove some or all of the gap during the price control period.

8.10 Where appropriate we will also use atypical expenditure and special cost factors. We note that we expect the GDNs, as part of their business plan submissions, to indicate any atypical expenditure and special cost factors they consider relevant and material.

8.11 We will issue materiality thresholds for consideration of special cost factors during pre-determination consultation with GDNs, including our partnership approach to model development with the GDNs through a working group.

8.12 A similar partnership approach to the development of a common dataset to support benchmarking has worked well during NI Water and NIE Networks' most recent price controls at PC21 and RP6 respectively. A GD23 Cost Assessment Working Group (CAWG) on similar lines should enable all parties to develop a common and agreed dataset well in advance of Business Plan submissions.

8.13 An agreed dataset will facilitate GDNs to develop benchmarking for subsequent efficiency offerings as part of their Business Plan submissions.

The same agreed dataset will also enable us to develop our own benchmarking of the GDNs, depending on the eventual path we take as regards GD23 efficiency target setting.

8.14 Any atypical expenditure submission around the base year(s) used for efficiency modelling may otherwise reduce a company's base year expenditure going forward, whilst allowing for a smaller estimate of any inefficiency compared to frontier performance. Depending on our eventual approach to benchmarking some atypical adjustment(s) may become necessary, for modelling purposes only, whilst not subsequently applied to base year expenditure rolled forward.

8.15 Further detailed guidance and timescales around submission of both special factors and atypical expenditures will be issued as part of our business plan information requirements to GDNs. The benchmarking process will, as far as is possible, compare data from NI GDNs against comparable GB GDN data.

8.16 Query processes will follow (i) our sending out of business plan information requirements to GDNs, (ii) the GDNs submitting their business plans, (iii) our draft and final determinations and, finally (iv) any company submissions in response to our draft determination. These will provide the opportunity to fine tune any local GDN data which is deemed materially different to GB GDN comparator datasets due to reasons other than efficiency.

8.17 Like any regulator we will consider, as part of any top-down analysis, a number of different modelling approaches, including:

- Historical expenditure models, including Totex (total expenditure) as well as other types of expenditure aggregation. Totex models can be expected to better account for opex-capex trade-offs.

- Activity and/or operational or functional level analysis that may take into account a greater number of potential factors that explain costs better than alternative models.

- Models based on historic data that have the benefit of being anchored in actual (as opposed to forecast data).

- Models using forecast data to take into account GDNs' views on how costs will change over the price control period.

8.18 To ensure as like-for-like comparison of local GDNs to their GB counterparts as possible, we shall consider whether any non-controllable or controllable costs might be better excluded from top-down efficiency models to help improve model robustness.

8.19 When setting catch-up efficiency targets, we will review the following:

- Rate of catch-up.
- Application of efficiency discounts to various expenditure items.

8.20 Aspects we will review when determining the rate of catch-up include (but are not necessarily limited to) the following:

- Size of remaining efficiency gap.
- GDNs' business plans.
- Regulatory precedent for rates of catch-up.
- What other utilities have achieved at similar stages of development.
- What efficiency we believe is achievable overall i.e. the net efficiency challenge (including any increases or decrements in expenditure and any catch-up efficiency as well as frontier shift).

Frontier shift

8.21 As part of the frontier shift calculation, the impact of input price inflation needs to be established. As the nominal prices for different types of cost inputs can develop in different ways, it is good practice to distinguish between different cost categories. As part of the GD17 price control, we differentiated between the cost categories shown in Table 8.1 below. For GD23, we will review the following:

- Maintain as a minimum the cost categories already identified as part of GD17.
- Consider the data provided by the GDNs as part of their submissions and of best practice applied as part of other price controls and review whether a further differentiation of the cost category "Other" is appropriate.
- Maintain the differentiation between opex and capex with respect to the assessment of the impact of input price inflation for the different cost categories.
- Consider the data provided by the GDNs, of the approach used by Ofgem for other GDNs in GB and of best practice applied as part of other price controls and review whether the percentage splits for opex and capex between the different cost categories is still appropriate. This will include a review of whether and under what

particular circumstances company-specific weightings might be used.

Cost category	Opex	Capex
Labour (direct and contracted)	52%	56%
Materials	6%	19%
Equipment / Plant	1%	4%
Other	41%	21%

Table 8.1: Cost Categories and Weightings for Efficiency Analysis as part of GD17 Price Control

8.22 In line with the approach taken as part of the GD17 price control, we will base our assumptions for the cost indices and nominal input cost price increases across a variety of different cost categories and their forecast increases using either our own extrapolation of trends in indices/nominal time series or publically available forecasts.

8.23 In line with the approach taken as part of the GD17 price control, we will determine the opex and capex nominal input price increase forecast for each year of the price control period by calculating the weighted average of the input price increases for the different cost categories. We will determine the opex and capex real input price increase forecast for each year of the price control period by subtracting our inflation forecast (whether RPI or CPI/CPIH) from the nominal input price increase forecast.

8.24 In line with the approach taken as part of the GD17 price control, we will assume a separate annual average productivity increase for both opex and capex based on analysis from a number of sources. In doing so we will also review best regulatory practice applied as part of other price controls.

8.25 As in GD17, we will establish the capex and opex base year with review of the years on which the input data for the GD23 price control process was based. In line with the approach previously taken at GD17 price control, we will apply opex/capex real price effects and productivity increases for each year, starting from the year following the base year to the end of the price control period.

8.26 We will apply the relevant compound real price effect and ongoing productivity increase factors to opex/capex allowances in order to determine the opex/capex allowances net of efficiencies (frontier shift plus any catch-up and plus/minus incremental/decrements in expenditure categories) for each year of the price control. Whilst as part of the GD17 final determination we have published the opex/capex allowances for each year of the price control period and for the price control period as a whole as an aggregate and not broken down into the different cost items, we will for GD23, in order to facilitate improved monitoring of performance against price control targets we will publish the opex/capex allowances net of efficiencies for each year of the price control period and for the price control period as a whole. These will be presented at cost item level and as totals across all controllable cost items.

9. Operational Expenditure

Overview

9.1 The approach set out in this chapter provides a broad view of how we might assess particular elements of operational expenditure based on our previous experience and regulatory best practice. It is important to note that at this stage we cannot fetter our discretion regarding our approach to setting pre-efficient allowances, as doing so could result in adopting a suboptimal approach and in turn have a harmful effect on consumers and/or the GDNs.

9.2 The primary method used to challenge operational expenditure in GD17 was a bottom up assessment of the detailed proposals submitted by the GDNs, supported by targeted benchmarking of GDN costs in areas such as maintenance, metering and emergencies. This approach will form part of our assessment for GD23. We will also review ways of benchmarking the costs of the GDNs against the costs of GDNs in GB (see Chapter 8 for more detail).

9.3 The Regulatory Instructions and Guidance (RIGs) for annual/cost reporting issued to the GDNs include a series of main opex cost categories which will provide a framework for our detailed bottom up assessment. Where appropriate, we may also conduct a more detailed analysis for selected expenditure types, including, but not necessarily limited to, staff and network rates.

9.4 Where applicable, internal recharges will be reviewed and benchmarked against prior years and against deemed efficient third party costs for any goods/services provided. In all cases, a 'value for money' approach will be adopted, to ensure consumers gain a fair deal in not having such goods/services outsourced on a third party arm's length transaction basis.

9.5 We may also review additional information in our analysis such as (but not necessarily limited to) the views of industry and subject matter experts outside our own organisation.

9.6 We will review opportunities to benchmark core business costs such as HR costs or IT costs against similar costs incurred by other industries.

9.7 In light of the ongoing uncertainty regarding the implementation of the TMA (Traffic Management Act) and its effect on operating costs, we will include an estimate of TMA costs in the opex allowances. This will only be necessary in the event that a decision on the timing and details of the TMA has not been made by the time of our determination. This estimate would be subject to retrospective adjustment as part of the uncertainty mechanism at the time of the next price control. This would be in line with our approach as part of the GD17 price control and protect both the GDNs (in the event that actual costs turn out to be higher than the estimate) and consumers (in the event that implementation is delayed or that the impact is less than the estimate). Should a decision on timing and details of the TMA have been taken before our determination, we will base our determination on this decision. Rates for TMA allowances would then not be included in the uncertainty mechanism, but there would still be a retrospective adjustment for the TMA cost drivers.

9.8 The main opex categories used in the GD17 price control and subsequent annual reporting are set out below. Further information on our approach to the bottom up assessment of these cost are set out in the remainder of this chapter.

Work Management

- Asset Management.
- Operations Management.
- Customer Management (Emergency Call Centre).
- Customer Management (Including Non-Emergency Call Centre) & Network Support (Including System Mapping).
- System Control.

Work Execution

- Emergency.
- Metering.
- PRE Reports.
- Maintenance.
- Other Direct Activities.

Business Support

- IT & Telecoms.
- Property Management.
- HR & Non-operational Training.
- Audit, Finance & Regulation.

- Insurance.
- Procurement.
- CEO & Group Management.
- Stores & Logistics.

Other Opex Categories

- Advertising & Market Development (owner-occupied and non-owner-occupied properties).
- Trainees & Apprentices.
- Non-Controllable Opex.

Work Management

Asset Management

9.9 The GDNs asset management costs are in the main driven by its associated staff costs incurred in managing the network's assets. Our approach to determining staff costs is discussed in section 9.43.

9.10 Where companies propose further investment in asset management systems, they should explain how these will improve service or have resulted in savings in operational costs which are sufficient to justify the investment.

Operations Management

9.11 We will review the following areas in relation to the day to day planning and supervision of the operatives and contractors working within the work execution processes as follows:

- First Line Managers.
- Depot Managers.
- Safety, Health and Environmental.
- Operations support.

9.12 The GDNs costs for these activities are driven by staff costs. Our approach to determining staff costs is discussed in section 9.43.

Customer Management (Including Emergency/ Non-Emergency

<u>Customer Call Centre) & Network Support (Including System Mapping)</u>

9.13 We will review this area covering the following categories:

- Call centres (including central emergency call centre charge for emergency service).
- Customer services and commercial/contract management departments that handle enquiries/complaints, monitor standards, manage contracts etc.

9.14 We will review the call centre cost benchmarking, both between the NI GDNs and with other GDNs, where reasonable and possible. In doing so, we will review the specifics of the NI natural gas network which may impact on the number of calls, such as relatively high prepaid meter basis, new gas connections, any adverse weather conditions and any other pertinent factors.

9.15 The GDNs costs for customer service and management activities are mainly driven by staff costs. Our approach to determining staff costs is discussed in section 9.43. In GD17 we reallocated a portion of these costs to be recovered by the GDNs through the connection incentive. Depending on the outcome of our review of the connection incentive we will consider if we will take a similar approach for GD23.

<u>System Control</u>

9.16 We will review the existing arrangements for monitoring the safe flow of gas through the network and the associated costs incurred. The related costs should represent the cost of running the control room (e.g. staff costs of resource working within the control room). Our approach to determining staff costs is discussed in section 9.43.

Work Execution

<u>Emergency</u>

9.17 We will use the call centre model and first response activities when setting our allowances on emergency costs.

9.18 We will, where reasonable and possible, use additional information such as relevant benchmarking data and material NI or GDN-specific special factors.

Metering

9.19 We will analyse historic and forecast GDN data when assessing metering costs. We may also review, where reasonable and possible, additional information such as relevant benchmarking data and material NI or GDN-specific special factors.

9.20 We expect GDNs to provide information on unit costs of metering activities (such as meter replacement, and battery replacement) and information on future levels of activities, based on asset inventory information and cycle times for maintenance. We will review how this information can be used to assess future changes in expenditure and to benchmark costs between GDNs.

9.21 We expect GDNs to consider both consumer expectations and needs in relation to meter functionality. They should have regard to this as they set out their proposals for the long term management of meter stock, the implications of any proposed changes to metering policies and costs. Specifically this should have due regard to:

- The impact of the roll-out of smart meters in other jurisdictions, including (but not limited to) meter costs, meter availability, cost of operations and maintenance.
- The ongoing availability of existing technology (e.g. U6 credit meters) as the roll out of smart meters progresses elsewhere.
- Consumer impacts, including the lack of a remote top-up capability in current pre-payment meters, which have been exposed during the COVID19 lockdown and the plans they will have developed to deal with this.

9.22 We are undertaking a meter reading review to clarify the roles and responsibilities in relation to metering activities. We are minded to move the meter reading responsibility from supply to distribution companies, including any consequential effects that may arise from this change (e.g. Meter Inspections etc). If this review is not completed in time for any changes to be incorporated into GDN Business Plans and / or our final determinations, we will include a section in the Uncertainty Mechanism to deal with the outcome of any subsequent decisions.

PRE Repairs

9.23 We will use an appropriate metric for GDN repair cost forecasts, based on the size of the network, and consider whether a driver such as MEAV (Modern Equivalent Asset Valuation) should be used.

Maintenance

9.24 Maintenance activities are direct activities required for the examination, repair and upkeep of plant and equipment within the network. These activities can be split into three types:

- Planned or Routine maintenance (i.e. maintenance activities that recur at a regular interval).
- Reactive or Non-routine maintenance (i.e. maintenance activities that recur non-regularly, but can generally be expected).
- Exceptional items maintenance (any maintenance activities that are neither routine nor non-routine maintenance).

9.25 We expect GDNs to provide information on unit costs of maintenance activities (such as the inspection and maintenance of regulators) and information on future levels of activities based on asset inventory information and cycle times for maintenance. We will review how this information can be used to assess future changes in expenditure and to benchmark costs between GDNs.

9.26 We will benchmark at a detailed activity level if we consider that we have sufficient robust benchmark maintenance activities.

Other Direct Activities

9.27 We will assess any costs for other direct activities on a case-by-case basis. We note that we expect the GDNs to provide sufficient detail on the nature of these activities, as well as justification for the associated costs, to inform our analysis.

Business Support Costs

General considerations

9.28 We will review actual costs incurred and benchmark these areas where appropriate. In GD17 we reallocated a portion of these costs to be recovered by the GDNs through the connection incentive. Depending on the outcome of our review of the connection incentive we will consider if we will take a similar approach for GD23.

IT and Telecoms

9.29 The IT & telecoms cost category covers the provision of IT services for day to day service delivery. For example, this should include Graphical

Information Systems (GIS) costs, in this area. We will review actual costs incurred and benchmark these areas where appropriate.

Property Management

9.30 The Property Management cost category covers the activity of managing, providing and maintaining non-operational premises. This should include costs such as rent, rates (business), utilities costs including electricity, gas and water, maintenance/repair costs of premises and the provision of the facilities/property services such as reception, security, access, catering, mailroom, cleaning and booking conferences.

9.31 A significant element of property management costs relates to network rates. We have in the past set network rates using a formula which links the allowance to determined revenues. Our approach to network rates is discussed in section 9.46.

HR and Non - Operational Training

9.32 HR covers provisions of the HR function i.e. the full range of professional activity for an individual's career path from recruitment to retirement and post retirement where applicable, e.g. management and administration of pension payments and from related professional advice to directly resolving grievances for staff. We will review actual costs incurred and benchmark these areas where appropriate.

Audit, Finance and Regulation

9.33 Audit Finance & Regulation covers performing the statutory, regulatory and internal management cost and (business support activity) performance reporting requirements and customary financial and regulatory compliance activities for the network. We will review actual costs incurred and benchmark these areas where appropriate.

Insurance

9.34 The Insurance cost category covers support and expertise to develop the business risk profile, managing the claims process and provision of information and understanding to the business in relation to insurable and uninsurable risks.

9.35 We will review in detail the cost make-up of the insurance sub categories as well as performing benchmarking against peers and actual outputs from prior years, where appropriate.

Procurement

9.36 This cost category covers the procurement of goods & services in the support of the business operations, through the management of procurement contracts with suppliers. We will review actual costs incurred and benchmark these areas where appropriate.

CEO and Group Management

9.37 This cost category covers costs related to communications, group strategy, legal department, corporate responsibility and investor relations, board members, ring fence compliance and credit reference agencies. We will review actual costs incurred and benchmark these areas where appropriate.

Stores and Logistics

9.38 The Stores and Logistics cost category covers the activity of managing and operating stores. We will review actual costs incurred and benchmark these areas where appropriate.

Other Opex Categories

Advertising & Market Development (owner-occupied and non-owner-occupied properties)

9.39 Our approach to Advertising & Market Development for owner occupied properties will be informed by our review of the connection incentive as discussed in section 11.5 We will expect the GDNs to include any related corporate overheads costs within this category (both staff related and business support related) depending upon the outcome of our review of the connection incentive. It is important to note that OO (Owner Occupied) properties are those domestic premises which do not fall into the definition of:

- Domestic New Build; or
- NIHE or Housing Association.

9.40 Our approach to Advertising & Market Development for non-owner occupied properties will be to review actual costs incurred and to take account of projected growth in non-owner occupied connections in the price control period. We expect the GDNs to explain how it has apportioned staff costs between the Advertising and Market Development owner occupied and non-owner occupied categories.

Trainees & Apprentices

9.41 We will consider reviewing actual costs incurred and benchmark where appropriate.

Non-Controllable Opex

9.42 We will review all items to be non-controllable on a case-by-case basis to ascertain that this classification remains appropriate. In GD17 the only non-controllable cost allowed was licence fees.

Other Expenditure Types

Staff

9.43 For GD17 we did not set an explicit staff cost allowance, as staff costs form part of most of the cost categories within the ACRT, rather than being an individual cost category. We will follow a similar approach for GD23. We will expect each GDN to provide evidence as why their projected FTEs for the price control period should differ from the base year and historic level of FTE's. We may also use breakdown of staff data by SOC (Standard Occupational Classification) Code for benchmarking purposes.

9.44 Included under the staff opex will be all staff-related additional costs that can be calculated using the presented drivers (for example, commission, entertainment, allowances, travel & subsistence, car allowance and fleet costs).

9.45 We will consider assessing assumptions around all inputs/driver data for reasonableness through benchmarking and actual outputs from previous years, where deemed appropriate.

Network Rates

9.46 For determining network rates allowances, we will retain the formula based calculation in relation to network rates in line with our approach for GD17. However, we will consider reviewing this and, where appropriate, updating the multiplier assumptions applied to revenue and the agreed rateable values as advised by the Land & Property Services (LPS).

9.47 We expect GDNs to be able to demonstrate that they have taken all steps to minimise their rates valuations.

10. Capital Investment

10.1 The approach set out in this chapter provides a broad overview of how we will assess particular elements of capital expenditure based on our previous experience and best regulatory practice. It is important to note that at this stage we cannot fetter our discretion regarding our approach to setting pre-efficient allowances. To do so could result in adopting a suboptimal approach and in turn have a harmful effect on consumers and/or the GDNs.

10.2 In line with the Regulatory Instructions and Guidance for annual/cost reporting issued to the GDNs, we will distinguish between the following main capex categories as part of the GD23 price control:

- ***Growth***, including: connecting individual large I&C (industrial and commercial) customers; passing additional properties (domestic, small and/or medium I&C); reinforcing the network and increasing security of supply.
- ***Replacement*** of assets which have reached the end of their economic life.
- ***Other Capex***, including: system operations; IT and related Telecoms; Commercial Gas Trading IT; plant, tools & equipment; land, buildings, furniture and fittings; security; vehicles and wheeled plant and other.

10.3 We expect GDNs to:

- Provide clear and well evidenced plans for investment.
- Demonstrate that these plans have the support of consumers.
- Provide a clear statement of the methodologies used to estimate future investment which shows how projected costs relate to current costs and have been reviewed and challenged to drive out further efficiencies.

10.4 We will use a combination of top-down and bottom-up approaches in the analysis we undertake to determine capital allowances for GD23.

10.5 In line with the methodology applied in the GD17 price control process, we will use the 'basket of works' approach to benchmark capex expenditure between GDNs. The key steps in this process are:

- Identify the items of work contained within the basket.

- Assess to what extent cost elements are fixed, i.e. not dependent on the level of workload carried out.

- Select a standard set of unit rates to be used for each of the items within the basket.

- Identify the workloads and associated costs submitted by the companies for these items over a relevant time period.

- Calculate the product of the company workload and the standard unit rate for each work item.

- Rescale these for each work item so that the total work item cost equals the company's submission.

- Establish an efficient level of performance for the basket of items in the base year.

- Calculate the efficient level of performance for each of the work items in that year, with and without consideration of fixed costs.

- Roll this performance forward to the individual years of the GD23 price control period. In line with the approach taken as part of the GD17 price control process, we will classify all capex cost items as controllable.

10.6 We will review bottom up capex estimates provided by the GDNs, historical run-rates of expenditure and relevant benchmarking data as part of our assessment. We will give greater weight to costing methods which have a clear link to historical costs and relevant benchmark data.

10.7 In line with the approach for Opex described in Section 9.7, we will include an allowance for the potential impact of the Traffic Management Act on construction costs, which would then be subject to adjustment through the uncertainty mechanism.

10.8 Further investment in extending the network (i.e. growth) should be evaluated and undertaken on an economic basis. It should be supported by an economic analysis which assesses the whole life cost of the investment. This analysis should have regard to (but not necessarily be limited to) consideration of costs, rate of return, conveyance tariffs, average consumption, properties passed and connection rates for same per customer category and should identify the distribution tariff necessary to support the investment.

10.9 Where the above principle does not apply (for example reinforcing the network and security of supply), a sound business case must be submitted and justified before any approvals can be granted.

10.10 Most capital allowances will be subject to review and adjustment as part of the uncertainty mechanism so that consumers continue to pay for the quantum of assets which have been delivered. Where appropriate, we will also decide upon determining lump sum allowances which are subject to the cost risk sharing mechanisms of the respective licences.

10.11 We expect GDNs to consider both consumer expectations and needs in relation to meter functionality. They should have regard to this as they set out their proposals for the long term management of meter stock, the implications of any proposed changes to metering policies and costs. Specifically this should have due regard to:

- The impact of the roll-out of smart meters in other jurisdictions, including (but not limited to) meter costs, meter availability, cost of operations and maintenance.
- The ongoing availability of existing technology (e.g. U6 credit meters) as the roll out of smart meters progresses elsewhere.
- Consumer impact of the lack of a remote top-up capability in current pre-payment meters which has been exposed during the COVID19 lockdown.

10.12 We are current engaging with companies in relation to short term metering issues. This may result in a change in type and functionality of meters and a change in the balance of credit and pre-payment meters. If this work cannot be complete by the final determination for GD23 we will consider including a mechanism for amending the determined unit cost of new and replacement meters in the Uncertainty Mechanism.

10.13 Capital cost estimates will be subject to the application of a frontier shift to reflect the impact of real price effects and on-going productivity improvements.

11. Incentives and Innovations

Overview – Incentives

11.1 Incentives are an important part of the Regulatory framework.

11.2 A number of incentives have been used in previous price controls, to aid and promote efficient and economic development of the gas industry. The GD17 price control included the following main incentives:

- Connection Incentive.
- Properties Passed Incentive.

11.3 Both the Connection Incentive and the Properties Past incentives are being considered for use as part of the GD23 price control and are discussed in greater detail below.

11.4 We will consider other incentives for GD23 which will work to improve performance or reduce costs to consumers. We note that one respondent indicated that 3 new incentives could be included and welcome the proposals to be presented in the Business Plan of how they will work. Proposals for additional incentive mechanisms should demonstrate how they work in the interest of consumers.

Connection Incentive

11.5 A key aspect of the initial development of the gas industry in Northern Ireland has been the need to persuade consumers to convert to natural gas to and realise environmental benefits and ensure the network can be delivered at a competitive tariff.

11.6 To support the GDNs in acquiring connections we have included funding in previous price controls for marketing and advertising as well as the costs of engaging with individual consumers when they apply for a connection. Initially this was in the form of ex-ante allowances and, more recently in the form of a connection incentive payment for each new owner-occupied connection.

11.7 This Connection Incentive Payment has been subject to a level of non-additionality. This means that we only provide the incentive payment for each connection acquired above a certain threshold which recognises that some consumers will connect to natural gas in the absence of active marketing and promotion by network companies.

11.8 In our final determination for GD17, we committed to reviewing the owner-occupied connection incentive for GD23. During the initial stages of this review we will ask GDNs to provide information on the effectiveness of the current mechanisms and provide their views, supported by evidence, on how the connection incentive should be developed.

11.9 Having assessed the evidence provided, we plan to consult on the future of the connection incentive as part of the consultation on the GD23 draft determination.

Properties Passed Incentive

11.10 The Properties Past Incentive is also designed to facilitate an increase in the numbers of customers that can connect to the network, whilst also acting as a check to ensure that any network expansion is done along an optimal route to engage as many potential customers as possible.

11.11 We are minded to continue the Properties Past incentive until the remaining network development is complete.

Innovation

11.12 GD17 presented a framework of "Innovation Funding Principles" which outlined our requirements and criteria for any new innovation projects, as follows:

- Quantified and robust cost benefit analysis.
- Detailed and robust project plan for the innovation project.
- Credible and binding commitments from any project partners to participate in/contribute to funding the project, as well as proposed contingency arrangements in case any of the project partners should fall short of their obligations.
- Justification of why funding through the overall price control package is considered not appropriate/sufficient and why funding through specific innovation allowances and increased prices is requested.
- Explanation of how the GDN has arrived at its chosen bid for innovation and how this interacts with other innovation investments planned under the normal price control regime.
- Explanation of how the innovation bid was identified/prioritised and justified in consultation with consumers and other stakeholders.

- Explanation of why there exists a barrier towards innovation which requires some form of regulator action to progress, and the consequences of the innovation not happening.

- Details on what deliverables/benefits may be expected for local consumers from the research/development/trials.

- Detailed risk assessment as well as details on and justification of proposed treatment of risk and reward.

- Description of how the innovation, if successful, could be efficiently rolled out within the GDN and/or other NI or GB GDNs.

- Justification of how the proposed innovation is different to anything that has occurred previously, whether within the GDN, another NI or GB GDN or within the wider industry.

11.13 We would be minded to keep these criteria in any evaluation of Innovation projects presented.

11.14 Some respondents to the consultation on our approach to GD23 highlighted the potential to include mechanisms for funding innovation in the Price Control to allow GDNs to propose activities which would reduce carbon dioxide emissions and contribute to achieving net zero. We will engage further on these proposals. However, it may be better that this type of work continues to be funded through wider social mechanism (such as the existing NISEP scheme) which maximises carbon reduction for a given investment and socialises costs rather than imposing specific decarbonisation costs on gas consumers.

11.15 Some respondents indicated that a mechanism and / or fund should be established in the GD23 to allow companies to secure funding for innovation projects. We would welcome individual and common proposals from GDNs for innovation funding in their Business Plans which we will assess against the criteria outlined above. We will give further consideration to including a general innovation funding mechanism in our determination. However we would still expect this to require proposals from GDNs which would be assessed against the criteria outlined above.

11.16 When assessing innovation funding we are aware of the risk that innovation projects may fail to deliver the benefits they set out to deliver. We would expect GDNs to assess this risk in their evaluation and submission of innovation projects to identify optimal projects which do not carry a high risk for consumers.

12. Uncertainty Mechanism

12.1 The uncertainty mechanism addresses uncertainties and reduces the related risks to consumers and GDNs by retrospectively adjusting price control allowances based on differences between actual and allowed costs or outputs. For GD23, we will have three categories of retrospective adjustments:

- Output-based cost: For this cost, forecast outputs and related allowances will be reconciled with actual outputs and related allowances.
- Ring-fenced cost: This cost, based on its nature, is not known with certainty at the time of the determination. Submission of a fully justified business case will be required by the GDN for this cost to be approved.
- Pass through cost: A cost that is entirely outside of the control of the GDN to manage. Cost categories in these areas will be limited.

12.2 We will update the current uncertainty mechanism models, as part of the GD23 price control, to ensure they reflect the settlement of allowances which are based on outputs, ring-fenced or pass through costs. And we will provide an explanation of the outcome of this work in our determinations for GD23.

12.3 We are minded to include a new mechanism for dealing with the outcome of the Energy Strategy and proposals in relation to metering, as mentioned in previous sections above.

Reopeners

12.4 In light of the ongoing development of the natural gas market in Northern Ireland and the duration of the GD23 price control period, developments may happen during the GD23 price control which have a significant impact on the GDNs' cost base but for which impact and/or timing cannot be foreseen with a sufficient level of detail and confidence to allow for consideration as part of the GD23 allowances. We will have appropriate re-openers for such developments, where relevant and material. Details of how this will work will be contained within the Draft Determination.

Materiality Thresholds

12.5 In line with our approach as part of GD17 price control, we will have a materiality threshold for significant costs not reasonably foreseeable at the price control determination but incurred as part of the GDN operations during the price control period, eg Change of Law. GDNs can request approval of such costs from us, provided they are above the materiality threshold and sufficiently justified with a robust business case. The materiality threshold was set at £100,000 per project for the duration of both the GD14 and GD17 price control periods. Some respondents indicated that it was perfectly adequate and see no reason to change the current approach. However, we will consider further on whether to have a set figure or move to a figure calculated as a percentage of turnover per annum (e.g. 0.5%), for each respective GDN due to the different size and scale of the respective GDN's. This is similar to how OFGEM approach these issues.

12.6 In taking decisions on granting of additional allowances we will consider the balance between the material unforeseen costs and any unforeseen cost reductions or revenue gains achieved during the price control period, to ensure a fair balance to GDN's and consumers.

13. Financial Issues

GD23 Base Year

13.1 Our approach for the base year(s) for expenditure and modelling will depend in large extent on whether we choose to adopt new efficiency models which rely upon (i) a single year of data or (ii) pooled or panel data, drawn from more than a single year of data (and whether such a dataset is drawn from an equal or unequal number of years data by company).

13.2 We will calculate the GDNs price control base year following their submission of the 2021 business plan. We expect the GDNs business plans to detail any atypical or exceptional costs and a submission of any special cost factors which explain why expenditure might be higher or lower than comparative industry benchmark costs.

13.3 We will ask the GDNs to establish their baseline expenditure cost and identify foreseeable reductions, or increases, in costs for future years. For example we would expect the GDNs to detail any management initiatives it plans to undertake to reduce costs or mitigate cost increases and to identify any upward cost pressures.

13.4 We are also aware of the effect of COVID 19 has had in the year 2020 and beyond. We would expect the GDN's to be able to quantify any effect that this has had to its business operations and expenditure.

Rate of Return

13.5 In relation to rate of return, we will:

- Use a standard CAPM (Capital Asset Pricing Model) methodology for assessing a suitable rate of return for the GDNs.
- Use similar regulatory settlements to benchmark appropriate rates.
- Conduct a review of the risks faced by businesses which no longer have a major construction programme.
- Consider whether the cost of debt mechanism (introduced in GD17) should change from a 'benchmark to benchmark' approach to a 'benchmark to actual cost' approach.

13.6 The PNGL and firmus energy GD17 Rate of Return was calculated pre-tax, while the SGN Rate of Return was calculated post-tax. We will continue this approach for GD23.

Financeability

13.7 We will review the financeability of the licence holders, using established financial metrics, such as gearing, debt ratios and PMICR (Post-Maintenance Interest Coverage Ratio), etc., which can be used to benchmark the GDNs with the levels of an efficient, well-managed, regulated company.

13.8 Sensitivity analysis will also form part of this assessment, to ensure that the business could cope under shock conditions.

13.9 We will continue to rely on setting an appropriate WACC and depreciation allowance while considering financeability. This is premised on the idea that rational investors will recognise that the combination of a RAB and an independent regulator provides assurance of a return on and of capital over time.

Capitalisation

13.10 We will expect the GDNs to outline their capitalisation policy over the GD23 period and explain any differences in its forecast capitalisation rates and policy compared to those used in prior years including the base year.

14. Price Control Outputs

Form of Price Control

14.1 PNGL and firmus currently operate under revenue cap price control regimes which have been in place since 2006 and 2016 respectively. Before that the companies operated under price cap regimes for a period of approximately 10 years from the initial grant of licence. The price cap regimes provide strong incentives for the companies to identify and connect new consumers during the initial stages of network development. We will not change the form of price control for PNGL or firmus.

14.2 SGN currently operates under a price cap price control regime. SGN connected its first consumers in 2017 and continues to develop its network and build its consumer base. Based on the response from SGN we still believe that it is appropriate to allow the business to develop over a further price control period before contemplating a change to a revenue cap price control regime. Therefore we will continue with a price cap regime for SGN for the GD23 period.

Profiling of Revenues

14.3 Although allowances for a price control are determined at each review period, the phasing of allowances post price control is important in establishing allowed revenues and prices (dependent on the cap type the licensee is subject to). Making reasonable assessments of future revenues and volumes is important to ensure stable tariffs as the network develops in the long term.

14.4 We will engage with GDNs through the price control process to derive the most accurate profile of post determination GD23 allowances for tariff modelling purposes.

Pi-Model

14.5 We will expect the GDN’s to submit a Pi tariff models, alongside their Business plans, that tie in with their financial data. This will ensure consistency for the GD23 price control, subject to any changes necessary to update such models.

14.6 This should be submitted with the most up to date Uncertainty Mechanism model, to provide clarity on actual outputs.

Designated Parameters and Determination Values

14.7 We will review all designated parameters as part of the GD23 price control, to allow update for current circumstances, should any require alteration.

14.8 Determination values will be based on all information presented to us for consideration throughout the review period; this will include consideration of any engagement and responses to our draft determination, where applicable.

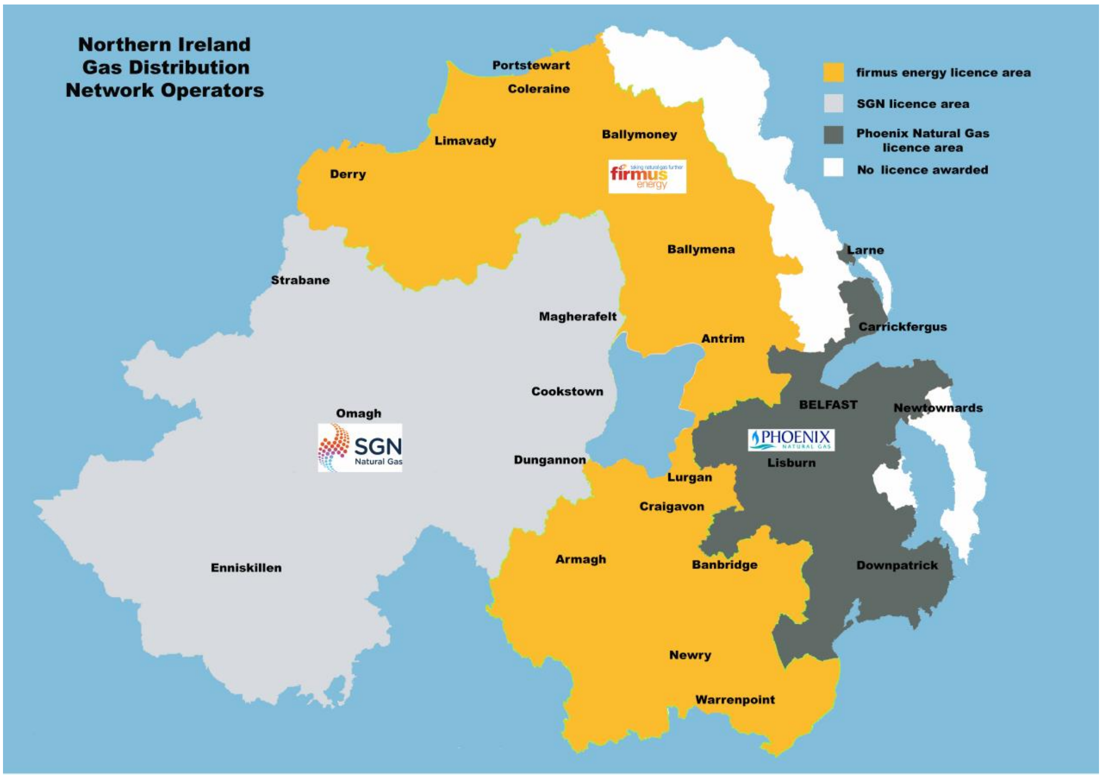
14.9 Any changes to Designated Parameters and Determination Values will require licence modifications. These will be consulted on and implemented with consideration of the consultation responses received.

15. Timelines

GD23 Key Milestones	Timeline
GD23 Approach Document Consultation	1 June 2020
GD23 Approach Document Consultation Ends	7 August 2020
GD23 Approach Document published	6 November 2020
Business Plan information requirements published	31 January 2021
GDNs submit BPs for GD23	30 June 2021
UR publishes DD consultation for GD23	9 December 2021
DD consultation period ends	24 February 2022
GD23 FD and licence consultation published	23 June 2022
GD23 GDN licence modifications published	8 September 2022
GD23 Price control takes effect	1 January 2023

Table 15.1: Key Milestones of GD23

Appendix 1: NI Gas Distribution Network Operators Map



For exact clarification of individual licenced areas, reference should be made to the relevant licences.

Appendix 2: Glossary

Reference	Definition
CAPM	Capital Asset Pricing Model. A model that describes the relationship between risk and expected return.
CAWG	Cost Assessment Working Group – partnership working group tasked with developing an agreed, common dataset to facilitate cost benchmarking.
CEWG	Consumer Engagement Working Group – partnership group advancing consumer and stakeholder engagement for GD23 and beyond (modelled on similar working groups for the other sector network companies, plus relevant Departments and CCNI).
CMA	Competition and Markets Authority - The statutory body to deal with errors in price controls and makes a new decision after listening to the evidence from all related parties.
CPI & CPIH	Consumer Price Index and Consumer Price Index including Housing, which is a recognised and international inflation measure.
Domestic New Build	Domestic Premises which have never previously been owned or occupied by any person (that is they are, or are to be, newly built premises) and in respect of which the connection to the Network shall be made prior to the premises first being occupied, but excluding any such premises which fall within the definition of NIHE.
GD14, 17 and 23	The name for the Gas Distribution price controls. GD14 covers the calendar years (ie January –December) 2014 – 2016. GD17 covers the calendar years 2017 – 2022. GD23 covers the calendar years 2023 - 2028.
GDN	Gas distribution network company – firmus, PNGL and SGN
I&C	Industrial and commercial properties
NIEN	Northern Ireland Electricity Networks
NIHE	Domestic Premises which are (or will be when built) owned by: the Northern Ireland Housing Executive; or a housing association in Northern Ireland.
Ofgem	Office of Gas and Electricity Markets. Regulates the electricity and gas markets in Great Britain.
OO (Owner Occupied)	Domestic Premises which do not fall into the definition of: Domestic New Build; or NIHE or Housing Association.
Pi model	Model used for the calculation of conveyance charges for the GDNs.
PRE	Public Reported Escapes

Reference	Definition
RIGS	Regulatory Instructions and Guidance
RIIO-GD1	This is the first gas distribution price control by Ofgem under the new RIIO (Revenue = Incentives + Innovation + Outputs) model. The price control is set for an eight-year period from 1 April 2013 to 31 March 2021.
RIIO-GD2	This is the second gas distribution price control by Ofgem under the new RIIO (Revenue = Incentives + Innovation + Outputs) model. The price control is set to take effect on 1 April 2022 to 31 March 2027.
RPI	Retail Price Index – a measure of inflation
TMA	Traffic Management Act. The objective of the TMA is to tackle congestion and disruption on the road network. The TMA places a duty on local traffic authorities to ensure the expeditious movement of traffic on their road network and those networks of surrounding authorities. This has yet to come into force in Northern Ireland, at time of writing.
TRV	Total Regulatory Value: the Depreciated Asset Value plus any incentive adjustments including the profile adjustment.

Appendix 3: Consultation Respondents

PNGL
Firmus
SGN
SSE Airtricity
CCNI