GD23 - Gas Distribution Price Control 2023-28

Final Determination Annex Q
Promoting connections
October 2022

About the Utility Regulator

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

This Annex provides the Utility Regulator's decisions on funding to promote connections during the GD23 price control period. Connections will continue to be provided free to consumers at the time the connection is made. For the GD23 final determination we reviewed the additional information provided and acknowledge the value of increased advertising marketing and development compared to the allowance provided within the DD.

Audience

This assessment forms part of our final determination for GD23 and is of direct relevance to the gas distribution regulated companies. It may also be of interest to consumers and their representatives, government and other regulated bodies.

Consumer impact

The overall consumer impact of GD23 is set out in the main final determination report. The estimates of capital and operational expenditure in this annex, contribute to the determination of tariffs for GD23.

Contents

Executive Summary

This Annex to the GD23 final determination sets out the Utility Regulator's decisions on how work necessary to promote and secure new connections to the gas network will be funded in GD23.

Our decisions distinguish between domestic owner occupied (OO) connections and all other types of connections including domestic new build, social housing and industrial and commercial connections collectively referred to as non-OO connections. This Annex focuses on OO connections and Non-OO incentives for SGN.

For the draft determination we proposed moving to a Cost-to-Serve model for OO connections which provided only minimal allowances for promoting connections while funding the GDNs to respond to connection requests as they arose. For the GD23 final determination we reviewed the additional information provided and acknowledge the value of increased advertising and marketing compared to the allowance provided within the DD.

For the GD23 final determination we have retained many of the changes to the structure of the funding mechanism for funding OO connections proposed in the draft determination. The recovery of general overheads have been removed from the mechanism with separate provisions made for these overheads in the determination. An element of the allowed funding is in the form of a fixed sum with the remainder funded as a variable amount per connection. While this weakens the overall incentive, it allows GDNs to plan activities and maintain awareness through periods of uncertainty such as those in the recent past.

Our determination of funding for FE and SGN now exceeds the reasonable economic rate for expenditure on OO connections. This was also the case in GD17 where an additional "new areas" allowance was provided for all GDNs in excess of the economic rate.

The funding levels have been reviewed, in light of the current economic circumstances and the desire to support and encourage consumers to become connected to the gas network, with a view to assisting the transition to Net Zero sooner.

Funding to promote OO connection will become progressively more challenging as the number properties available to connect gradually reduces. Unless the costs of advertising, marketing and development reduces through new more efficient approaches, future costs will become progressively more and more uneconomic and we expect to move to actual Cost-to-Serve for GD29.

1. Introduction

1.1 In previous price controls we have included allowances and incentive mechanisms to promote connections through advertising, marketing and development (AMD).

1.2 In GD17 we distinguished between the methods of funding to support domestic Owner Occupied (OO) connections and all other types of connections including new build domestic, NIHE domestic and all industrial and commercial connections (referred to collectively as Non-OO):

- An allowance was provided for AMD in respect of Non-OO connections. These allowances were based on historical levels of expenditure which are reviewed and challenged at each price control. They are not dependent on the numbers of new connections or additional consumption delivered.

- A connection incentive mechanism was included to support AMD for Owner Occupied connections. The revenue generated under this mechanism was dependent on the number of OO connections delivered. The incentive rate was calculated at an economic level which ensured that the marginal benefit of additional revenue from new connections is shared between the cost of AMD to secure connections and existing consumers.

1.3 In addition to supporting AMD, our GD17 determination continued to ensure that individual consumers did not pay for a new connection at the time the connection was made. The GDNs were funded to make connections and the investment is recovered through revenues from all consumers over the long term.

1.4 In the GD23 draft determination we proposed moving to a Cost-to-Serve model for OO connections which provided only minimal allowances for promoting connections while funding the GDNs to respond to connection requests as they arose. For the GD23 final determination we reviewed the additional information provided and acknowledge the value of increased advertising and marketing compared to the allowance provided within the DD.

1.5 For the GD23 final determination we have retained many of the amendments made to the structure of the funding mechanisms for OO connections as follows:

a) The recovery of general overheads has been removed from the funding mechanism with separate provisions made for these overhead costs elsewhere in the determination.

b) An element of the funding is in the form of a fixed sum with the remainder funded as a variable amount per connection. While this weakens the overall incentive, it allows the company's to plan activities and maintain awareness through periods of uncertainty such as those of the recent past.

1.6 The GD23 final determination includes Non-OO incentives for SGN to secure small and medium industrial and commercial connections.

1.7 In subsequent sections of this Annex, we set out the background to the OO connection incentive mechanism and our decisions on funding the connections in GD23.

Changes from Draft Determination to Final Determination

1.8 For the GD23 draft determination we proposed a minimal cost-to-serve model for funding work undertaken by GDNs to promote and secure OO connections with separate funding for marketing. For the GD23 final determination we have:

- Reviewed additional information provided by the GDNs and acknowledged the value of increased advertising marketing and development compared to the allowance provided within the draft determination.
- Reviewed the economic test for funding OO connections to take account of revised parameters (such as the rate of return). We removed the contribution towards the cost of mains from this assessment as these are now considered a sunk cost.
- Maintained the general structure of funding for OO connections set out in the draft determination including removing non-additionality and general overheads from the allowances and providing fixed and variable elements for the allowance.
- Discontinued the cap and collar mechanism which formed part of the GD17 mechanism.
- Included Non-OO incentives for SGN to secure small and medium industrial and commercial connections.

2. GD17 Owner Occupied connection incentive mechanism

2.1 GD17 included a connection incentive mechanism to support AMD for Owner Occupied connections. The revenue generated under this mechanism was dependent on the number of OO connections delivered. The incentive rate was calculated at an economic level which ensures that the marginal benefit of additional revenue from new connections is shared between the cost of AMD to secure connections and existing consumers. The key characteristics of this mechanism were:

- The incentive rate was calculated from the net present value of the additional revenue generated by each OO connection over a 15 year period, net of the direct costs of the new service pipe and meter. A further amount was deducted to represent investment already made in the network, ensuring that new consumers continue to make a contribution to investment made to develop the network.

- In GD17, in response to feedback from the GDNs, we included an additional amount in the incentive rate as a 'new areas' allowance. The new areas allowance recognised the fact that all three GDNs had significant expansions planned in GD17, and that GD17 was likely to be the last price control where such expansions are considered. We concluded that there was a case to be made for an additional allowance to drive awareness of gas and ultimately lead to increased momentum in connection rates. Given the uniqueness of the extent of the extensions in GD17 we noted that this additional allowance would only be applied in the GD17 period and we did not anticipate further new areas allowances in GD23 and beyond.

- The OO connection incentive in GD17 was subject to non-additionality. Non-additionality is an estimate of the number of connections which would be delivered if the incentive mechanism did not exist. In principle, it is only economic to apply the connection incentive rate to properties connected in excess of this. For GD17, non-additionality was set at a percentage of the OO connection target with percentages of 25%, 33% and 0% applied to FE, PNGL and SGN respectively.

- As well as direct costs associated with AMD, the incentive mechanism covers an allocation of general corporate overheads.

- In GD17, payments under the OO incentive mechanism were restricted if a GDN underperformed the annual connection target by more than 50%. In these circumstances, the incentive rate was reduced to 25% of the determined value.

- The mechanism does not define or prescribe the investment GDNs make in AMD or the type of activities they undertake. GDNs are incentivised to identify efficient and effective means of promoting connections. Both the GDNs and consumers benefit when GDNs out-perform their connection targets. Lower more efficient costs revealed in one price control can be captured in subsequent price controls.

2.2 The resulting OO connection incentive rates for the last year of GD17 is included in Table 2.1. The data is presented in 2020 prices. The estimated revenue for 2022 is based on the GDNs' estimated number of OO connections in 2022. The figures are presented in the relevant price base of each company. Figures for FE and PNGL are adjusted for the GD17 frontier shift. An estimate of the revenue which would be generated through the incentive mechanism is provided based on the estimates of the number of OO connections in 2022 included in the GDN's Business Plans.

	Economic incentive rate £ per property	New Areas Allowance rate £ per property	Connection incentive rate £ per property	Non-additionality	Estimate of 2022 connections £m	Estimate of 2022 connection incentive revenue £m
FE	457	163	620	25%	3961	1.84
PNGL	459	66	524	33%	4700	2.00
SGN	512	637	1150	0%	811	0.93

Note 1: All costs are in 2020 price consistent with the relevant GDN price base.

Table 2.1: GD17 OO connection incentive rates and estimated revenue for 2022

2.3 Since the GDNs made their Business Plan Submissions in June 2021, there has been a material change in economic circumstances with an increase in energy bills and wider inflationary pressure. The GDNs have experienced a reduction in OO connections and do not expect to achieve the level of connections in Table 2.1 and some might fall below 50% of target connections which will trigger a reduction in the incentive rate to 25% of the determined value with further loss of revenue.

3. GDN views on the OO incentive mechanism

3.1 In addition to setting out their plans for OO AMD in GD23 we asked the GDNs to provide feedback on the OO connection mechanism under three broad headings:

- The approach and activities used to develop connections;
- The relationship between expenditure and the number of connections delivered; and
- The structure of the connection incentive and the incentive values.

3.2 Each GDN provided a substantive response to the questions posed. We have provided a brief synopsis of those responses below.

The approach and activities used to develop connections

3.3 We asked each GDN to describe the approach and activities used to acquire OO connections. The GDNs provided information on the wide range of work undertaken to promote OO connections including marketing and advertising supported by survey work and analysis of consumer feedback to understand consumer awareness, attitudes to gas and barriers to uptake. The GDNs demonstrated how a range of channels and techniques had been used for marketing and set out how these had developed over time to target specific audiences and issues. The submissions demonstrated the thought and effort which had gone into the development of structured and targeted marketing to promote OO connections.

The relationship between expenditure and the number of connections delivered

3.4 We asked each GDN to set out their understanding of the relationship between expenditure on AMD and the number of connections delivered. The GDNs generally considered that current levels of expenditure on OO AMD were optimal and that any reduction in expenditure would be detrimental to the number of connections delivered. The GDNs went on to propose either maintaining or increasing the level of investment in AMD in GD23. However, GDNs were generally unable to provide quantitative evidence on how varying the level of investment in AMD generally or on individual activities would increase or decrease the number of connections delivered over GD23. Continued investment in AMD at the same or higher levels than in GD17 was considered essential to maintain awareness of gas to ensure that it remained front of mind when consumers were considering changing their heating system.

The structure of the connection incentive and the incentive values.

3.5 As part of their submission each GDN provided feedback on the methodology we had used to calculate the economic incentive rate for GD17. A number of common themes were drawn out in these responses:

- GDNs suggested that that the 15 year limit applied when assessing the benefit of additional revenues for each connection was not justified. Longer durations were suggested such as 20 years (consistent with the life of a meter) or 40 years (consistent with the depreciation period of the mains). The value of the incentive rate is sensitive to the duration of the analysis with longer durations leading to a higher incentive rate.

- GDNs disagreed with the application of non-additionality in the connection incentive, arguing that the incentive rate should be applied to all connections. They noted that all properties which connect will have been exposed to AMD at some stage and are likely to have been influenced by it.

- FE challenged the deduction of a contribution for existing mains. The company argued that as no material expansion of the network is planned, most connections will be made to existing mains and the cost of mains has become a sunk cost.

- PNGL challenged the allocation of an element of corporate overheads to AMD expenditure, arguing that these costs are fixed and should not be attached to a variable incentive mechanism. The company also argued that most AMD expenditure was fixed and suggested that only direct incentive payments to consumers was truly variable in proportion to the number of connections made.

- SGN suggested that the cap and collar mechanism should be removed because it could unduly penalise GDNs which failed to deliver 50% of their connection targets due to external factors. This was informed in part by the company's experience in GD17 where delays to the completion of High Pressure mains under the Gas to the West High Pressure license limited SGN's ability to make connections during the early stages of GD17.

4. UR Decisions for GD23

UR proposals at the GD23 draft determination

4.1 In the draft determination we noted the increases in expenditure per property proposed by the GDNs in their Business Plan submissions to promote and secure OO connections. We recognised that this was the result of proposals to maintain or increase costs at a time when numbers of connections delivered either peaked or began to decline. Our draft determination proposed moving to a Cost-to-Serve model for OO connections which provided only minimal allowances for promoting connections while funding the GDNs to respond to connection requests as they arose.

4.2 The draft determination made no allowance for incentives to promote Non-OO connections. Allowances were provided to process and secure Non-OO connections based on a review and challenge of historical costs.

4.3 In GD23 draft determination we made the decision to continue to fund GDNs to make new connections so that consumers generally do not pay for these connections at the time they are made. The costs of new connections will continue to be recovered through revenues from all consumers over the long term, although this may be considered separately in the future, where customers may be required to make some form of financial contribution to have a connection.

Review of an economic rate for OO connections

4.4 A key part of our assessment the funding allowed to promote and secure OO connections is whether the connections are economic. This approach was used to underpin the connection incentive mechanism in GD17 and the calculation of the economic rate has been updated for GD23. This calculation has been updated for the final determination as shown on Table 4.1.

		GD17	GD23
Domestic consumption	therms/yr	380	416
Recovery period	years	15	15
Conveyance tariff	p/therm	46	49
Rate of return (Post GD23 5.45%)	%	4	4.39
NPV of revenue	£	2,105	2,160
NPV of additional opex including maintenance	£	not used	(207)
Domestic service value	£	(1,012)	(1,185)
Domestic meter value	£	(228)	(206)
Infill reduction	£	(387)	0
Economic rate for promoting OO connections	£	478	570
Connection incentive rate at 2022 post frontier shift	£	459	

Note 1: All costs are in 2020 prices.

Table 4.1: Calculation of an economic rate for promoting OO connections

4.5 In calculating the economic rate for promoting and securing OO connections we have:

a) Used values for consumption, tariff and rate of return which are consistent with the GD23 final determination. The rate of return used is the average of the pre-tax WACC for FE and PNGL. Consumption has been adjusted to reflect both long term energy efficiency and reductions in short term consumption due to current economic circumstances.

b) Continued to apply a 15 year limit when assessing the benefit of additional revenues for each connection. We recognise that the value of the incentive rate is sensitive to the duration of the analysis with longer durations leading to a higher incentive rate and note that GDNs reiterated this in their response to the draft determination. However, we consider this an appropriate limit which shares the benefit of additional connections between funding the cost of marketing and reducing tariffs for all consumers.

c) Continued to include additional opex and maintenance costs for each connection. The costs cover business rates, battery replacement costs and meter service costs.

d) Deducted the cost of new service and meter. The rates for these items reflect the determined rates subject to the capex frontier shift which includes an uplift in excess of inflation for 2022 costs.

e) Removed the ‘infill reduction’ having considered feedback from the GDNs that this should be treated as a sunk cost.

4.6 When we compare the proposed and determined allowances for each GDN with the economic rate of £570 per connection in the subsequent sections of this Annex, we make two further adjustments to the average cost per connection:

a) We add an allowance for general overhead costs. We have estimated this as 50% of the allocation of general overheads to OO connections following the methodology adopted for GD17. We consider this a reasonable balance between allowing 100% overhead allocation and assuming that all overheads are fixed irrespective of activity.

b) We have continued to adjust for non-additionality. Non-additionality allows for the fact that a proportion of the benefit of a planned expenditure could be delivered if the expenditure was not made. In line with the rates for GD17 we have allowed non-additionality rates of 25%, 33% and 0% for FE, PNGL and SGN respectively.

Overall approach to OO allowances for GD23

4.7 Following consideration of the response to the draft determination we have reviewed the additional information provided and acknowledge the value of increased advertising and marketing compared to the allowance provided within the DD. However, we also recognise that the level of expenditure proposed by the GDNs would exceed our assessment of an economic rate for promoting OO connections. We have therefore considered and adjusted the costs proposed by each GDN as described in the next three sections of this Annex.

4.8 While we have reviewed and increased the allowance for promoting and securing OO connections from the draft determination, we have maintained key changes to the structure of funding introduced when we considered a Cost-to Serve mechanism. In particular:

a) Funding for OO connections no longer includes any element of general overheads with overhead costs included elsewhere in the final determination under relevant cost categories.

b) Non-additionality has not been applied in the funding mechanism.

c) The funding mechanism includes an element of fixed and variable costs. 40% of the determined costs have been funded as a fixed sum. The remaining costs are funded as a variable unit rate per connection, with funding adjusted through the Uncertainty Mechanism for the number of connections delivered. While this weakens the overall incentive, it allows the companies to plan activities and maintain consumer awareness through periods of uncertainty such as those of the recent past.

4.9 We have discontinued the cap and collar mechanism which formed part of the GD17 funding mechanism.

5. FE - Promoting OO Connections

FE's proposals

5.1 In GD17, an element of general overheads was recovered through the OO connection incentive. In the final determination for GD23, these general overhead costs have been excluded from the allowances for promoting OO connections and included in the relevant opex categories. In this Annex, the company's proposals and determination of allowance for promoting OO connections are stated excluding general overheads and pre-capitalisation.

5.2 The company's proposed expenditure was based on delivering 20,740 OO connections in the GD23 period. As described in Annex C, we have reduced the planned number of connections delivered in the first two years of GD23 to reflect a reduction in connections delivered in 2022, which has been attributed to general economic conditions, including increases in gas prices. The number of connections proposed by FE and the number determined are shown in Table 5.1 below.

P1 - Owner Occupied domestic	2023	2024	2025	2026	2027	2028	GD23 Total
Connections proposed by FE	3,852	3,685	3,524	3,371	3,224	3,084	20,740
Determined OO connections	2,000	2,750	3,524	3,371	3,224	3,084	17,953

Table 5.1: FE additional Owner Occupied domestic connections in GD23

5.3 FE's proposals for expenditure in the GD23 period are shown in Table 5.2 below. This expenditure relates to the number of connections proposed by the company.

	2023	2024	2025	2026	2027	2028	GD23 Total
Staff costs (£k)	555	560	565	570	574	579	3,403
Other costs (£k)	30	30	30	30	30	30	182
Advertising and Marketing (£k)	898	874	948	907	867	829	5,322
Incentives (£k)	484	448	404	358	316	276	2,286
Total (£k)	1,967	1,913	1,947	1,864	1,788	1,715	11,194

Note 1. £k, Av2020 prices

Table 5.2: FE - proposed expenditure for promoting OO connections GD23

FE expenditure 2017-2020

5.4 The company's proposals are generally in line with actual expenditure per connection in the first four years (2017 to 2020) of GD17 as shown in Table 6.3 below.

	2017	2018	2019	2020	Total
Staff costs (£k)	441	486	505	530	1,962
Other costs (£k)	49	23	22	25	120
Advertising and Marketing (£k)	480	600	580	494	2,154
Incentives (£k)	282	266	412	326	1,286
Total (£k)	1,252	1,376	1,519	1,374	5,522
Connections delivered (nr)	2,224	2,395	3,115	2,604	10,338

Note 1. £k, Av2020 prices

Table 5.3: FE expenditure promoting OO connections 2017 to 2020

5.5 Expenditure on promoting and securing OO connections in the period 2017 to 2020 averaged £534 per connection excluding general overheads and pre-capitalisation. The average expenditure proposed by the company for GD23 has increased to £611 per connection, an increase of 14% (at determined connection numbers). The main driver for the increase in expenditure per connection is a proposed increase in the advertising and marketing budget.

Determination of expenditure to promote and secure OO connections in GD23

5.6 There are two issues to consider when determining expenditure necessary to promote and secure OO connections:

a) The first is that expenditure should be no more than necessary.

b) The second is that expenditure should be less than the economic benefit delivered as set out in our economic test.

5.7 In respect of the first test, we note that:

a) The company proposed to increase expenditure on promoting and securing connections in GD23 by 32% compared to the first four years of GD17. This increase in cost is off-set by an equivalent increase in the proposed number of connections delivered.

b) The cost per connection delivered in GD23 is 60% more than that proposed by PNGL.

c) The company has not been able to provide information which shows how the number of connections secured varies with the level of expenditure proposed. As a result, it is not possible to demonstrate that expenditure has been optimised, other than noting the level of recent expenditure.

5.8 In the absence of further information we have reviewed the expenditure proposed by the company and we consider the following to be reasonable adjustments in light of the declining number of connections.

Annual average expenditure and connections	GD17 2017-2020	FE proposed	UR Adjusted
Staff costs (£k)	490	567	478
Other costs (£k)	30	30	30
Advertising and Marketing (£k)	539	850	632
Incentives (£k)	321	381	330
Total (£k)	1,380	1,829	1,471
Connections delivered / determined (nr)	2,585	2,992	2,992
Cost per connection (£ each)	534	611	492

Note 1. £k, Av2020 prices
Note 2: The average annual number of connections proposed by FE was 3457

Table 5.4: FE - adjusted expenditure for promoting OO connections GD23

5.9 These adjustment were based on the following:

a) The company proposed staff costs for GD23 averaging £490k per annum to deliver an average of 3,457 connections per annum (£164/connection). In the first four years of GD17, PNGL delivered an average of 5,321 connections per annum with an average staff cost of £470k per annum. For GD23, our determination for PNGL on a staff cost equates to £131 per connection. In view of the material difference in cost per connection, we conclude that there is scope for FE to deliver more efficiently. For GD23, we have based our assessment of a staff cost per connection of £147, half way between the company's proposed cost and the PNGL cost.

b) 'Other' costs proposed by FE have been accepted.

c) The company has proposed a stepped increase in Advertising and Marketing costs from an annual average in 2017-2020 of £539k to an average in GD23 of £850k (58% increase). We recognise that advertising and marketing undertaken by the company in the first four years of GD17 did not deliver the target connections. We recognise that as the company completes the construction of infill mains it will lose the natural advantage that comes from increased visibility, although this will be off-set in part by an increase in the number of properties available to connect. We note that the level of marketing and advertising proposed by FE is almost twice that allowed in our assessment of PNGL's proposals for a similar number of connections delivered. In the absence of information on how connection numbers respond to advertising and marketing expenditure, it has not been possible to determine a rationale adjustment. We have therefore taken a cautious approach, allowing a 30% of the increase in Advertising and Marketing costs proposed by the company relative to the first four years of GD17.

d) Incentive payments have been reduced in proportion to the number of connections to reflect a reduction in activity.

5.10 In respect of the economic test:

a) The adjusted average expenditure per connection is £492 per connection for the determined number of connections.

b) The average allowance of £492 excludes shared overheads. An allowance for the recovery of shared overheads was recovered through the connection incentive in GD17. FE estimated an allocation of general overheads for GD23 by applying the same allocation methodology applied in GD17 to give an average allocation of £68 per connection. In GD17, the full allocation of shared overheads was recovered through the connection incentive. The company has allocated that these costs are fixed and none should be set against an economic assessment of the economic value of a connection. We have accepted this in part. For GD23 we have allowed 50% of the overhead cost (£34) against the economic allowance. The combined average cost, including overheads is £525 per connection.

c) In GD17 we included an adjustment for non-additionality in the OO connection incentive. Non-additionality reflects the level of output (in this case the number of connections) which would be delivered in the absence of the incentive scheme. In GD17 a non-additionality of 25% was applied and the connection incentive payment only applied when the company had delivered the first 25% of target connections. The average cost per connection of £525 (including an overhead allowance) is the equivalent of £701 per non-additional connection. This is in excess of our economic test of £570 per connection.

5.11 Our adjusted allowance for promoting and securing OO connections now exceeds the value of our economic test. We have accepted this for GD23, recognising the challenges the company has had in delivering connections in GD17 and the increased challenge of securing connections in GD23 as the company ceases the layout of infill mains.

5.12 As set out in Section 4 we concluded that 40% of the determined allowance for GD23 will be a fixed sum with the balance forming a variable amount linked to the number of connections delivered. The determined allowance for GD23 is therefore:

Estimated allowance (£)	1,470,761
Fixed allowance 40% (£)	588,304
Estimated variable allowance (£/a)	882,456
Determined OO connections per annum	2,992
Determined variable rate (£/connection)	294.92

Note 1. Avg 2020 prices

Table 5.5: FE - OO connection incentive - determined values

5.13 The determined allowances for FE are set out in Table 5.6.

	2023	2024	2025	2026	2027	2028	GD23 Total
Determined connections	2,000	2,750	3,524	3,371	3,224	3,084	17,953
Fixed allowance (£k)	588	588	588	588	588	588	3,530
Variable rate (£/connection)	294.92	294.92	294.92	294.92	294.92	294.92	
Variable allowance (£k)	590	811	1,039	994	951	910	5,295
Total allowance (£k)	1,178	1,399	1,628	1,582	1,539	1,498	8,825

Note 1. £k, A2020 prices

Table 5.6: FE - Advertising & Market Development (Owner Occupied) Costs, Allowed, £k

5.14 While our determination is based in part on a consideration of individual components, it is for the company to decide on the best balance and profile of expenditure to optimise the delivery of connections.

6. PNGL - Promoting OO Connections

PNGL's proposals

6.1 In GD17, an element of general overheads were recovered through the OO connection incentive. In the final determination for GD23, these general overhead costs have been excluded from the allowances for promoting OO connections and included in the relevant opex categories. In this Annex, the company's proposals and determination of allowance for promoting OO connections are stated excluding general overheads and pre capitalisation.

6.2 The company's proposed expenditure was based on delivering 22,918 OO connections in the GD23 period. As described in Annex C, we have reduced the planned number of connections delivered in the first two years of GD23 to reflect a reduction in connections delivered in 2022 which has been attributed to general economic conditions including increases in gas prices. The number of connections proposed by PNGL and the number determined are shown in Table 6.1 below.

P1 - Owner Occupied domestic	2023	2024	2025	2026	2027	2028	GD23 Total
Connections proposed by PNGL	4,522	4,159	3,727	3,612	3,502	3,396	22,918
Determined OO connections	3,000	3,400	3,727	3,612	3,502	3,396	20,637

Table 6.1: PNGL additional Owner Occupied domestic connections in GD23

6.3 PNGL's proposals for expenditure in the GD23 period is shown in Table 6.2 below.

	2023	2024	2025	2026	2027	2028	GD23 Total
Staff costs (£k)	518	518	518	478	478	478	2,987
Other costs (£k)	58	56	53	52	51	51	320
Advertising and Marketing (£k)	480	480	480	480	480	480	2,883
Incentives (£k)	285	285	285	285	285	285	1,711
Total (£k)	1,341	1,339	1,336	1,296	1,295	1,294	7,901

Note 1. £k, Sep_2020 prices

Table 6.2: PNGL - proposed expenditure for promoting OO connections GD23

6.4 We understand the company would plan the same level of expenditure in GD23 notwithstanding the reduction in connection numbers in 2023 and 2024.

PNGL expenditure 2017-2020

6.5 The company's proposals are generally in line with actual expenditure per connection in the first four years (2017 to 2020) of GD23, as shown in Table 6.3 below.

	2017	2018	2019	2020	Total
Staff costs (£k)	455	448	505	470	1,878
Other costs (£k)	72	60	49	48	230
Advertising and Marketing (£k)	675	534	481	464	2,155
Incentives (£k)	279	300	302	261	1,142
Total (£k)	1,481	1,342	1,338	1,243	5,405
Connections delivered (nr)	4,993	5,493	5,719	5,080	21,285

Note 1. £k, Sep_2020 prices

Table 6.3: PNGL expenditure promoting OO connections 2017 to 2020

6.6 Expenditure on promoting and securing OO connections in the period 2017 to 2020 averaged £254 per connection excluding general overheads and pre-capitalisation. The average expenditure proposed by the company for GD23 has increased to £383 per connection, an increase of 51% due to the reduction in the number of connections. This trend in reducing connections is expected to continue beyond GD23 and, if expenditure does not reduce, the cost per connection will continue to rise.

Determination of expenditure to promote and secure OO connections in GD23

6.7 There are two issues to consider when determining expenditure necessary to promote and secure OO connections:

a) The first is that expenditure should be no more than necessary.

b) The second is that expenditure should be less than the economic benefit delivered as set out in our economic test.

6.8 In respect of the first test, we note that:

a) The company proposed that expenditure on promoting and securing connections in GD23 should remain the same as in the first four years of GD17 despite a reduction of 35% in the number of connections delivered. This implies that the cost of promoting and securing connections is fixed (and might imply that it remains fixed) as the rate of connections continues to decline.

b) The company has not been able to provide information which shows how the number of connections secured varies with the level of expenditure proposed. As a result, it is not possible to demonstrate that expenditure has been optimised, other than noting the level of recent expenditure.

6.9 In the absence of further information, we have reviewed the expenditure proposed by the company and we consider the following to be reasonable adjustments in light of the declining number of connections.

Annual average expenditure and connections	GD17 2017-2020	PNGL proposed	UR Adjusted
Staff costs (£k)	470	498	450
Other costs (£k)	57	53	29
Advertising and Marketing (£k)	539	480	432
Incentives (£k)	285	285	185
Total (£k)	1,351	1,317	1,096
Connections delivered / determined (nr)	5,321	3,440	3,440
Cost per connection (£ each)	254	383	319

Note 1. £k, Sep _2020 prices

Table 6.4: PNGL - adjusted expenditure for promoting OO connections GD23

6.10 These adjustment were based on the following assessment:

a) Average staff costs in the period 2017 to 2020 were £470k per annum. We have concluded that there is no reason for this to increase when numbers of connections delivered are declining. From 2026 we have reduced the cost of staff by £40k per annum to reflect reductions proposed by the company at that stage.

b) Stationery costs have been reduced proportion to the number of connections to reflect a reduction in activity.

c) Advertising and Marketing costs have been reduced by 10%. In the absence of information on how connection numbers respond to advertising and marketing expenditure, it has not been possible to determine a rationale adjustment. We have therefore taken a cautious approach, applying an adjustment which is materially less than the reduction in connections.

d) Incentive payments have been reduced in proportion to the number of connections to reflect a reduction in activity.

6.11 In respect of the economic test:

a) The adjusted average expenditure per connection is £319 per connection for the determined number of connections.

b) The average allowance of £319 excludes shared overheads. An allowance for the recovery of shared overheads was recovered through the connection incentive in GD17. PNGL estimated an allocation of general overheads for GD23 by applying the same allocation methodology applied in GD17 which provides an average allocation of £106 per connection. In GD17, the full allocation of shared overheads was recovered through the connection incentive. The company has allocated that these costs are fixed and none should be set against an economic assessment of the economic value of a connection. We have accepted this in part. For GD23 we have allowed 50% of the overhead cost (£53) against the economic allowance. The combined average cost, including overheads is £372 per connection.

c) In GD17 we included an adjustment for non-additionality in the OO connection incentive. Non-additionality reflects the level of output (in this case the number of connections) which would be delivered in the absence of the incentive scheme. In GD17 a non-additionality of 33% was applied and the connection incentive payment only applied when the company had delivered the first 33% of target connections. The average cost per connection of £372 (including an overhead allowance) is the equivalent of £555 per non-additional connection. This remains within the limit of our economic test of £570 per connection.

6.12 We conclude that the adjusted allowance for promoting and securing OO connections in GD23 is both reasonable and falls within our economic test.

6.13 As set out in Section 4 we have determined that 40% of the determined allowance for GD23 will be a fixed sum with the balance as forming a variable amount linked to the number of connections delivered. The determined allowance for GD23 is therefore:

Estimated allowance (£/a)	1,096,244
Fixed allowance 40% (£)	438,497
Estimated variable allowance (£/a)	657,746
Determined OO connections per annum	3,440
Determined variable rate (£/connection)	191.23

Note 1. Sep_2020 prices

Table 6.5: PNGL - OO connection incentive - determined values

6.14 The determined allowances for PNGL are set out in Table 6.6.

	2023	2024	2025	2026	2027	2028	GD23 Total
Determined connections	3,000	3,400	3,727	3,612	3,502	3,396	20,637
Fixed allowance (£k)	438	438	438	438	438	438	2,631
Variable rate (£/connection)	191.23	191.23	191.23	191.23	191.23	191.23	
Variable allowance (£k)	574	650	713	691	670	649	3,946
Total allowance (£k)	1,012	1,089	1,151	1,129	1,108	1,088	6,577

Note 1. £k, Sep_2020 prices

Table 6.6: PNGL - Advertising & Market Development (Owner Occupied) Costs, Allowed, £k

6.15 While our determination is based in part on a consideration of individual components, it is for the company to decide on the best balance and profile of expenditure to optimise the delivery of connections.

7. SGN - Promoting OO Connections

SGN's proposals

7.1 In this Annex, the company's proposals and determination of allowance for promoting OO connections are stated, excluding general overheads and pre-capitalisation.

7.2 The company's proposed expenditure was based on delivering 3,750 OO connections in the GD23 period. As described in Annex C, we have reduced the planned number of connections delivered in the first two years of GD23 to reflect a reduction in connections delivered in 2022 which has been attributed to general economic conditions including increases in gas prices. The number of connections proposed by SGN and the number determined are shown in Table 7.1 below.

P1 - Owner Occupied domestic	2023	2024	2025	2026	2027	2028	GD23 Total
Connections proposed by SGN	623	593	599	652	643	640	3,750
Determined OO connections	200	364	529	565	544	562	2,765

Table 7.1: SGN additional Owner Occupied domestic connections in GD23

7.3 SGN's proposals for expenditure in the GD23 period are shown in Table 7.2 below.

	2023	2024	2025	2026	2027	2028	GD23 Total
Staff costs (£k)	309	309	318	318	320	320	1,894
Other costs (£k)	0	0	0	0	0	0	0
Advertising and Marketing (£k)	669	644	649	693	686	683	4,023
Incentives (£k)	312	297	300	326	322	320	1,875
Total (£k)	1,290	1,250	1,267	1,337	1,327	1,323	7,792

Note 1. £k, Av2020 prices

Table 7.2: SGN - proposed expenditure for promoting OO connections GD23

7.4 When considering its proposals, the company prepared an economic assessment of investment to secure OO connections. This included an economic assessment of the benefits of each connection, allocating most of the benefit of each connection over the full revenue recovery period to investing in securing the connection. The company asked for a continuation of a proportion of the additional New Areas Allowance applied in GD17. The company also identified a further allowance for costs it considered to be fixed and which it excluded from its economic assessment. The build-up of cost per connection proposed by the company for Advertising & Market Development (Owner Occupied) Costs is shown on Table 7.3 below.

Economic benefit test (£/connection)	1,134
Additional "New Areas" allowance (£/connection)	189
Fixed costs in addition to the above (£/connection)	755
Total cost per connection (£/connection)	2,078
Planned connections (nr)	3,750
Expenditure (£k)	7,792

Note 1. Av2020 prices

Table 7.3: SGN's economic test of its proposals

7.5 In its own assessment for a connection incentive, the company only counted Sales Representatives in staff costs against the OO connection incentive and excluded costs for a range of other staff involved in promoting and securing OO connections averaging 3.8 FTEs across the GD23 period.

SGN expenditure 2017-2020

	2017	2018	2019	2020	Total
Staff costs (£k)	47	82	123	183	435
Other costs (£k)	0	0	0	0	0
Advertising and Marketing (£k)	29	66	133	429	657
Incentives (£k)	2	38	19	243	301
Total (£k)	78	186	275	855	1,394
Connections delivered (nr)	3	127	82	593	805

Note 1. £k, Av2020 prices

Table 7.4: SGN expenditure promoting OO connections 2017 to 2020

Determination of expenditure to promote and secure OO connections in GD23

7.6 In principle, we consider two issues to consider when determining expenditure necessary to promote and secure OO connections:

a) The first is that expenditure should be no more than necessary.

b) The second is that expenditure should be less than the economic benefit delivered as set out in our economic test.

7.7 In the case of SGN, we have set aside consideration of the economic test for the following reasons:

a) SGN has only begun delivering Gas to the West. In the early stages of development, there is a need to build consumer awareness of gas and ensure that it is considered as an option when consumers have the opportunity to install gas.

b) In GD17 we allowed SGN a connection incentive rate greater than the economic allowance (through a New Areas allowance) to provide an opportunity to build awareness. However, delays to the completion of the Gas to the West high pressure pipelines, followed by COVID-19, followed by increased gas prices have all limited the opportunity for SGN to take advantage of these higher allowances to build awareness in GD17.

7.8 We sought and received further information from SGN underpinning staff costs and how it had assessed the costs of advertising and marketing. In light of this information, and the gap between the company's assessment of cost per connection and our economic test, we have reviewed the expenditure proposed by the company and we consider the following to be reasonable adjustments for the GD23 period.

Annual average expenditure and connections	GD17 2017-2020	SGN proposed	UR Adjusted
Staff costs (£k)	109	316	276
Other costs (£k)	0	0	0
Advertising and Marketing (£k)	164	671	336
Incentives (£k)	75	313	161
Total (£k)	348	1,299	773
Connections delivered / determined (nr)	201	625	461
Cost per connection (£ each)	1,731	2,078	1,678

Note 1. £k, Av2020 prices

Table 7.5: SGN - adjusted expenditure for promoting OO connections GD23

7.9 These adjustments were based on the following assessment:

a) The number of staff was reduced to reflect a 26% reduction in the number of connections delivered.

b) We have accepted the company's assessment of other costs.

c) The company provided information on monthly advertising and marketing expenditure and OO connections up to December 2020 as the basis of its assessment for GD23. This indicated average expenditure per connection delivered of £1,087 and formed the basis of the company's assessment of expenditure for GD23. However, we note that this included data for 2017, 2018 and 2019 when opportunities were limited by the delayed commissioning of the high pressure pipeline and the development of the distribution network. In 2020 the cost of marketing and development was £846 per connection delivered. If the months of April and May 2020 are excluded on the basis that COVID-19 lockdown not only limited the delivery of connections but also the impact of marketing and advertising, the average cost per connection delivered falls to £798. We expect the effectiveness of marketing and advertising to continue to increase over time as brand awareness grows and the layout of distribution mains are completed increasing the potential connections in the area. We have therefore assumed that the rate per connection in 2023 should be 80% of the 2020 rate and this should decline to 55% by 2028. We have applied these unit costs to the company's planned number of connections (3,750) to arrive at an allowance for GD23.

d) We note that the incentive payments proposed by the company are materially higher than those currently allowed by PNGL and FE. In light of the high cost per connection (which exceeds the economic allowance), we have adjusted the level of incentive payments downwards.

Estimated allowance (£/a)	772,885
Fixed allowance 40% (£)	309,154
Estimated variable allowance (£/a)	463,731
Determined OO connections per annum	461
Determined variable rate (£/connection)	1,006.25

Note 1. Av2020 prices

Table 7.6: SGN - OO connection incentive - determined values

7.10 We note that the variable rate remains close to the full connection incentive rate for 2022 and provide a strong incentive for the company to increase expenditure if it believes that this will secure additional connections.

7.11 The determined allowances for SGN are set out in Table 7.7.

	2023	2024	2025	2026	2027	2028	GD23 Total
Determined connections	200	364	529	565	544	562	2,765
Fixed allowance (£k)	309	309	309	309	309	309	1,855
Variable rate (£/connection)	1,006	1,006	1,006	1,006	1,006	1,006	
Variable allowance (£k)	201	367	532	569	548	566	2,782
Total allowance (£k)	510	676	841	878	857	875	4,637

Note 1. £k, Av2020 prices

Table 7.7: SGN - Advertising & Market Development (Owner Occupied) Costs, Allowed, £k

7.12 While our determination is based in part on a consideration of individual components, it is for the company to decide on the best balance and profile of expenditure to optimise the delivery of connections.

8. SGN Non-OO connection incentive

8.1 In its Business Plan, SGN included an allowance for incentive payments to promote small/medium industrial and commercial (I&C) connections. These incentive payments were in addition to the cost of staff working to deliver and support Non-OO connections. The incentive rates proposed by the company were £679 for IC1 (small connections) and £3,365 for IC2 (medium connections). The estimated cost of this incentive scheme over the GD23 period was £1,302k.

8.2 The company provided an economic assessment to justify the connection incentive rate based on a declining share of the net revenue from a new connection over a 10 year period.

8.3 In the draft determination, we excluded any incentive payments for Non-OO connection incentives on the basis that SGN had made no provision for such incentives when it submitted its application for the Gas to the West distribution licence in 2014.

8.4 For the final determination, we have:

a) Noted the low rate of connections of small I&C properties in the SGN area to date. It is clear that SGN has been unable to secure small and medium I&C connections at the rate initially envisaged for Gas to the West.

b) Noted the impact that changing economic circumstances might have on the ability to promote gas.

c) Noted that the incentive rates proposed by SGN still leaves a reasonable net additional revenue from each additional connection which will reduce costs for all consumers.

d) Noted that other GDNs were allowed costs to promote I&C in the early stages of development. These were subsequently removed as the network matured.

e) Noted that the company has not been able to demonstrate the marginal impact of different levels of incentive rate on the number of connections delivered.

8.5 Based on the information available to us, we have concluded that it is appropriate to make provision for an incentive to support the promotion of small/medium I&C connections by SGN in GD23. We have set these incentive rates at £600 for IC1 (small connections) and £3,000 for IC2 (medium connections). The allowance included in the final determination for these incentives, based on the connection numbers outlined in Annex C, is shown in Table 8.1 below. These allowances will be adjusted through the Uncertainty Mechanism on the basis of the actual number of relevant connections delivered.

8.6 Further details of how this will work is contained with Annex D, under AMD (NON OO) as well as the duration of this incentive.

	2023	2024	2025	2026	2027	2028	Total
IC1 connections	16	32	48	92	82	77	347
IC2 connections	11	23	34	59	55	53	235
	2023	**2024**	**2025**	**2026**	**2027**	**2028**	**Total**
IC1 connection incentive £k	10	19	29	55	49	46	208
IC2 connection incentive £k	33	69	102	177	165	159	705
Non-OO connection incentive total	43	88	131	232	214	205	913

Table 8.1: SGN - Non-OO connection incentives