Price Control for Northern Ireland's Gas Transmission Networks GT17

Proposed Approach

30 June 2016



About the Utility Regulator

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

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

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

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

Our Mission	Value and sustainability in energy and water.
Our Vision	We will make a difference for consumers by listening, innovating and leading.

Our Values

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

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

This paper sets out our approach to GT17, the price control review for the four gas conveyance licence holders in Northern Ireland who operate high pressure pipeline networks. This price control period will commence on 1 October 2017. This approach document sets out a package of measures that will facilitate the continued development of an efficient gas industry in Northern Ireland.

The key decision for the price control will be determining an efficient level of costs for the gas transmission companies to fund their licensed activities.

Audience

Industry, consumers and statutory bodies.

Consumer Impact

Transmission charges make up around 10% of a typical domestic customer's final bill. The price control approach detailed in this document will set out the basis on which we propose to determine the efficient level of expenditure that the transmission companies will recover through the Northern Ireland Postalised Transmission Tariff.

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1 Introduction

Purpose of the Document

1.1 The purpose of this document is to set out our high level approach to the next price control review for the four high pressure gas networks in Northern Ireland, GT17. The four gas conveyance licence holders covered by this price control are:

- GNI (UK) is a subsidiary of Ervia, a utility infrastructure company owned by the government of the Republic of Ireland. GNI (UK) is subject to a traditional 'revenue cap' incentive framework.
- Premier Transmission Limited (PTL), Belfast Gas Transmission Limited (BGTL) and West Transmission Limited (WTL)[1] are all part of the Mutual Energy Group. These companies are all subject to a 'mutualised' model in which Northern Ireland gas consumers absorb deviations between forecast and actual operating costs in return for an absence of equity funding / returns from the business.

Background to GT17

Operating Expenditure

1.2 This price control review will determine an efficient level of operating cost for the review period commencing on 1 October 2017. However the potential impact of these allowances on the licence holder will vary depending on whether they operate a 'revenue cap' or a 'mutualised' model.

1.3 In the case of GNI (UK), the allowance represents a fixed amount the licence holder will recover from consumers. Any variation between this allowance and actual operating expenditure is absorbed by the licence holder. In this instance the consumer is exposed to no operating cost risk, instead this risk is borne entirely by the shareholders of the

[1] WTL is licensed under the name of Northern Ireland Energy Holdings

licence holder and is reflected in the rate of return. This provides the licence holder with a very clear incentive to effectively manage operating expenditure.

1.4 In the case of the Mutual Energy Group of licence holders the allowance represents merely a forecast of future outcomes. Actual allowances that the licence holder will recover from consumers will vary with actual expenditure. The licence holders, in this case PTL, BGTL and WTL, is exposed to none of the potential operating expenditure risk, instead this risk is borne entirely by the Northern Ireland gas consumer. We however continue to determine an efficient level of operating costs as if a 'revenue cap' was in place during what has previously been described as a 'shadow' price control. The licence holder then has a reputational incentive to manage costs effectively in line with the determined 'shadow' allowance. In addition, management incentives may be set to align with these allowances again as a means of effective operating cost control. Performance against the 'shadow' allowances also provides the Utility Regulator (UR) with a metric to judge whether existing licence conditions continue to facilitate our statutory duties.

Capital Expenditure

1.5 The price control process does not set allowances for capital expenditure. Two of the licence holders (PTL and BGTL), purchased existing assets, the Scotland Northern Ireland Pipeline and Belfast Gas Transmission Pipeline respectively, and are therefore not required to fund capital formation. In the case of the other two licence holders; GNI (UK) which built both the North West and South North Pipelines along with their associated spurs, and WTL which will build the Gas to the West network; capital allowances are set in accordance with a completely separate methodology outside the price control process. The GNI (UK) network was completed in 2012 and the process of setting capital allowances for this network is almost complete. On the other hand WTL is in the early stages of developing the Gas to the West Network and so capital allowances will not be finalised for a number of years.

Rate of Return

1.6 As with operating and capital expenditure the cost of capital has a different treatment depending on the particular licence holder. In the case of both GNI (UK) and WTL we are required to review the rate of return on capital at each review. In the case of the former the licence has been modified since the previous price control review such that the UR is better able to align the allowance with prevailing market conditions. In the case of the later, the allowance for the price control period commencing on 1 October 2017 will align with the output from the competitive licence award process which awarded WTL the licence.

1.7 For the other two licence holders (PTL and BGTL), rate of return on capital is excluded from the price control review process. Both these licence holders are entirely funded by debt finance in the form of a long term bond. The repayments on this bond including principle and interest will be made in accordance with a predetermined schedule that has been previously agreed by the Utility Regulator. There is therefore no provision in either of these licences to review the rate of return.

Single System Operation

1.8 A significant development in the Northern Ireland regulatory regime will be establishment of a single system operator for Northern Ireland on 1 October 2017. This will be a contractual joint venture (CJV) between the licence holders rather than a separate legal entity. Its operations will therefore continue to be funded through the existing licences. However we will require the licence holders to supply a single agreed joint submission for the allowances necessary to fund this activity. Our proposed approach to establishing an allowance for activities related to single system operation is set out in section 2.

1.9 The creation of a single system operator for Northern Ireland also means we need to consider other changes to the existing high pressure conveyance licences that need to be modified. In the first instance it would seem sensible to align the duration of the price control review period across the four licences, such that the length of this review period would not be predetermined but would be determined at each preceding review date.

We will bring forward licence modifications to align the duration of the price control review period after the draft determination is published (see Table 2).

Regulatory Instructions and Guidance

1.10 We will also consider that it is necessary to introduce for the first time a set of Regulatory Instructions and Guidance (RIGs) such that licence holders submit business plans and ongoing cost reporting data in accordance with a predetermined template. This will facilitate effective comparison of costs over time and between licence holders. It will also facilitate the monitoring of performance against the allowances determined by the price control review. We consider that the adoption of a RIGs approach may also need to be underpinned by licence conditions.

Summary

1.11 The table below summarises the above discussion and sets out for each licence holder the cost categories that will and will not be determined at this price control review as set out in the individual licences.

Table 1: Price Control Output by Licence Holder

<table>
<tr><th>Price Control Item</th><th>GNI (UK)</th><th>Premier Transmission</th><th>Belfast Gas Transmission</th><th>West Transmission</th></tr>
<tr><td>Controllable operating expenditure (non CJV)</td><td>Allowance fixed at review</td><td colspan="3">Allowance forecast at review but actual allowance matches actual costs</td></tr>
<tr><td>Controllable operating expenditure (CJV)</td><td>Allowance fixed at review</td><td colspan="3">Allowance forecast at review but actual allowance matches actual costs</td></tr>
<tr><td>Uncontrollable operating expenditure</td><td colspan="4">Allowance forecast at price control review but actual allowance matches actual costs</td></tr>
<tr><td>Weighted average cost of capital</td><td>Allowance fixed at review</td><td>Not applicable</td><td>Not applicable</td><td>Allowance fixed at review</td></tr>
</table>

Responding to this Document

1.12 We are keen to hear respondents views that we would intend to reflect in our formal consultation later in the year. Responses should be received by Friday 19th August 2016 and should be addressed to:

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Queens House
14 Queen Street
Belfast
BT1 6ED
Tel: 028 9031 6627

E-mail: roy.colville@uregni.gov.uk

1.13 The Utility Regulator's preference would be for responses to be submitted by e-mail.

1.14 Individual respondents may ask for their responses (in whole or in part) not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, the Utility Regulator will also ask respondents to supply the redacted version of the response that can be published.

1.15 As a public body and non-ministerial government department, the UR is required to comply with the Freedom of Information Act (FOIA). The effect of FOIA may be that certain recorded information contained in consultation responses is required to be put into the public domain. Hence it is now possible that all responses made to consultations will be discoverable under FOIA, even if respondents ask us to treat responses as confidential. It is therefore important that respondents take account of this and in particular, if asking the Utility Regulator to treat responses as confidential, respondents should specify why they consider the information in question should be treated as such.

1.16 This paper is available in alternative formats such as audio, Braille etc. If an alternative format is required, please contact the office of the Utility Regulator, which will be happy to assist.

Next Steps

1.17 We have set out the key milestones during the GT17 process below. We expect all parties to work towards these milestone dates and will update if there are any changes required.

Table 2: Key Milestones of GT17

Key Milestones of GT17 - Key Points	Proposed Date
Cost reporting format developed	April - June 2016
Publication of approach document	Late June 2016
Licence holders information submissions (Opex, Repex and Rate of Return)	Early September 2016
Publication of Draft Determination for consultation together with licence modifications	Early December 2016
Publication of Final Determination	Late April 2017
Postalised tariff setting for gas year 17/18	July 2017

2 Our Approach

General Approach

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

- Business plan templates along with the accompanying instructions have been developed with the assistance of the licence holders. The draft final version of each will be available from the end of June and licence holders will have until first week of September to populate the template. Any atypical costs and special factors should be identified separately in individual submissions.
- Areas of high expenditure will receive substantially more scrutiny and analysis than low value items, along with new additional operating expenditure where we shall expect to have presented the net impacts from such increases and any decrements.
- Benchmarking will be used where appropriate and a triangulated approach may 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.
- The price control will be based on a standard RPI-X framework, which will incentivise the licence holders to control their costs through the setting of efficiency targets and adjustment of allowances at subsequent price controls.
- Allowances will not be given for profit margins to any affiliated business to which contracts have been awarded.
- Allowances will not be given for contingency elements within budgets.

2.2 We will adopt a light touch approach if:

- There is evidence to show that the licence holder is comparatively efficient.
- Past costs are a strong indicator of future costs.

2.3 We will adopt a more detailed approach if:

- The licence holder is comparatively inefficient.
- Past costs are a weak indicator of future costs.
- Cost lines are increasing and are of a material nature.
- Data is available for more detailed statistical analysis i.e. benchmarking.

2.4 We would expect licence holders to provide the data necessary to support a robust assessment of expenditure and outputs. Where 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. We also propose to consider as part of our price control, where relevant and appropriate, best practice relating to other price controls and findings from our project to make network price controls more consistent, by adopting cross-utility approaches, principles and standards of regulation.

2.5 We will continue to ensure that the information we require from the licence holders is proportionate but sufficient to:

- Allow licence holders to communicate their business plans to us in a clear and effective manner.
- Ensure that we can submit the plans to effective and focused scrutiny.

2.6 For GT17 we will:

- Require the licence holders to submit their business plans in the format as provided, with sufficient historic information included. It will also include an explanation of the impact of these business plans presented in a way that can be understood by network users.
- Promote the working together that is already present within the gas industry and seek further alignment between price control submissions and other processes.
- Consider whether further amendments to the format of our price control determination or other regulatory submissions are necessary to ensure clarity and reconciliation between them.
- Use appropriate methods to check and verify key information.

2.7 In support of the drive towards the provision of high quality robust submissions, we expect the licence holders to:

- Demonstrate that responsibility for the assurance of the data and plans submitted resides at board level.
- Provide reliable, consistent driver-based information with appropriate explanations of any changes in numbers or circumstances.
- Provide any information requested within the timelines specified.
- Be able to demonstrate that all costs are necessary to run an efficient well managed business.
- Demonstrate the basis of apportionment of costs shared between group and related parties.

Regulatory Instructions and Guidance

2.8 Each of the existing licences includes obligations on the licence holder to provide data to the UR in a way that will permit it to set allowances, and to monitor ongoing performance against those allowances. However these reporting conditions are not consistent across the various licences and are no longer regarded as being in accordance with best regulatory practice[2], for example there is no obligation on the licence holder to provide cost information in a pre–determined way approved by the UR or on a consistent basis over time or between licence holders.

2.9 As have other economic regulators, the UR has in recent years committed itself and the firms it regulates to annual cost reporting supported by specific licence conditions. For instance a common cost reporting template has been developed for gas distribution companies. This along with a standardised business plan submission has formed the basis for determinations made as part of the Gas Distribution Price Control 2017 (GD17).

2.10 Accordingly, in preparation for the Gas Transmission price control (GT17) we have been working with the four licence holders to develop a common cost reporting template and standardised business plan submission format. This work has progressed well and we will require all business plans to be submitted on the basis of the new format. The common cost reporting template is published for information alongside this document. We will continue to refine it as licence holders develop their business plans clarifications and as minor adjustments are required.

2.11 We will also require that actual costs from the period commencing 1 October 2012 to be reported to us using the new cost reporting format. Into the future we will require the annual cost reporting requirements of the licence to be met using the new cost reporting template.

[2] GNI (UK) Gas Conveyance Licence Condition 2.2.4 . PTL and BGTL Gas Conveyance Licence Condition 3.1.6 (b) and (c) - WTL Gas Conveyance Licence Condition 4.7.2 and 4.7.3

2.12 To give effect to these ongoing requirements we will modify the existing licences to include a new Regulatory Instructions and Guidance condition. This will be a new standard condition added to section one of the licence and will match that which is to be included in the conveyance licences of the distribution companies.

2.13 We consider that these Regulatory Instructions and Guidance will provide for:

- Consistent cost reporting that will facilitate the ongoing monitoring of performance against regulatory allowances.
- Standardised templates which will facilitate benchmarking where appropriate.
- Reporting templates signed off by senior management in the company.

Duration of the Price Control

2.14 At present the duration of the review period varies between licence holders. In the case of GNI (UK) the review period is defined[3] as being every fifth year commencing on 1 October 2007. The next review period will therefore commence on 1 October 2017.

2.15 In the case of PTL and BGTL the licence holder must submit a forecast of Controllable Operating Expenditure every third year for approval by the UR[4]. The next review period will therefore also commence on 1 October 2017. However, licence changes to the PTL and BGTL licences would be needed to align the duration of the shadow price control period to the same duration as the price control for GNI (UK). At present we are making the working assumption that the subsequent review date will be 1 October 2022.

2.16 We have discussed this with all four licence holders and they are content to provide forecast costs data up to 30 September 2022. However, we do not propose to pre determine the length of review period in the licence. Instead the formulation in the WTL

[3] GNI (UK) Gas Conveyance Licence Condition 2.2.19
[4] PTL and BGTL Gas Conveyance Licence Condition 3.1.6 (b)

licence[5] would seem preferable. It states that, the date of the subsequent price control review will be determined by the UR at the time of the previous review.

2.17 In the case of WTL the licence holder must also submit a forecast of Controllable Operating Expenditure every third year for approval by the Authority[6]. We will review the relevant condition in the company licence[7] and consult on any changes that may be necessary to align the review period such that it will also commence on 1 October 2017.

2.18 This alignment of price control review periods will permit more effective comparisons between licence holders as allowances are set under the same set of market conditions. It will facilitate a consistent approach to similar issues by the UR. And will lead to greater efficiency on the party of the Utility Regulator as all relevant licence holders will have their reviews carried out at the same time.

2.19 The licence changes necessary to facilitate alignment of price control periods and duration of controls are straightforward and we will publish the draft modifications alongside the draft determination for the price control towards the end of 2016.

2.20 Given the proposed licence modifications, the date of the subsequent review and thus the length of the price control period will become a matter for determination following public consultation.

Single System Operator - Contractual Joint Venture

2.21 Our intention is to have in place a single system operator for the Northern Ireland high pressure network by 1 October 2017.

[5] WTL Gas Conveyance Licence Condition 4.1.2 (b)
[6] WTL Gas Conveyance Licence Condition 4.7.2 (a)
[7] WTL Gas Conveyance Licence Condition 1.1.6

2.22 As the Northern Ireland Single System Operator is not a legal entity it cannot be granted a licence by the UR. Consequently, the funding for the activities of system operation must be provided by those licence holders which are a party to the Contractual Joint Venture (CJV). We have considered a number of ways these funding arrangements might work and our proposed approach would ensure that Northern Ireland gas consumers are no more exposed to the cost risk associated with single system operation, than they are at present, or in comparison to any other category of controllable operating costs. This approach will require minimal, if any modifications to existing price control related licence conditions.

2.23 Parties to the Contractual Joint Venture will submit a jointly agreed business plan for the activity of single system operation. However it is recognised that as the Contractual Joint Venture is not a legal entity it is unable to enter into a contract with the supplier of any of the resources necessary to deliver single system operation. Whether that be employees, IT Systems or any other required resource. Only a licence holder, being a legal entity, can enter into such contracts. The business plan will therefore need to identify which of these contracts / costs each licence holder is responsible for. We would expect that the licence holders would allocate contracts such that the cost of marshalling the necessary resources is minimised.

2.24 We will make our determination on the basis of this joint agreed business plan. Each licence holder being allocated a price control allowance in accordance with the pattern of resource contracts set out in the business plan. Each licence holder would then be exposed to the same cost risk mechanism that applies to other categories of controllable operating cost. For GNI (UK) this would be a 'revenue cap' mechanism while for the other three licence holders an operating cost pass through' mechanism would apply.

2.25 Table 3 sets out the various steps in the price control process as they relate to the activities of the Northern Ireland Single System Operator.

Table 3: Northern Ireland Single System Operator Price Control Process

Price Control Process
Step 1 – UR will issue a business plan cost template. This will cover all Transmission System Operation (TSO) activities with a separate table for CJV costs.
↓
Step 2 – TSOs will discuss what CJV activities are required and the estimated cost of each e.g. rent, staff, IT cost, General Manager (GM) cost etc.
↓
Step 3 – TSOs to decide the split of activities and cost between themselves.
↓
Step 4 – Companies will submit a joint CJV cost submission in early September 2016. This will include a five year forecast of total CJV costs split by TSO.
↓
Step 5 – UR will consider the joint cost submission and the efficiency factor (if any) to be applied to the CJV. This may differ from efficiency targets for the rest of the business.
↓
Step 6 – UR will decide the global allowance for the term of the price control. Revenue for the CJV will be allocated to licensees based on the jointly agreed TSO cost split.
↓
Step 7 – The GM and TSO governing committee will manage the annual CJV budget
↓
Step 8 – The TSOs will be required to submit a report of actual expenditure incurred during the previous gas year in a format to be determined by the UR.

2.26 Only the direct costs of delivering the activity of system operation, such as staff and IT systems, will be treated in this way. General overheads / allocated costs, such as corporate functions, will be included within the licence holders non system operation cost category. This approach is being adopted in order to facilitate the creation of a clear and transparent distinction between CJV system operation and other cost categories. This will assist in mitigating the risk of cost shifting within and between licence holders. Again a robust system of Regulatory Instructions and Guidelines will be part of a wider mitigation strategy. As is the case with the business plan submission a single joint annual cost reporting submission will be required.

2.27 In the normal course of events there are unlikely to be many unforeseen developments that would impose significant costs on the parties to the Contractual Joint Venture. However there may be unknown factors (relevant items) which could facilitate special consideration. Any such factors must be unforeseen, outside management control, and will be subject to a materiality threshold. We are of the view that existing licence conditions are sufficient to accommodated these situations[8].

2.28 We recognise that during the price control period changing circumstances may require that the allocation of activities and costs between licence holders is realigned. We do not propose to revisit our determination as a consequence of any realignment. One possible option is that changes could be accommodated by means of recharging between licence holders. However, we will discuss this further with the TSOs as their business plan for the CJV develops. In any case, the cost reporting template will allow the parties to reveal where changes have occurred. Our initial view would be that any realignment should result in increased cost efficiency, however we recognise that in exceptional cases there may be other valid justifications. We intend to monitor this flexibility closely for inappropriate behaviour and if necessary take remedial action.

[8] GNI (UK) Gas Conveyance Licence Condition 2.2.4 (i) and (j)

Controllable Operating Expenditure

2.29 The price control seeks only to determine an efficient level of costs for controllable operating expenditure. No allowances for capital expenditure will be granted as part of this price control as these are determined by an entirely separate process as set out in the licences of both GNI (UK) and WTL.[9] There is no provision for setting capital expenditure allowances in either the PTL or the BGTL licences. For the purposes of this price control capital expenditure is any expenditure that results in an increase in the overall capacity of the network to convey gas.

2.30 Much of what in accounting terms might be classified as capital expenditure we consider as being asset replacement in that it does not increase the capacity of the network but simply replaces obsolete or worn out assets. We have made specific provision in the business plan and cost reporting templates for such expenditure. Licence holders will be required to identify individual projects under this heading, providing a justification for the project, alternatives considered and amongst other things quantify the benefits to consumers relative to the expenditure proposed. As these tend to be periodic bespoke projects we may seek specialist advice on the validity and cost effectiveness of the projects proposed. We will also be guided by our determinations on such projects from previous price controls.

2.31 In determining allowances for the Northern Ireland Single System Operator we will be guided by the principle that we are determining allowances for a single Contractual Joint Venture and not four separate licence holders. Similarly when determining non-CJV allowances for the MEL gas companies we will be guided by the principle that we are determining allowances as far as possible for a single company and not four separate licence holders.

2.32 For other categories of controllable operating expenditure one of the objectives of the Regulatory Instructions and Guidance is to identify robust cost drivers for broad categories of expenditure. This will allow us to make comparisons between licence

[9] GNII (UK) Gas Conveyance Licence Condition 2.2.2 and 2.2.3, WTL Gas Conveyance Licence Condition 4.2

holders, against industry standards and over the course of time. We will take the efficient level of costs determined in the previous price control period together with actual costs from earlier periods as the starting point for future allowances. We will also seek specialist advice where necessary.

2.33 As with single system operation we believe that there may be additional cost savings which could be delivered if GNI (UK) and the Mutual Energy licence holders acted jointly rather than separately, when for example awarding the Maintenance and Emergency Response Contract (MERC). We will need to consider whether the determination should take account of these potential cost savings. We are certain however that profit margins for affiliates contracted by the licence holder and contingency will not be allowed for in our determination of allowed costs.

2.34 As a general principle we consider that re-opening our determination during the price control period should only be considered in exceptional circumstances which can be demonstrated to be unforeseen, outside management control, and of a material financial impact the determination can be re-opened. We are of the view that existing licence conditions are sufficient to accommodate these situations[10].

Uncontrollable Operating Expenditure

2.35 As the name suggests these costs are considered as being outside the control of the licence holder and so are not subject to any incentive mechanism. That is no allowance is determined for them at the time of the price control and consumers rather than the licence holder bears all cost risk. These are often described as cost pass through items.

2.36 Only GNI (UK)[11] is required to submit forecasts of these costs. The other licence holders are not. However, in PTL's case these costs are substantial as they include sums paid by PTL to secure capacity on behalf of Northern Ireland network users

[10] GNII (UK) Gas Conveyance Licence Condition 2.2.4 (i) and (j)
[11] GNII (UK) Gas Conveyance Licence Condition 2.2.4 (f)

under the Transportation Agreement (TA). Our analysis of actual cost data since 2010 demonstrates that TA costs contribute circa 20% of the total Postalised Transmission Required Revenues. This is similar to the contribution of controllable operating expenditure for all four licence holders covered by this GT17 review.

2.37 In order to provide transparency to network users and gas consumers we believe that the data presented in the price control determination should give as full a picture as possible of total costs over the price control period. We therefore intend to modify the PTL, BGTL and WTL licences to align their obligations with those of GNI (UK). This will place a negligible extra burden on these licence holders as they are already required as part of the annual Postalised Transmission Tariff setting process each July to make a rolling five year forecast of these costs[12].

Efficiency Targets

2.38 When setting an efficiency target, two effects need to be considered; catch-up to frontier performance and continued movement of the frontier over time.

- Frontier shift describes the efficiency gains resulting from companies in the economy becoming more efficient over time.
- The move towards the frontier describes the efficiency gains an individual company can achieve through catching-up with the economic frontier.

2.39 A number of broad approaches are available to any economic regulator to take account of both or either of these effects. Whenever possible regulators have tended to use both approaches in combination when setting allowances.

- Use a bottom-up approach to analyse each of the main cost categories to determine what might be considered as an efficient level of costs. In doing so,

[12] PTL, BGTL, WTL GNI (UK) Gas Conveyance Licence Condition 2A2.3.1

any atypical circumstances that might impact on costs need to be taken into account as appropriate.

- Use a top-down approach to analyse the efficiency gap with a comparator operating at a chosen performance. A variety of statistical approaches are available foremost amongst these is econometric analysis. Again any atypical circumstances that might impact on costs need to be taken into account as appropriate.

2.40 In our situation the bottom up approach is likely to be our principle tool. The top down approach in our situation is likely to be problematic due to a lack of effective comparators. Although, there are four licence holders for which allowances are to be determined, three (PTL, BGTL and WTL) are held by the same organisation (Mutual Energy) and WTL has not yet commenced operations. Effectively therefore there are only two comparators in Northern Ireland. In Great Britain there is only one gas transmission company, National Grid, but the size and scope of its operations may render comparisons difficult. In the Republic of Ireland GNI is an integrated transmission and distribution business with a single licence, which again provides benchmarking problems.

2.41 In determining allowances we will in the first instance seek to ensure that the allowances represent catch-up to the frontier. Either immediately through a one off adjustment to the level of allowances, or more gradually by means of a series of smaller steps over a period of years. The creation of a standardised business plan and common cost reporting template as discussed previously will assist us in this process, and the benefits of such a regime will only increase over time as the volume of cost data collected on a consistent basis increases.

2.42 Next we will make a global adjustment to these catch up allowances to take account of our assumptions about future frontier shifts. We will consider whether a single global figure should apply to all the activities funded through the licence or where there should be separate adjustments made for the activity of the Northern Ireland Single System Operator and the other activities of the licence holders.

2.43 In previous transmission price controls no account has been taken of real price effects. That is the deviation between the Retail Prices Index measure of inflation and the rate by which the licence holders input prices increase. Such real price adjustments are applied in most other price control determinations made by the UR and other economic regulators. We therefore intend to include an analysis of whether or not such an adjustment is necessary as part of the GT17 process.

Incentives & Innovation

2.44 One licence holder GNI (UK) is subject to a standard and fairly straightforward incentive mechanism in the form of a 'revenue cap'. Under this mechanism the licence holder is given an allowed revenue to carry out its duties under the licence. The licence holder is exposed to the cash flow risk associated with deviations between allowed revenue and actual costs. In the case of GNI (UK) this risk is mitigated to some extend by two mechanisms:

- The ability to seek allowances for Unforeseen Operating Expenditure.[13]
- The ability to seek a forecast expenditure review should actual expenditure be greater than 15% above the allowance in any gas year.[14]

2.45 In contrast the other three licence holders, PTL, BGTL and WTL, operate under an operating cost pass through mechanism whereby gas consumers bear all cost risk in return for an absence of shareholder equity and returns. There are a number of specific governance arrangements in place to prevent inappropriate behaviour by management against the interests of gas consumers. As part of this price control review we intend to commence a review of these governance arrangements, including consideration of the management incentive plan in accordance with existing licence conditions.[15]

[13] GNII (UK) Gas Conveyance Licence Condition 2.2.4 (j)
[14] GNII (UK) Gas Conveyance Licence Condition 2.2.4 (i)
[15] PTL and BGTL Gas Conveyance Licence Condition 3.3.3 WTL Gas Conveyance Licence Condition 3.2

2.46 As part of this review we intend to review the operation and purpose of the Approved Surplus. Under this arrangement shadow allowances as determined by the UR at the beginning of a three year period are compared with actual controllable operating expenditure. If actual costs are above forecast then the surplus is zero but if they are less than forecast then there is a surplus. Some or all of this surplus maybe returned to consumers. This is a decision of the UR. One factor that the UR considers when making this judgement, is the extent to which the surplus is a result of effective management as opposed to external factors. That part of the surplus not returned to consumers is held in a Social Enhancement Fund (SEF), to be used for purposes that are to the benefit of all gas consumers in Northern Ireland.

2.47 These arrangements have been in place for over a decade and the SEF now stands at some £5 million, although no funds have been added since the time of the previous price control in October 2012. It would be useful to understand stakeholder views on the value of continuing with the SEF. As part of the price control we intend to work with licence holders to review these arrangements.

2.48 At present there is no specific mechanism to encourage innovation as there is within for example RIIO-T1. In the Gas to the West licence award process we included a specific innovation criterion as part of our assessment. We have no plans at present to modify the licences and introduce a specific mechanism. However we would encourage licence holders to include innovations in their business plans that would lead to improved efficiency and or improved customer service. These will be considered, if a robust and appropriate business case has been submitted which sets out clearly the detailed costs and benefits as well as how risks will be allocated.

Weighted Average Cost of Capital

2.49 The treatment of this component of the price control determination is not consistent across the licence holders. In the case of PTL and BGTL it will be entirely absent from the determination. In both cases the purchase of the regulated assets was entirely financed by the issuance of a long maturity bond. The schedule of bond payments has been previously accepted by the UR and these payments known as the Fixed Amounts[16] are included in the calculation of annual allowed revenue without adjustment.

2.50 In the case of WTL for the price control period commencing 1 October 2017, the value of this component of the determination, was established during the Gas to the West competitive licence award process[17]. However, as we made clear during this licence award process this would only be as far as was reasonable[18]. We did not explicitly set out how any judgement as to regards reasonableness would be made. However during the application process we provided some further clarification on this matter[19].

In making future determinations the Authority will take account of the capital structure revealed in the licence application process and whether it remains appropriate. In addition the Authority will consider the level of risk, how market conditions may have changed over time, and all other relevant circumstances

2.51 As part of the review we will therefore consider whether the rate of return revealed by the competitive process and included in the licence remains reasonable given contemporary conditions. Should it be concluded that it is not, we will give due consideration to making the necessary adjustments.

2.52 In the case of GNI (UK) we have modified the licence[20] such that the UR has greater discretion over the setting of this component of the determination. In setting the rate of return we will

- Use a standard CAPM (Capital Asset Pricing Model) methodology for assessing a suitable rate of return for the Gas Transmission Networks;

[16] PTL and BGTL Gas Conveyance Licence Condition 3.1.4
[17] WTL Gas Conveyance Licence Condition 4.5.3
[18] Gas too the West Applicant Information Pack paragraph 3.29
[19] Gas to the West Clarification Questions - Question 18
[20] Decision to Modify GNI (UK) Rate of Return Licence Conditions

- Use all available similar regulatory settlements to benchmark appropriate rates.

2.53 Ultimately the objective of an economic regulator is to set a rate of return that reflects the cost of capital, both debt and equity, that the markets will bear given the level of risk associated with the business. It is important that we properly assess the level of risk associated with the licensed activity.

2.54 We intend to publish the capital repayments proportion of the total required revenues for each licence holder during the price control period as part of our determination. This will assist network users in forecasting the future level of the Postalised Transmission Tariff.

Price Control Outputs

2.55 The principle objective of GT17 will be to determine, for each licence holder, a robust controllable operating cost allowance and where applicable a robust weighted average cost of capital. In addition our objective is to produce robust forecasts of uncontrollable operating costs such that a forecast total Postalised Required Revenues for each year of the control period can be calculated.

2.56 Table 4 sets out how we might present the output from the price control process for each licence holder:

Table 4: Price Control Output Presentation

Price Control Item	Status	Real Value*** Yr t+x
Controllable Operating Expenditure (non CJV)	Determined / Fixed	£Xm
Controllable Operating Expenditure (CJV)	Determined / Fixed	£Xm
Controllable Operating Expenditure (Total)	Determined / Fixed	£Xm
Efficiency Target	Determined / Fixed	X%
Efficient Controllable Operating Expenditure	Determined / Fixed	£Xm
Uncontrollable Operating Expenditure	Forecast / Variable	£Xm
Weighted Average Cost of Capital*	Determined / Fixed	X%
Capital Allowance	Determined / Fixed**	£Xm
Total Allowed Revenue	Forecast / Variable	£Xm

* Excluding PTL and BGTL

** In the case of GNI (UK) and WTL this value will vary from year to year due to the financial model adjusting for a number of factors including tax rates, under / over recovery and opening asset value at First Operational Commencement Date

*** Anticipated price base of March 2016 for all data

3 Stakeholder Engagement and Social Impact

Approach to Stakeholder Engagement

3.1 During the GT17 price control process, we will engage with the key stakeholders. This will allow us to take full account of stakeholders' views in making a final determination. It will also assist stakeholders in achieving a better understanding of our determination and the thinking behind that determination. We will do this primarily through public consultations and existing mechanisms in which interested parties already participate such as the Gas Market Opening Group.

3.2 In recognition of their statutory role we will engage with the Consumer Council of Northern Ireland. While this will be the principle means of engagement with gas consumers, we also intend to engage with representatives of major energy users through groups such as Manufacturing Northern Ireland.

Consumer Impact

3.3 Transmission network costs account for a relatively small component of a final consumers gas bill. For larger consumers the importance of transmission network costs increases. The biggest component of any consumers bill, the wholesale gas price, is rightly set by market conditions rather than by regulation. Despite this however we feel it is important that we analyse the impact of our decisions on a range of indicative customer groups, including in particular domestic consumers and power generators.

Greenhouse Gas Emissions

3.4 We intend to publish a carbon budget for each of the licence holders, this will be in line with the existing reporting requirements of large and medium sized UK companies.