

BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF AN APPEAL

UNDER ARTICLE 14B OF THE GAS (NORTHERN IRELAND) ORDER 1996

B E T W E E N : -

FIRMUS ENERGY (DISTRIBUTION) LIMITED

Appellant

and

THE NORTHERN IRELAND AUTHORITY FOR UTILITY REGULATION

Respondent

**RESPONDENT'S REPRESENTATIONS & OBSERVATIONS
ON THE NOTICE OF APPEAL**



**Two Snowhill
Birmingham
B4 6WR**

**Tel: +44 (0)370 903 1000
Reference: 2627597/JAC/RKR/CPW2**

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SECTION 1. INTRODUCTION

- 1.1 On 28 October 2016, the Northern Ireland Authority for Utility Regulation (the **UR**) published its decision to modify Firmus Energy (Distribution) Limited (**FE**)'s licence to implement its GD17 price control determination, setting FE's price control for the period between 2017 to 2022.
- 1.2 On 25 November 2016, FE sought permission from the Competition & Markets Authority (**CMA**) under Article 14B(1) and (3) of the Gas (Northern Ireland) Order 1996 (the **Gas Order**) to appeal the UR's decision to modify its licence conditions.
- 1.3 On 28 December 2016, the CMA granted permission to FE to bring the appeal set out in its Notice of Appeal (**NoA**).
- 1.4 This response contains the UR's representations and observations to the CMA in relation to FE's appeal, in accordance with paragraph 3(4) of Schedule 3A to the Gas Order. The UR resists each of the grounds of appeal and submits that the appeal should fail in its entirety and that the CMA should confirm the UR's decision.
- 1.5 In this document, the UR sets out its response to each of the grounds of appeal. It will be happy to provide the CMA with such further and supporting information as it needs in order to fully understand the issues and make its determination.
- 1.6 For ease of reference, we have followed the same numbering conventions, and as far as possible used the same terminology, which is set out in the NoA.
- 1.7 This response contains information which is confidential and commercially sensitive.

19 January 2017

SECTION 2. GLOSSARY

2.1 In this response, the following terminology is adopted -

BGE	Bord Gais Eireann
CMA	Competition and Markets Authority
Capex	Capital expenditure
DAV	Depreciated Asset Value
Energy Order	Energy (Northern Ireland) Order 2003
FE	Firmus Energy (Distribution) Limited
FTE	Full time equivalent
Gas to the West	The project to extend natural gas networks to the west and south of Northern Ireland, encompassing SGN's licence area.
Gas Order	The Gas (Northern Ireland) Order 1996
GB	Great Britain
GD14	The GD14 price control (which preceded GD17), the process of setting it, or the period (as the context requires).
GD17	The GD17 price control, the process of setting it, or the period (as the context requires).
GD23	The GD23 price control (which is proposed to follow GD17), the process of setting it, or the period (as the context requires).
GDN	Gas distribution network operator
GIS	Geographic Information System
Licence Area	The area in which FE is authorised to convey gas in accordance with its licence, as set out in Schedule 1 to its licence.
Northern Powergrid and British Gas (together the ED1 Determinations)	mean the determinations of the CMA in the respective appeals in Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority (September 2015) and British Gas Trading Limited v The Gas and Electricity Markets Authority (September 2015).

Non Confidential Version

NI	Northern Ireland
Opex	Operating expenditure
PNGL	Phoenix Natural Gas Limited
SGN	SGN Natural Gas Limited
UR	Northern Ireland Authority for Utility Regulation
TRV	Total Regulatory Value
WACC	Weighted average cost of capital

SECTION 3. STATUTORY FRAMEWORK

3.1 The relevant statutory framework which underpins this appeal is set out below. The framework governing the regulation of gas distribution activities in Northern Ireland is principally set out in two pieces of legislation: the Energy (Northern Ireland) Order 2003 (the **Energy Order**) and the Gas Order.

The Utility Regulator

3.2 The Energy Order establishes the UR¹ and sets out its objectives, powers and duties. Its '*principal objective*' in relation to gas is set out in Article 14 of the Energy Order. This duty is –

'to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland , and to do so in a way that is consistent with the fulfilment by the Authority, pursuant to Article 40 of the Gas Directive², of the objectives set out in paragraphs (a) to (h) of that Article³.

3.3 It follows that the UR's principal objective is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry, in a way that is consistent with a number of objectives which are set out in European law.

3.4 In carrying out its functions in a way that furthers its principal objective, the UR has a number of general duties which include having regard, among other things, to:

- (a) the need ensure a high level of protection of the interests of consumers of gas, and
- (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part 2 of the Gas Order⁴.

3.5 Subject to this duty, the UR must carry out its functions in the manner which it considers is best calculated to meet a number of objectives, including among others to promote the efficient use of gas and to secure a diverse, viable and environmentally sustainable long-term energy supply⁵.

3.6 In addition, under article 6B of the Energy Order, the UR is required to carry out its functions in the manner that it considers is best calculated to implement, or to ensure compliance with, any binding decision of the Agency for the Cooperation of Energy Regulators or the European Commission which is made under relevant EU

¹ Article 3 of the Energy Order

² Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC

³ Article 14(1) of the Energy Order set out in full in Notice of Appeal, [para 3.18](#)

⁴ Article 14(2) of the Energy Order, set out in full in Notice of Appeal, [para 3.20](#)

⁵ Article 14(5) of the Energy Order, set out in full in Notice of Appeal, [para 3.22](#)

legislation relating to gas.

Licensing of gas distribution

- 3.7 Unless a statutory exemption applies⁶, it is an offence for any person to convey gas from one place to another unless authorised to do so by licence⁷. Under Article 8 of the Gas Order, the UR may grant any person a licence to convey gas from one place to another in an area authorised by the licence⁸.
- 3.8 The UR granted a licence to BGE on 24 March 2005. This was assigned to BGE (NI) Distribution Ltd (FE) from 20 June 2005. FE changed its name to Firmus Energy (Distribution) Limited from 4 May 2006.

Modification of licence conditions

- 3.9 Under Article 10 of the Gas Order, a licence may include conditions and, in the event a licensee fails to comply with a condition of its licence, the UR has a number of enforcement functions⁹.
- 3.10 Under Article 14 of the Gas Order¹⁰, the UR may make modifications to the conditions of a particular licence. Before doing so, it is required to publish a notice setting out the modifications which it proposes to make and its reasons for doing so¹¹. Following consideration of any representations which are duly received, the UR must publish its decision¹².
- 3.11 On 15 September 2016, following an extensive engagement process, the UR conducted the required statutory consultation on its proposed modifications to FE's licence to implement the GD17 Final Determination. The UR published its decision to proceed with licence modifications on 28 October 2016.

Appeal of licence condition determination

- 3.12 Article 14B(1) of the Gas Order provides that:

'An appeal lies to the CMA against a decision by the [UR] to proceed with the modification of a condition of a licence under Article 14'.

- 3.13 An appeal may be brought by a '*relevant licence holder*', which in relation to a modification of a condition of a particular licence, is the holder of that licence¹³.

⁶ Under Article 7 of the Gas Order

⁷ Article 6(1) of the Gas Order

⁸, **NOA-1/Tab 32**

⁹ Articles 41 – 51 of the Gas Order

¹⁰ **NOA-1/Tab 32**

¹¹ Article 10(2) of the Gas Order

¹² Articles 10(5) and 10(8) of the Gas Order

¹³ Articles 14B(2) and 10(11) of the Gas Order

- 3.14 Article 14D of the Gas Order sets out how the CMA must determine any appeal which is referred to it. In particular, Article 14D(2) provides that:

'In determining an appeal the CMA must have regard, to the same extent as is required of the [UR], to the matters to which the [UR] must have regard —

(a) in the carrying out of its principal objective under Article 14 of the Energy Order; and

(b) in the performance of its duties under that Article and Article 6B of the Energy Order'.

- 3.15 This requires the CMA to have regard, to the same extent as is required of the UR, to the UR's principal objective and general duties which are referred to above.

- 3.16 Article 14D(3) of the Gas Order provides that:

'In determining the appeal the CMA—

(a) may have regard to any matter to which the [UR] was not able to have regard in relation to the decision which is the subject of the appeal; but

(b) must not, in the exercise of that power, have regard to any matter to which the [UR] would not have been entitled to have regard in reaching its decision had it had the opportunity of doing so'.

Grounds of Appeal

- 3.17 Fundamentally in relation to this appeal, article 14D(4) of the Gas Order sets out the only circumstances in which the CMA may allow an appeal. Article 14D(4) provides that:

'The CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong on one or more of the following grounds—

(a) that the [UR] failed properly to have regard to any matter mentioned in paragraph (2);

(b) that the [UR] failed to give the appropriate weight to any matter mentioned in paragraph (2);

(c) that the decision was based, wholly or partly, on an error of fact;

(d) that the modifications fail to achieve, in whole or in part, the effect stated by the [UR] by virtue of Article 14(8)(b);

(e) that the decision was wrong in law'.

- 3.18 In accordance with article 14D(5), to the extent the CMA does not allow the appeal, it must confirm the decision appealed against.

Standard of Review

- 3.19 As noted by FE, while this is the first appeal to the CMA under Article 14B of the Gas Order, guidance was given in the CMA determinations in *British Gas Trading Limited v The Gas and Electricity Markets Authority (British Gas)* and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority (Northern Powergrid)* (together the **ED1 Determinations**).
- 3.20 The ED1 Determinations explored the legislative provisions in section 11E(4) of the Electricity Act 1989, which are for all relevant purposes equivalent to those applicable to this appeal.
- 3.21 As noted by FE, in the ED1 Determinations, the CMA stated that:

'We agree that we are not limited to reviewing the decision on conventional judicial review grounds and that we are not only able, but required by EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute'¹⁴.

- 3.22 However, FE conspicuously omits to draw the CMA's attention to a number of important passages on the standard of review contained in the ED1 Determinations and these are set out below.
- 3.23 In particular, the CMA cited the Competition Commission appeal (under section 175 of the Energy Act 2004) in *E.On UK plc v GEMA : energy code modification appeal*. The CMA stated the following:

'In relation to the review of GEMA's exercise of discretion, in paragraph 5.11 of the E.ON decision, the CC stated that:

"As a specialist appellate body charged with considering whether a decision of GEMA is wrong, the function of the CC is to provide accountability in relation to the substance of code modification decisions. However, leaving to one side errors of law, it is not our role to substitute our judgment for that of GEMA simply on the basis that we would have taken a different view of the matter were we the energy regulator."

Further, the CC took the view that the statutory test:

¹⁴ British Gas, [para 3.24](#) and CMA Northern Powergrid, [para 3.23](#)

"clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA's decision is wrong on one of the statutory grounds. For example, GEMA may have taken a view as to the weight to be attributed to a factor which differs from the view we take, but which we do not consider to be inappropriate in the circumstances."

'We consider that these observations are equally apposite for the standard of review which we must apply in the present context' (emphasis added)¹⁵.

3.24 The CMA further summarised the approach on standard of review as follows this:

*'Our view is therefore that the CMA should not substitute its views for GEMA's solely on the basis that it would have taken a different approach (eg on issues of the weight to be attached to particular considerations), but the standard of review goes further than the traditional heads of judicial review. The key question is whether GEMA made a decision that was wrong (on one of the prescribed statutory grounds) To that extent, the merits of GEMA's decision must be taken into account and we have done so.'*¹⁶.

3.25 While the standard of review is not limited to conventional grounds of judicial review, that review is limited to the statutory grounds. It is not a rehearing. The CMA acknowledged this point expressly:

*'We do not consider that an appeal under EA89 involves a rehearing where it is open to us to decide matters afresh untrammelled by GEMA's decision.'*¹⁷.

3.26 The CMA also acknowledged that it was not required to have conducted a re-run of GEMA's original decision making process or to had held a de novo hearing of the evidence¹⁸.

3.27 Moreover, the CMA confirmed that, in addition to being required to limit itself to the statutory grounds of appeal, it may only do so *'to the extent that such grounds are raised by the appellants'*¹⁹. This appeal is limited to the grounds raised by FE in its Notice of Appeal.

3.28 In relation to the evaluation of facts, the CMA adopted the position in *Azzicurazioni Generali Spa v Arab Insurance Group*²⁰, which was that *'so far as the appeal raises*

¹⁵ British Gas, [para 3.27 to 3.29](#) and Northern Powergrid, [paras 3.26 to 3.28](#)

¹⁶ British Gas, [para 3.43](#) and Northern Powergrid, [para 3.42](#)

¹⁷ British Gas, [para 3.36](#) and Northern Powergrid, [para 3.35](#)

¹⁸ British Gas, [para 3.37](#) and Northern Powergrid, [para 3.36](#)

¹⁹ British Gas, [para 3.37](#) and Northern Powergrid, [para 3.36](#)

²⁰ [2001] 1 WLR 577

*issues of judgment on unchallenged primary findings and inferences, this court ought not to interfere unless it is satisfied that the judge's conclusion lay outside the bounds within which reasonable disagreement is possible*²¹.

3.29 The CMA went on to confirm that:

*'We also agree that where the errors relate to evaluations of fact... rather than conclusions of primary fact then we should approach such evaluations in the same way that we approach the exercise of discretion*²².

3.30 Where an appeal relates to whether appropriate weight has been given to a matter mentioned in article 14D(2) of the Gas Order, an appeal should not succeed because the CMA considers that there may have been other ways in which various interests could have been balanced. An appeal should only succeed where '*undue or unsupported weight*' has been given²³.

'Cherry-picking'

3.31 In the ED1 Determinations, a submission was made that companies accepted their price control as a whole and that consequently to allow '*cherry-picking*' appeals against parts of a price control would make the appeal process unfair.

3.32 The CMA acknowledged that it must '*determine the appeal "through the prism of the specific errors" alleged by the appellant*²⁴. However, the CMA noted that in principle:

*'... we accept that it may in some circumstances be necessary to take care that overturning one aspect of a complex regulatory decision does not have knock-on consequences for other, unappealed aspects of the Decision...'*²⁵.

3.33 The principle which it decided to adopt was that:

*'... the question as to whether there are sufficient links between the parts of the Decision which are challenged and parts which are not challenged must be decided on a case-by-case basis taking into account the circumstances of each case. Where there are such links, we would, in the first instance, have expected GEMA to have highlighted these and addressed them in its response... We accept, however, that if, in the evidence submitted to the CMA, such links become apparent, we may take this into account where appropriate*²⁶.

²¹ British Gas, [para 3.30](#) and Northern Powergrid, [para 3.29](#)

²² British Gas, [para 3.31](#) and Northern Powergrid, [para 3.30](#)

²³ British Gas, [para 7.44](#)

²⁴ British Gas, [para 3.48](#) and Northern Powergrid, [para 3.47](#)

²⁵ British Gas, [para 3.50](#) and Northern Powergrid, [para 3.49](#)

²⁶ British Gas, [para 3.52](#) and Northern Powergrid, [para 3.51](#)

- 3.34 In line with the above approach, the CMA should take full account of the matters raised in this response (set out below) in which the UR identifies links between parts of FE's GD17 price control determination which are included within FE's appeal and parts which are not. The CMA should be mindful of 'cherry-picking' in its consideration of the appeal and take this into account in coming to its determination.

Materiality

- 3.35 Finally, in the ED1 Determinations, the CMA agreed with the parties that it '*should only interfere with the Decision if we consider that the error identified is material*'²⁷. The CMA expanded on this as follows:

*'We consider that an error will not be a material error where it only has an insignificant or negligible impact in relative terms on the overall level of price control that has been set by GEMA. Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. Relevant factors would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle. This list is not intended to be exhaustive'*²⁸.

- 3.36 It follows from the above that, in considering the materiality of any ground of appeal, the UR should consider the particular circumstances of that ground (including those set out above).

²⁷ British Gas, [para 3.58](#) and Northern Powergrid, [para 3.56](#)

²⁸ British Gas, [paras 3.60 – 3.61](#) and Northern Powergrid, [para 3.58](#)

SECTION 4. EXECUTIVE SUMMARY

- 4.1 The decision to set a price control is the classic example of the exercise of regulatory judgment. Price controls have many different elements, usually existing in a complex relationship to each other. They engage all the elements of a regulator's legal duties. And they require a balance to be established between a range of interests which are often competing – including the interests of consumers, companies and investors.
- 4.2 For this reason, while there may certainly be '*wrong*' price control decisions, there is almost never only one '*right*' decision. The assessment of allowed revenue in a price control is not a precise science. There will often be many possible decisions falling within the scope of what is reasonable.
- 4.3 The current statutory framework is relatively new. Before it, when an energy price control came to the CMA, it did so in its entirety, and the CMA made a fresh decision of its own in relation to all the elements of the control.
- 4.4 Under the new arrangements, regulated companies are entitled to choose grounds on which to appeal. They will inevitably wish to be selective about what they seek to place before the CMA. The CMA is no longer invited to consider a price control in the round.
- 4.5 These facts give rise to two related risks, and the CMA recognised them on the one previous occasion – in the two appeals brought against Ofgem's RIIO-ED1 control – on which it was asked to exercise its jurisdiction under the new arrangements. The risks are that:
- (a) companies will engage in 'cherry picking', leading to an overall outcome that is unbalanced and leans too far in favour of the price controlled company and against other interests;
 - (b) the subjects that are appealed will be subject to a forensic rehearing in which the understanding that there was a reasonable range of regulatory discretion is lost.
- 4.6 In the ED1 appeals, the CMA made clear that it understood these risks, and indicated how it intended to deal with them.
- 4.7 The UR emphasises this point at the outset, because both risks are alive and well in the context of this appeal.
- 4.8 First, this appeal presents a number of particularly stark examples of cherry picking. Under Ground 2, for instance, FE challenges targets set by the UR for connecting new customers to its network, but not the size of the allowances available to meet those targets. Under Ground 4, it challenges not the WACC as a whole, but only elements of the WACC – the asset beta, debt beta and nominal gearing.
- 4.9 There are a number of reasons why this is important. One of them is the obvious risk

this creates of generating an unbalanced result. In a context in which investors have recently paid substantial premia in order to acquire gas distribution businesses²⁹ – a fact which invites questions about whether the regulatory community is currently striking the right balance in setting price controls – it may be particularly important to consider not just the narrow elements of the GD17 control which are appealed, but how they sit in relation to those related elements which are unappealed.

- 4.10 Another reason why this is important is that the CMA is unlikely to hear directly from consumers or their representatives in this appeal. Energy price control appeals are expensive; consumer representative bodies have limited resources. While the new statutory arrangements provide for equality of rights, they do not establish equality of opportunity. The consumer interest is no less important because it is not currently represented at the table.
- 4.11 Second, there are elements of this appeal in which FE appears to be inviting the CMA to engage in a rehearing. Under Ground 4, for instance, it produces expert evidence which the UR says is inconsistent with the proposals that were put forward by FE and its consultants during the GD17 process. Specifically, in relation to the asset beta and debt beta, the UR made decisions that were consistent with the reasonable ranges supported by FE's then consultants. Those are now challenged on grounds different from any previously advanced.
- 4.12 The CMA in its decisions in the ED1 appeals indicated how it proposed to strike the right balance in relation to cherry picking and the standard of review, including by applying an appropriate materiality test to the matters under consideration.
- 4.13 The UR notes that, in FE's summary of the statutory framework for this appeal³⁰, only selective references are made to the ED1 decisions, and that they do not include the CMA's statements about cherry picking or the sense in which a regulatory decision must be '*wrong*' if an appeal is to succeed. The UR says that this is revealing. In this document, the UR has referred to the relevant sections in full.
- 4.14 In relation to the matters which are under appeal, the UR is confident that it made decisions which were reasonable and appropriate, and therefore within the range of regulatory judgments that were properly open to it. It made them following a very full and detailed consultation process which involved regular and active engagement with FE, consumers, investors and other stakeholders³¹. It had regard to the specific circumstances of FE and set its decisions accordingly.
- 4.15 The UR is happy to speak to the merits of those decisions, and to demonstrate to the CMA why they were the right ones – and in any event not '*wrong*' in the sense that FE must establish if it is to succeed in this appeal. The UR will approach the appeal in that positive sense.

²⁹ Earwaker-1, [para 3.51](#)

³⁰ Notice of Appeal, section 3

³¹ See McHugh-1 for a summary of the extensive engagement process conducted

- 4.16 But the burden of proof remains with FE, particularly where (as for instance under Grounds 1B and 2) it seeks to argue for the exceptionality of its circumstances, or where (as for instance under Grounds 1D and 1E) it attaches values to its appeal that are supported by no calculations and cannot be understood by the UR, or where (as for instance under Grounds 1A and 3) it makes statements about what the UR did or did not do which the UR says are factually inaccurate.
- 4.17 A brief summary of the UR's response to each of the grounds of FE's appeal is set out below.

Ground 1A – 'The Benchmarking Error'

- 4.18 During the GD17 process, the UR carried out an exercise in top-down benchmarking involving econometric modelling. FE says that this modelling was '*wholly unsuitable and unreliable*'. It argues that the UR '*inappropriately*' allowed the output of the top-down exercise to '*influence*' its bottom-up assessment of costs in a way that resulted in '*downward bias*' to opex³².
- 4.19 The UR does not accept the premise that the top-down benchmarking exercise was fundamentally flawed, but FE's argument fails for a more basic reason which renders that question academic for the purposes of this appeal. This is that, having carried out a benchmarking exercise, the UR decided not to use it for the purpose of setting the GD17 allowances. These were instead determined (as in previous price controls) solely by the well-established bottom-up approach.
- 4.20 The UR's published documents were clear on this point. They stated that the bottom-up approach *had* been used to set allowances and that the outputs of the top-down benchmarking had *not* been used for that purpose. They indicated that the top-down benchmarking existed as part of a longer-term project which '*may be used*' in GD23. They noted that the modelling would be developed and refined for that purpose.
- 4.21 In making these decisions, the UR was responsive to concerns that were expressed by the companies about the use of top-down benchmarking in GD17. Its decisions demonstrate that it took them into account.
- 4.22 Notwithstanding this, FE seeks to portray the UR as having relied upon the top-down benchmarking exercise in a way that it plainly did not. Ground 1A of the appeal is therefore built around an error of fact. For that reason it is unsustainable.

Ground 1B – 'The Maintenance Sparsity Error'

- 4.23 FE argues that it operates in a sparsely populated, largely rural area. It claims that this is a special factor that imposes greater costs on its maintenance activities, that the UR failed to take proper account of it, and in consequence that its allowance for

³² Notice of Appeal, [paras 2.5 – 2.7](#), [para 4.7](#) and [paras 4.13 – 4.39](#)

maintenance opex is understated³³.

- 4.24 The UR does not dispute that FE's licensed area has a comparatively low population density, but the extent and significance of this factor are considerably overstated in its submissions. FE's network is being developed only in the more populous parts of its area, which exist along linear transport corridors. Other networks in other parts of the UK operate in lower density areas.
- 4.25 The UR does not consider, when all relevant factors are taken into consideration, that there is any basis for concluding that FE is subject to materially higher costs by comparison with the costs of similar activities that are undertaken by Phoenix Natural Gas Limited (**PNGL**).
- 4.26 FE's argument for the proposition that '*sparsity*' leads to higher maintenance costs – which is substantially repeated in this appeal – was fully considered and rejected by the UR in the Final Determination. The UR was right to do so, for reasons set out in this response.

Ground 1C – 'The GIS Oversight Error'

- 4.27 FE states that an allowance for professional and legal costs associated with the computerised mapping software (the Geographic Information System - **GIS**), has been omitted from the Opex allowance.
- 4.28 The UR has not however made a substantive decision to disallow any of these costs. Accordingly, there is no decision which can be the subject of an appeal in respect of this Ground 1C.
- 4.29 The UR is minded to modify the FE Licence to include an additional allowance in respect of such costs and will do so subject to representations received to its statutory consultation on its proposal.
- 4.30 FE's appeal on this ground is therefore misguided but in any event certainly premature.

Ground 1D – 'The Manpower Scale Error'

- 4.31 FE says that it is expected to deliver significant growth in its network and number of connections during GD17, and that its manpower allowance fails to keep pace with the corresponding increase in the size of its business. It argues that, in setting this allowance, the UR failed to take proper account of the cost drivers associated with the scale of a gas distribution network³⁴.
- 4.32 The argument is misconceived. The manpower allowance relates to activities that might best be described as central business services, and not to activities associated

³³ Notice of Appeal, [paras 2.8 - 2.9](#) and [paras 4.40 – 4.56](#)

³⁴ Notice of Appeal, [paras 2.13 - 2.14](#) and [paras 4.64 – 4.77](#)

with the physical construction, connection or maintenance of assets (all of which are the subject of separate allowances). FE implies the existence of a linear relationship between the growth of its business and its manpower requirement for these central services. This is unsupported, indeed contradicted, by historic data.

- 4.33 In practice, an appropriate assessment of FE's manpower requirements required a bottom-up analysis of the needs of each of the central business functions. This was the exercise carried out by the UR. It involved a full process of engagement with FE, and led to a material increase in FE's manpower allowance for the GD17 period that was reasonable in relation to FE's needs.
- 4.34 The UR was right to take that approach, and FE's arguments on this ground of appeal are unsustainable for the reasons set out in this response.

Ground 1E – 'The Omissions Error'

- 4.35 FE argues that in determining its opex allowance for GD17, the UR failed to properly take account of FE's efficient costs associated with audit, finance and regulation costs and central service costs which were previously accounted for in a '*parental recharge*' mechanism in FE's price control³⁵.
- 4.36 This ground is in reality two separate grounds of appeal. In relation to audit, finance and regulation costs, the 2014 base year (used by the UR in the bottom-up methodology for the determination of opex allowances) was entirely appropriate. Contrary to what is stated in its appeal, including on the basis of statements made by FE previously, the base year did include costs in relation to engaging with a price control process.
- 4.37 FE states that no allowance has been included to cover costs which were previously accounted for in the parental recharge mechanism. This is simply an error of fact. The UR did include an appropriate allowance in relation to these costs.

Ground 2A – 'The Connection Target Error'

- 4.38 FE argues that the UR used an unjustified assumption to set annual connection targets, and that the use of this assumption led to annual connection targets being determined for GD17 which fail to properly to take account of FE's historic performance and the specific circumstances in the Licence Area and are unachievable³⁶.
- 4.39 FE's appeal in relation to Ground 2A is fundamentally flawed, because it is based on a number of serious misconceptions as to how the UR determined FE's connection targets and the modelling it used. In any case, the matters which are raised by FE as making the connection targets unachievable do not justify that statement, either in relation to the circumstances existing previously (which have by the nature of the

³⁵ Notice of Appeal, [paras 2.15 - 2.16](#) and [paras 4.78 – 4.102](#)

³⁶ Notice of Appeal, [para 8](#)

modelling process been taken into account) or in relation to circumstances arising in GD17. The manner in which the connection targets was determined for GD17 was entirely appropriate.

Ground 2B – 'The Non-additionality Error'

- 4.40 FE argues that the UR arbitrarily determined that 25% of new customers will connect to its network in the absence of any direct sales or marketing activities by FE and that in doing so the UR ignored evidence put forward by FE³⁷.
- 4.41 FE's appeal in relation to Ground 2B is based on limited evidence which is used to assert that the non-additionality number is inappropriate. The UR's determination in this regard was not arbitrary, but was a reasoned estimate of the position adopting the same approach adopted for GD14 (a position which was not previously challenged). The limited evidence put forward does not justify an allegation that the determination made was inappropriate. On the contrary, the assumed percentage of properties which will connect per year without sales or marketing is reasonable and cannot be said to be wrong in law.

Ground 3 – Treatment of Under-Recoveries

- 4.42 FE's appeal is made in respect of the UR's decision to change the rate of return which can be earned by FE on its under-recoveries to one that is different to the rate of return on allowed cost of capital.
- 4.43 FE contends that this decision creates regulatory uncertainty and damages investor confidence, disregards the reasons for the licence conditions, and is based on errors in the selection of the new rate of return.

Ground 3A – 'Regulatory uncertainty / breach of the principle of non-retroactivity'

- 4.44 FE says that the GD17 Decision '*withdraws previous commitments in FE's Licence regarding the applicable rate*'³⁸.
- 4.45 This ground is based on a fundamental mistaken premise. There were no commitments in the FE Licence that the applicable provisions were not subject to variation through licence modification. No promise or representation has been made (let alone a clear and unambiguous one) by the UR at any time that the applicable rate of return would at all times be equal to the rate of return on FE's allowed cost of capital. But even if any such promise or representation had been made it would certainly not be unreasonable for the UR to vary the rate given the circumstances of the case.
- 4.46 FE also submits that the change in the allowed rate of return has "*retrospective*

³⁷ Notice of Appeal, [para 8](#)

³⁸ Notice of Appeal, [para 2.28](#)

*effect*³⁹. This argument has no merit and easily discounted given that the change takes effect from 1 January 2017 and is a prospective change.

Ground 3B – 'Disregarding the reasons for the licence condition in line with the UR's statutory duties'

- 4.47 FE says that the UR has disregarded the reasons for the under-recoveries licence conditions⁴⁰. Specifically, in certain paragraphs of the Notice of Appeal, FE purports to disagree with the view that under-recoveries are about managing differences between the relative price of oil and gas⁴¹.
- 4.48 There is no merit in FE's argument. The UR takes decisions taking into account all of the relevant factors and in line with its principal objective and general duties. It has not disregarded the reasons for enabling FE to under-recover against allowed costs.
- 4.49 Rather the UR has, as any regulator would, properly considered whether in building up its under-recoveries FE has taken proper account of the reasons for the under-recovery mechanism. The UR has concluded that in circumstances where the 'state of the market' and 'competitor fuels' (both factors acknowledged by FE to be relevant) could be assessed as favourable to gas consumers, there was no good reason for FE to have built up such considerable under-recoveries.

Ground 3C – 'Errors in the selection of a new rate of return'

- 4.50 FE considers its revised inflation rate to be *'inappropriate, arbitrary and disproportionate'*.⁴²
- 4.51 The UR refutes that there are errors in its decision to allow a rate of return on under-recoveries which is linked to LIBOR. It is not inappropriate to set a rate of return which encourages the collection and unwinding of under-recoveries. Nor is it arbitrary or disproportionate to set a rate of return which reflects typical financing costs over the short term period within which FE can recoup its under-recoveries and which is on par with that set for other GDNs.
- 4.52 The UR submits that FE's appeal on this ground should be dismissed.

Ground 4A – 'The Asset Beta Error'

- 4.53 FE argues that, in determining the WACC, the UR set an incorrect asset beta because it failed to take into account certain systematic risks facing FE which are not faced by comparator companies. In particular it argues that the UR has not taken account of the systematic risks arising from FE's connection targets and has placed insufficient

³⁹ Notice of Appeal, paras 2.28 and 6.28 - 6.29.

⁴⁰ Notice of Appeal, para 2.29.

⁴¹ Notice of Appeal, paras 2.29 and 6.34.

⁴² Notice of Appeal, para 2.30

weight on the scale of the company's capex programme⁴³.

- 4.54 The UR observes that it set the asset beta within a range which FE's own consultants (Oxera) regarded as reasonable, which positions FE logically in relation to relevant comparator companies, and which is above the nearest GB comparators in order to take into account specific factors relating to Northern Ireland GDNs.
- 4.55 The criticisms now levelled at the choice of asset beta derive from evidence provided by FE's new consultants (PwC). They are not sustainable because they rely on several factual errors, unjustified assumptions and misapprehensions, as well as a failure to take into account relevant considerations.
- 4.56 Moreover, even to the extent to which the evidence provided by PwC represents the legitimate opinion of an expert, it does nothing to render the UR's decision '*wrong*' in the sense meant by the Gas Order⁴⁴. The UR made a decision that was objectively reasonable, and in any event within the proper scope of its regulatory discretion.

Ground 4B – '*The Financeability Error*'

- 4.57 It is common ground that, in setting FE's allowances under GD17, the UR was under a duty to have regard to the need to ensure that the company will be able to finance the activities which are the subject of obligations under its licence ('financeability').
- 4.58 FE says that the UR failed to act in accordance with this duty, because it assumed that FE would be able to finance its business on terms consistent with maintaining an investment grade credit rating when in fact its own modelling indicates an outcome which is below investment grade. It says that the UR failed to take into account an '*appropriate*' sensitivity analysis. It asserts that FE '*will not be in a position to secure an investment grade rating for its debt*'⁴⁵.
- 4.59 These arguments are wholly misplaced. The UR did in fact carry out an appropriate sensitivity analysis. It concluded that FE would be able to finance its business while maintaining an investment grade credit rating if it adopted an appropriate capital structure, noting that a prudent company might choose to lower its gearing for that purpose.
- 4.60 The relief claimed by FE under this ground is a modification to the calculation of the WACC, including in particular an increase in the debt beta, for which purpose it argues for the first time in GD17 that the beta set by the UR of 0.1 is not appropriate. There is no merit in this argument, for the reasons clearly advanced by the UR's expert, John Earwaker of First Economics⁴⁶.

⁴³ Notice of Appeal, paras 2.32 - 2.35 and paras 7.1 – 7.47

⁴⁴ As explicated by the CMA in Northern Powergrid, paras 3.26 – 3.30 and British Gas, paras 3.27 – 3.31

⁴⁵ Notice of Appeal, para 2.36 and paras 7.48 – 7.58

⁴⁶ Earwaker-1, section 4

SECTION 5. GROUND 1A – 'THE BENCHMARKING ERROR'

Introduction

- 5.1 During the GD17 process, the UR carried out an exercise in top-down benchmarking involving econometric modelling. FE says that this modelling was '*wholly unsuitable and unreliable*'. It argues that the UR '*inappropriately*' allowed the output of the top-down exercise to '*influence*' its bottom-up assessment of costs in a way that resulted in '*downward bias*' to opex⁴⁷.
- 5.2 The UR does not accept the premise that the top-down benchmarking exercise was fundamentally flawed, but FE's argument fails for a more basic reason which renders that question academic for the purposes of this appeal. This is that, having carried out a benchmarking exercise, the UR decided not to use it for the purpose of setting the GD17 allowances. These were instead determined (as in previous price controls) solely by the well-established bottom-up approach.
- 5.3 The UR's published documents were clear on this point. They stated that the bottom-up approach *had* been used to set allowances and that the outputs of the top-down benchmarking had *not* been used for that purpose. They indicated that the top-down benchmarking existed as part of a longer-term project which '*may be used*' in GD23. They noted that the modelling would be developed and refined for that purpose.
- 5.4 In making these decisions, the UR was responsive to concerns that were expressed by the companies about the use of top-down benchmarking in GD17. Its decisions demonstrate that it took them into account.
- 5.5 Notwithstanding this, FE seeks to portray the UR as having relied upon the top-down benchmarking exercise in a way that it plainly did not. Ground 1A of the appeal is therefore built around an error of fact. For that reason it is unsustainable.

The Decision on Top-Down Benchmarking

- 5.6 Brian McHugh in his witness statement describes in detail the circumstances in which the UR carried out a top-down benchmarking exercise and then decided not to use it for the purposes of setting allowances in GD17⁴⁸. In summary these were as follows.
- 5.7 In December 2014, the UR issued a GD17 Approach Document, indicating that it intended to carry out a top-down benchmarking process⁴⁹. The document stated that the UR did not envisage relying on this alone for the purposes of GD17, but that it would also undertake a bottom-up assessment and would then consider combining

⁴⁷ Notice of Appeal, paras 2.5 – 2.7, para 4.7 and paras 4.13 – 4.39

⁴⁸ McHugh-1, paras 7.1 – 7.28

⁴⁹ UR: GD17, Discussion Document on our Overall Approach, paras 4.23 – 4.41 – NOA-1 / Tab 3 / Pages 394 - 398

the two as part of a '*triangulated approach*' to setting opex allowances⁵⁰.

- 5.8 However, as the document also made clear, this was an initial view and not a decision⁵¹. That fact is best understood in the context in which the UR considered the adoption of top-down benchmarking to be a long-term project and understood that its introduction was not a straightforward exercise⁵².
- 5.9 The UR then developed its proposed top-down benchmarking approach, at the same time carrying out a full engagement process which exposed that approach to testing and input from the companies, while also commissioning and relying on advice from specialists in the field⁵³.
- 5.10 By the time of its Draft Determination in March 2016, the UR did not yet have sufficient confidence in the results of the benchmarking exercise as to place reliance on them for the purposes of the proposed allowances. Instead, it relied solely on the results of its bottom-up assessment.
- 5.11 This was stated clearly in a section headed: '*Triangulation of Top-Down and Bottom-up Assessment Findings*' –
- 'After comparing the various indicative results from our top-down opex benchmarking to our bottom-up opex assessment we recognise there is a requirement for further engagement with local GDNs to decide how we shall apply special factors (both positive and negative) before we conclude on our econometric modelling. For this draft determination, we have decided to apply the results of our bottom-up opex assessment.'*⁵⁴
- 5.12 The UR then carried out a further engagement exercise, but by the time of the Final Determination in September 2016 was still of the same mind as it had been at Draft Determination stage. In the context of FE in particular, it regarded the results of the benchmarking as being useful '*for indicative purposes only*'⁵⁵. As Mr McHugh says: '*Although we had given a lot of further thought to the issue of top-down benchmarking...we were not satisfied that we ought to place reliance on it for the purpose of setting the opex allowances of FE (or PNGL)*'⁵⁶.
- 5.13 In consequence, the UR set opex allowances solely on the basis of its bottom-up assessment. This was clearly stated in the Final Determination and its annexes –

⁵⁰ UR: GD17, Discussion Document on our Overall Approach, [para 4.31](#) – NOA-1 / Tab 3 / Page 396

⁵¹ UR: GD17, Discussion Document on our Overall Approach, [para 4.30](#) – NOA-1 / Tab 3 / Page 396

⁵² McHugh-1, [paras 7.1 and 7.5](#)

⁵³ McHugh-1, [paras 7.9 – 7.18](#)

⁵⁴ GD17 Draft Determination, [para 6.182](#) – NOA-1 / Tab 6 / Page 799

⁵⁵ GD17 Final Determination, [para 6.46](#) – NOA-1 / Tab 7 / Page 1841

⁵⁶ McHugh-1, [paras 7.21 – 7.22](#)

*'We have decided to apply the results of our bottom-up opex assessment in the final determination...'*⁵⁷

and

*'These top-down model estimates have not been used for setting the GD17 final determination allowances, with the Utility Regulator relying on the separate bottom-up approach instead'*⁵⁸ (emphasis added).

- 5.14 Moreover, it was made clear that these decisions were firmly grounded in the UR's policy of viewing top-down benchmarking as a long-term development project –

'This top-down analysis marks the first comprehensive econometric and unit cost analysis undertaken into the gas distribution industry in Northern Ireland. The Utility Regulator considers undertaking benchmarking analysis as in keeping with good regulatory practice.

The analysis has proved useful in understanding and interrogating the proposed opex costs of the NI GDNs for GD17, and has formed a good foundation from which to further develop and refine the modelling, as additional data becomes available in future years.

...

*Benchmarking the NI GDNs may be used in conjunction with bottom-up analysis to assess the business plan forecasts in the next gas distribution price control of GD23.*⁵⁹

- 5.15 The only use made of the results of the top-down benchmarking for the purposes of GD17 was described in the Final Determination in the following terms: *'the top-down econometric and unit cost results have informed the final determination and have provided a useful "sense check" of the bottom-up results'*⁶⁰.

- 5.16 For the purposes of this ground of appeal, FE seeks to make a great deal – indeed far too much, in the various ways identified below – of this statement. What the 'sense check' in fact amounted to, and did not amount to, is described by Mr McHugh in his witness statement⁶¹. As he makes clear, it did not have any bearing on the GD17 opex allowances, which were generated from the bottom-up assessment only.

The Ground of Appeal

- 5.17 FE argues that the benchmarking exercise was '*fundamentally flawed*' in a number of

⁵⁷ GD17 Final Determination, [para 6.27](#) – NOA-1 / Tab 7 / Page 1839

⁵⁸ UR: Top-Down Benchmarking, [footnote 48](#) – NOA-1 / Tab 7E / Page 2850

⁵⁹ UR: Top-Down Benchmarking, [paras 6.1 - 6.2](#), and [para 6.9](#) – NOA-1 / Tab 7E / Pages 2854 - 2855

⁶⁰ GD17 Final Determination, [para 6.27](#) – NOA-1 / Tab 7 / Page 1839

⁶¹ McHugh-1, [paras 7.29 – 7.38](#)

ways that it seeks to substantiate through the evidence of Alan Horncastle of Oxera. However, even if this were correct, it would be insufficient to establish that the GD17 opex allowances were 'wrong' if in fact they were entirely unaffected by the benchmarking results.

- 5.18 FE therefore goes to some lengths in its Notice of Appeal to state, or imply, that the 'sense check' which the UR carried out at the end of the GD17 process did in fact – in spite of the clear statements made by the UR to the contrary – have a bearing on its opex allowances by way of applying a 'downward bias' to them⁶².

Response to the Ground of Appeal

- 5.19 The fundamental problem that FE has in relation to this ground of appeal, and which it is unable to overcome, is apparent from the way in which it attempts to frame its arguments.
- 5.20 The starting point is that the UR's 'sense check' took place only as the last act in the GD17 process. That is the natural meaning of the phrase 'sense check'. No mention was made of it in the Draft Determination. Instead it was applied to the 'results' of the bottom-up assessment at Final Determination stage⁶³. Brian McHugh describes it as '*a relatively cursory exercise carried out at the very end of the process*'⁶⁴. None of the allowances arrived at in reliance on the UR's '*separate bottom-up approach*'⁶⁵ were adjusted because of it.
- 5.21 However, this does not assist FE, which seeks to establish that benchmarking had an effect on the allowances. It therefore employs a range of formulations which state or strongly imply that this sense check occurred earlier, either prior to or as part of the bottom-up assessment.
- 5.22 For instance, the sense check is said to have been: '*used to inform the UR's bottom-up cost line assessment*'⁶⁶; '*inappropriately taken into account in the UR's bottom-up cost line assessment*'⁶⁷; and '*allowed...to influence [the UR's] bottom-up cost line assessment*'⁶⁸.
- 5.23 Most striking are the statements which explicitly reverse the chronology –

'The UR's top-down benchmarking assessment concluded that "there is scope to reduce FE's business plan Opex costs by up to 25.3%, to reach what

⁶² Notice of Appeal, [para 4.7](#)

⁶³ GD17 Final Determination, [para 6.27](#) – NOA-1 / Tab 7 / Page 1839

⁶⁴ McHugh-1, [para 7.36](#)

⁶⁵ UR: Top-Down Benchmarking, [footnote 48](#) – NOA-1 / Tab 7E / Page 2850

⁶⁶ Notice of Appeal, [para 2.6](#)

⁶⁷ Notice of Appeal, [para 4.36](#)

⁶⁸ Notice of Appeal, [para 4.18\(b\)](#)

has been assessed as efficient operational costs". This conclusion was then used by the UR to inform its bottom-up cost line assessment...¹⁶⁹

'The UR used the results of its top-down benchmarking analysis as an "indication" that there is scope to reduce FE's business plan Opex costs by up to 25.3% and then went on to cut FE's Opex allowance by 19%.¹⁷⁰

(emphasis added)

- 5.24 Instead of explaining that the bottom-up assessment was being concluded and then subjected to a sense check by reference to the outputs of benchmarking (the actual sequence of events), these statements are designed to suggest that a top-down analysis was completed first and then used to dictate the outcome of the bottom-up assessment.
- 5.25 This implied causation is drawn out most clearly in FE's statement that the top-down benchmarking *'gave rise to further downward bias in the UR's overall assessment of FE's efficient operating costs'¹⁷¹.*
- 5.26 However many times this point may be restated, and in however many ways, it fails because it bears no resemblance to the facts.
- 5.27 FE does not say by what mechanism this supposed *'bias'* was given effect, to what extent it influenced the bottom-up results, or what evidence exists to support the implication that it did. It cannot do so, because the alleged effect did not occur. As Mr McHugh states: *'it is entirely unclear by what kind of mechanism they say this happened...there is no means by which we could have used the top-down benchmarking in this way...as a matter of fact, this did not happen'¹⁷².*
- 5.28 The situation is clear. The UR relied solely on the bottom-up assessment to propose allowances in its Draft Determination⁷³. It relied solely on the bottom-up assessment to set allowances in the Final Determination⁷⁴. It did not rely on the outputs of the top-down benchmarking⁷⁵. But it may do so next time (i.e. for GD23)⁷⁶.
- 5.29 In these circumstances, the argument that the top-down benchmarking exerted any downward bias or other kind of inappropriate effect on FE's GD17 opex allowances is unsustainable.

⁶⁹ Notice of Appeal, [para 4.15](#)

⁷⁰ Notice of Appeal, [para 4.37](#)

⁷¹ Notice of Appeal, [para 4.7](#)

⁷² McHugh-1, [paras 7.37 - 7.38](#)

⁷³ GD17 Draft Determination, [para 6.182](#) – NOA-1 / Tab 6 / Page 799

⁷⁴ GD17 Final Determination, [para 6.27](#) – NOA-1 / Tab 7 / Page 1839

⁷⁵ UR: Top-Down Benchmarking, [footnote 48](#) – NOA-1 / Tab 7E / Page 2850

⁷⁶ UR: Top-Down Benchmarking, [para 6.2](#) – NOA-1 / Tab 7E / Page 2854

The UR Position on Ground 1A

- 5.30 FE's expert witness, Mr Horncastle, states that '*top-down benchmarking is a viable regulatory tool for regulating NI GDNs at some point in time*'⁷⁷. The UR agrees. That is why it is engaged in a project which is designed to lead to that outcome eventually. That is also why it carried out a comprehensive econometric and unit cost analysis as part of the GD17 process, why it intends to further develop and refine its models, and why it has said that it may make use of top-down benchmarking in GD23.
- 5.31 However, the UR also agrees that the time to use top-down benchmarking for the purposes of setting allowances is not now, in GD17. This is why it did not do so, and why it stepped back from its initial intention to adopt a triangulation approach and instead relied solely on its bottom-up assessment.
- 5.32 With regard to the '*sense check*', FE seeks to attach to this a significance and effect that it did not have. The top-down benchmarking had no impact on the determined opex allowances. '*The outturn was the same as it would have been if the sense check had never taken place.*'⁷⁸
- 5.33 The UR says that this is complete answer to the appeal brought under Ground 1A. For that reason, while it does not accept the statement that its econometric models contained '*fundamental flaws*' it has not engaged with the detail of that argument in this submission.
- 5.34 If, contrary to the UR's principal contention, the CMA wishes to explore the details of the modelling exercise, the UR will be willing to assist by making further submissions at that time.

Other Features of Ground 1A

- 5.35 Three features of this ground of appeal deserve note.
- 5.36 First, the UR's approach to top-down benchmarking provides a clear example of the success of the consultation and engagement process followed by it for the purposes of GD17. In deciding not to pursue a triangulation approach as originally intended, it was responsive to the concerns of the companies about difficulties associated with aspects of benchmarking. It accepted that '*it is likely to require a few more years of refinement, analysis and data*'⁷⁹ before benchmarking can be used to set allowances. Ironically, FE now wishes to insist that this outcome was not achieved.
- 5.37 Second, this ground of appeal is not said to stand alone. No specific relief is claimed by FE in relation to it⁸⁰. In spite of the generality with which it has been expressed, its function is: '*supporting FE's challenges to the other aspects of the UR's assessment of*

⁷⁷ Oxera OPEX Report, [para 1.14](#) – AH-1 / Tab 1 / Page 3

⁷⁸ McHugh-1, [para 7.38](#)

⁷⁹ McHugh-1, [para 7.25\(c\)](#)

⁸⁰ Notice of Appeal, [para 4.6](#)

*Opex challenged within ground 1*⁸¹. In the Notice of Appeal it is expressly said to support all such grounds other than Ground 1C⁸², but in fact it is only referred to as a supporting argument in Ground 1B⁸³ and Ground 1D⁸⁴.

- 5.38 Third, while FE insists that benchmarking has no proper place in affecting the UR's bottom-up allowances which form the subject-matter of Grounds 1B and 1D, it freely reaches for top-down benchmarking (or principles or information which derive from it), in its arguments that those allowances should be increased⁸⁵. This is neither a consistent nor persuasive way in which to advance its case in this appeal.

Conclusion

- 5.39 For all of the above reasons, FE's appeal on Ground 1A should be dismissed.

⁸¹ Freshfields Bruckhaus Deringer: Letter to Gavin Knott, 16 December 2016, [para 4.3](#)

⁸² Notice of Appeal, [para 4.7](#)

⁸³ Notice of Appeal, [para 4.52](#)

⁸⁴ Notice of Appeal, [para 4.74](#)

⁸⁵ Notice of Appeal, [para 4.48](#) and [paras 4.53 – 4.54](#) (Ground 1B) and [paras 4.65 – 4.66](#) (Ground 1D)

SECTION 6. GROUND 1B – 'THE MAINTENANCE SPARSITY ERROR'

Introduction

- 6.1 FE argues that it operates in a sparsely populated, largely rural area. It claims that this is a special factor that imposes greater costs on its maintenance activities, that the UR failed to take proper account of it, and in consequence that its allowance for maintenance opex is understated⁸⁶.
- 6.2 The UR does not dispute that FE's licensed area has a comparatively low population density, but the extent and significance of this factor are considerably overstated in its submissions. FE's network is being developed only in the more populous parts of its area, which exist along linear transport corridors. Other networks in other parts of the UK operate in lower density areas.
- 6.3 The UR does not consider, when all relevant factors are taken into consideration, that there is any basis for concluding that FE is subject to materially higher costs by comparison with the costs of similar activities that are undertaken by PNL.
- 6.4 FE's argument for the proposition that 'sparsity' leads to higher maintenance costs – which is substantially repeated in this appeal – was fully considered and rejected by the UR in the Final Determination. The UR was right to do so, for reasons developed in detail below.

The Decision on Network Maintenance Opex

- 6.5 In its GD17 Business Plan, FE proposed a trebling of its network maintenance opex allowance, from £0.47m per annum in 2015 to £1.44m per annum in 2022⁸⁷.
- 6.6 This '*marked escalation*'⁸⁸ in costs was mainly driven, as FE accepts in this appeal⁸⁹, by the need for FE to carry out a number of new maintenance activities during GD17, triggered by a requirement to maintain assets on a 10 year cycle for the first time⁹⁰.
- 6.7 In response to this, the UR –
- (a) asked its consultants to carry out a bottom-up review of FE's proposed costs⁹¹; and
 - (b) when that review concluded that the costs were broadly reasonable but were capable of efficiencies, carried out a benchmarking exercise to determine a reasonable allowance which took into account those efficiencies⁹².

⁸⁶ Notice of Appeal, [paras 2.8 - 2.9](#) and [paras 4.40 – 4.56](#)

⁸⁷ GD17 Final Determination, [para 6.202](#) – **NOA-1 / Tab 7 / Page 1866**

⁸⁸ GD17 Draft Determination, [para 6.23](#) – **NOA-1 / Tab 6 / Page 770**

⁸⁹ Notice of Appeal, [para 4.9\(b\)](#)

⁹⁰ FE GD17 Business Plan Commentary, [para 6.4.2](#) – **NOA-1 / Tab 19 / Pages 4629 - 4631**

⁹¹ GD17 Final Determination, [para 6.205](#) – **NOA-1 / Tab 7 / Page 1867**

- 6.8 The need for this benchmarking exercise – distinct from the top-down benchmarking addressed under the heading of Ground 1A – is described in the witness statement of Brian McHugh⁹³.
- 6.9 In summary, there were three reasons why this process was necessary.
- 6.10 First, because the increase in maintenance opex during GD17 was mainly driven by new activities being carried out by FE for the first time as part of the 10 year cycle, it followed that FE had no prior experience of undertaking those activities within a price controlled environment which would allow efficient costs to be revealed.
- 6.11 Second, bottom-up assessments of large volumes of small value activities carry a risk of incorrect cost estimation, in particular by failing to recognise potential efficiencies and economies of scale.
- 6.12 Third, the UR's consultants had highlighted the potential for such efficiencies.
- 6.13 Since PNLG was ahead of FE in the maintenance cycle, and had experience of carrying out comparable 10 year maintenance activities on its network, it was appropriate for the UR to carry out a benchmarking process assessing FE's proposed costs against the GD17 allowances determined for PNLG in the light of PNLG's historic cost data. Moreover, as the UR rightly concluded in the Final Determination, this approach was not only appropriate but also '*essential to protect consumers*'⁹⁴.
- 6.14 In contrast, FE asked the UR, and in this appeal it asks the CMA, simply to accept its proposed costs. For the purposes of the appeal it repeatedly misrepresents them as '*actual costs*'⁹⁵, when in fact they were merely FE's own estimates which required to be subjected to appropriate regulatory scrutiny.
- 6.15 The UR consulted on the benchmarking approach as part of its Draft Determination, outlining the nature of its analysis and reaching provisional conclusions about the efficiencies attainable by FE⁹⁶.
- 6.16 In its response to the Draft Determination, FE argued that the benchmarking failed to take proper account of the impact of sparsity⁹⁷, and submitted a report by DNV.GL in support of that proposition⁹⁸. The UR did not accept this argument for reasons given in the Final Determination⁹⁹ and – since the same argument is made in this appeal – developed in detail below.
- 6.17 However, at the same time, the UR continued to engage with FE in relation to the

⁹² GD17 Final Determination, [paras 6.206 – 6.212](#) – **NOA-1 / Tab 7 / Pages 1867 - 1868**

⁹³ McHugh-1, [section 8](#).

⁹⁴ GD17 Final Determination, [para 6.213](#) – **NOA-1 / Tab 7 / Page 1869**

⁹⁵ Notice of Appeal, [para 2.9](#) and [para 4.40](#)

⁹⁶ GD17 Draft Determination, [para 6.23](#) and [paras 6.116 – 6.127](#) – **NOA-1 / Tab 6 / Pages 770, 785 - 789**

⁹⁷ FE Response to the GD17 Draft Determination, [section 3.3](#) – **NOA-1 / Tab 21 / Pages 4860 - 4863**

⁹⁸ DNV.GL Response to Utility Regulator's Draft Determination – **NOA-1 / Tab 21G**

⁹⁹ GD17 Final Determination, [para 6.213](#) – **NOA-1 / Tab 7 / Page 1869**

other details of the benchmarking exercise, in the manner described in the witness statement of Brian McHugh¹⁰⁰.

- 6.18 The effect of this ongoing engagement was reflected in the refinement of the UR's analysis in several respects, as outlined in the Final Determination¹⁰¹.
- 6.19 In headline terms, at the Draft Determination stage the UR had calculated that the variable maintenance costs of PNLG were 27% lower than the benchmark calculated using unit rates derived from the FE bottom-up cost estimate for GD14, and in consequence had proposed a 25% adjustment to FE's estimate of its own future costs¹⁰². Following further engagement with FE, for the purposes of the Final Determination the corresponding figures were that PNLG's costs were shown as 21% lower than the FE benchmark, and the UR proposed a 15% adjustment to FE's own cost estimates¹⁰³.
- 6.20 In this conclusion, it is clear that by strictly applying the benchmarking analysis the UR would have been justified in reducing FE's proposed cost allowances by 21%. As Brian McHugh explains, the final adjustment of 15% was intended as a conservative application of the benchmarking data – the UR recognised the potential for a margin of error in the benchmarking exercise, and therefore exercised its discretion to err on the side of caution and in FE's favour¹⁰⁴.

The Ground of Appeal

- 6.21 FE says that the UR was wrong because it *failed to take proper account of sparsity (i.e. significantly lower population and customer densities) within FE's Licence Area*¹⁰⁵ and that the opex allowance for network maintenance was therefore understated by £0.97m¹⁰⁶. The calculation of this figure is not explained, but it appears to be the difference between what FE was allowed and what it requested.
- 6.22 In legal terms, the UR is said to be wrong by having failed properly to have regard or give appropriate weight to aspects of its principal objective and general duties, and by having determined to make modifications which fail to achieve one of the effects specified in the decision notice¹⁰⁷.
- 6.23 FE appears to rely on six lines of argument in its attempt to demonstrate that it was wrong of the UR not to make a special allowance for sparsity, specifically –
- (a) the data as to population and customer density;

¹⁰⁰ McHugh-1, [para 8.8](#)

¹⁰¹ GD17 Final Determination, [paras 6.210 – 6.211](#) – NOA-1 / Tab 7 / Pages 1867 - 1868

¹⁰² GD17 Draft Determination, [para 6.125](#) – NOA-1 / Tab 6 / Pages 788 - 789

¹⁰³ GD17 Final Determination, [para 6.212](#) – NOA-1 / Tab 7 / Pages 1868 - 1869

¹⁰⁴ McHugh-1, [para 8.10](#)

¹⁰⁵ Notice of Appeal, [para 4.41](#)

¹⁰⁶ Notice of Appeal, [para 4.56](#)

¹⁰⁷ Notice of Appeal, [para 2.17](#)

- (b) the DNV.GL report;
- (c) previous regulatory decisions;
- (d) anecdotal evidence relating to one of FE's contractors;
- (e) the impact of top-down benchmarking; and
- (f) the work of the UR's own consultants¹⁰⁸.

Response to the Ground of Appeal

6.24 Each of these lines of argument is addressed below, but it is necessary to begin with two general observations about FE's case in relation to this ground of appeal.

6.25 First, that case relies to a high degree on the selective use of sources. In particular, as is apparent from the analysis below, FE chooses to emphasise costs that might be associated with limited population density in rural areas ('sparsity') while declining to acknowledge any of the evidence – frequently found in the same source materials – relating to the costs associated with high population density in urban areas (so-called 'urbanity').

6.26 Second, FE misrepresents the UR's decision at least twice in its Notice of Appeal. Notably –

'By substituting FE's actual costs with the UR's own figures produced from a benchmarking exercise which compare the maintenance costs of FE with those of PNGL, and then applying a 15% reduction, the UR failed to take proper account of the impact of sparsity...'¹⁰⁹ (emphasis added)

6.27 The UR did not substitute 'actual costs' with its own figures. As noted above, much of the allowance sought by FE related to activities to be carried out by it for the first time in GD17. What was adjusted following benchmarking was FE's proposed cost allowances in the form of its own bottom-up estimates.

6.28 Similarly, the UR did not substitute one set of numbers with another and 'then' apply a 15% reduction. The adjustment of 15% was applied to FE's proposed allowances in the light of the output of the benchmarking exercise.

6.29 In addition –

'In setting FE's Opex allowance for maintenance in GD17, the UR substituted FE's actual costs for its own figures... This suggests that the UR approached its bottom-up assessment of FE's maintenance costs with a presumption that FE

¹⁰⁸ Notice of Appeal, paras 4.40 – 4.56

¹⁰⁹ Notice of Appeal, para 2.9

*is inefficient compared with PNLG. However, no justification is provided for this 15% reduction.*¹¹⁰ (emphasis added)

- 6.30 As already noted, the UR did not substitute actual costs with its own figures. Nor did it approach the benchmarking exercise with any presumptions – on the contrary, as Brian McHugh identifies, the entire purpose of carrying out a benchmarking analysis was to identify what efficiencies might be possible based on the experience of PNLG of operating to a 10 year maintenance cycle¹¹¹.
- 6.31 The statement that no justification was provided for the UR's 15% adjustment is also factually inaccurate. It is clear from the Final Determination that the adjustment derived from the benchmarking exercise¹¹². It must equally have been clear to FE how that adjustment was derived, not least since it was offered and took the opportunity to engage fully with the UR in relation to the benchmarking analysis. The product of this engagement was a refinement of the UR's analysis between the Draft and Final Determinations¹¹³, and a downward adjustment in the output of the exercise in order to allow (in FE's favour) for a potential margin of error.

Data as to Population and Customer Density

- 6.32 The UR takes no issue with the statement that the FE Licence Area has a low density of population when compared with the Greater Belfast conurbation which forms the majority of PNLG's Licence Area. It is unable to replicate the population density data to which FE refers¹¹⁴, but it is not necessary to do so in order to recognise the nature of the area, which is characterised by a number of small to medium sized population centres within an otherwise rural environment.
- 6.33 However, it does not follow from this fact alone that network maintenance activities within the FE area are more costly than those of PNLG in Greater Belfast.
- 6.34 When FE says that '*A small customer base spread across a largely rural Licence Area with low population density makes it more expensive for the company to maintain its network on a per customer basis*'¹¹⁵ it misleadingly conflates density of population with density of customers per kilometre of network. The closing words '*on a per customer basis*', make the statement irrelevant in any event. The UR did not set the maintenance opex allowance on a per customer basis, but determined an aggregate allowance. FE has taken no issue in this appeal with the assumptions about volume of activity which the UR made for that purpose.
- 6.35 FE's own expert witness, Alan Horncastle of Oxera, is carefully specific. Mr

¹¹⁰ Notice of Appeal, para 4.40

¹¹¹ McHugh-1, para 8.6

¹¹² GD17 Final Determination, para 6.212 – NOA-1 / Tab 7 / Pages 1868 - 1869

¹¹³ GD17 Final Determination, paras 6.210 – 6.211 – NOA-1 / Tab 7 / Pages 1867 - 1868

¹¹⁴ Notice of Appeal, para 4.45 and Martindale-1, para 5.3. Both refer to their source as being FE Response to the GD17 Draft Determination, Figure 3.4 – NOA-1 / Tab 21 / Page 4861. However, the underlying source of the data in that table is not specified. Consequently the UR is unable to verify the numbers given.

¹¹⁵ Notice of Appeal, para 4.42.

Horncastle says: 'the more sparsely populated the area is, the more expensive it is for a company to maintain its network on a per-customer basis and resource staff to attend emergency calls' (emphasis added)¹¹⁶.

- 6.36 Emergencies are not provided for within the maintenance opex allowance, but were the subject of a separate allowance which is not under appeal¹¹⁷. Excluding them, Mr Horncastle is making a point which relates only to 'unit costs'¹¹⁸.
- 6.37 Mr Horncastle's statement in his expert evidence for this appeal is consistent with the Oxera reports previously prepared for FE. Precisely the same language is used in both the May 2016¹¹⁹ and June 2015¹²⁰ reports.
- 6.38 The tentative observation of Oxera on which FE relies for the purposes of the appeal, that sparsity 'implies that FE may incur higher unit costs to maintain its network'¹²¹, is making the same point.
- 6.39 Moreover, any appropriately balanced analysis of the potential costs associated with varying degrees of population density must recognise that densely populated areas give rise to costs which are avoided in more sparsely populated ones. Oxera is aware of this fact, and acknowledges it in its June 2015 report under the heading '*Urbanity*', where it states that: '*The level of costs in urban areas may be influenced by lower productivity in such areas due to traffic, access restrictions, etc.*'¹²².
- 6.40 FE, which must therefore also be aware of this fact, fails to make any reference to it for the purposes of its appeal.
- 6.41 In short, there is no reason to conclude that the lower density of population in the FE area necessarily means that its network maintenance costs are higher than those of PNL.

The DNV.GL Report

- 6.42 The DNV.GL report is an attempt to explain and quantify what FE claims is the effect of sparsity, and it is the only document which tries to do so. However, its analysis is highly unreliable. The UR considered it for the purposes of the Final Determination, but was right to attribute little weight to it¹²³.
- 6.43 The analysis within the DNV.GL report is principally contained within its appendices.

¹¹⁶ Oxera OPEX Report, para 2.27 – AH-1 / Tab 1 / Page 10

¹¹⁷ GD17 Final Determination, paras 6.193 – 6.201 – NOA-1 / Tab 7 / Pages 1864 - 1866

¹¹⁸ Also at Oxera OPEX Report, para 2.27 – AH-1 / Tab 1 / Page 10

¹¹⁹ Oxera Review of the Utility Regulator's top-down OPEX Benchmarking for GD17, para 3.1 – AH-1 / Tab 2 / Page 39

¹²⁰ Oxera Benchmarking and Efficiency Assessment, para 4.1.3 – AH-1 / Tab 3 / Page 64

¹²¹ Notice of Appeal, para 4.42, quoting the Oxera (June 2015) Benchmarking and Efficiency Assessment, section 2 – AH-1 / Tab 3 / Page 58

¹²² Oxera Benchmarking and Efficiency Assessment, para 4.1.3 – AH-1 / Tab 3 / Page 63

¹²³ GD17 Final Determination, para 6.213 – NOA-1 / Tab 7 / Page 1869

Appendix A considers the impact of sparsity on travel time, which DNV.GL claims to account for the largest part (15%) of the impact of '*low asset concentration*' on FE's costs¹²⁴. Appendix B seeks to quantify that wider impact (24%), including the value of travel time¹²⁵.

Appendix A

- 6.44 DNV.GL has predicated its analysis on the assumption that all of FE's maintenance staff must each day start and finish work at the company's depot in Antrim, travelling to the location at which they carry out the maintenance and then making the return journey. It then carried out a desk based analysis of the travel time that would be taken for this purpose, relying on the online AA Route Planner. It made an equivalent assumption and carried out the same analysis for PNGL, and concluded that by virtue of extra travel time spent FE's productivity for maintenance work would be 85% that of PNGL.
- 6.45 Brian McHugh explains in more detail the fundamental flaws in this approach¹²⁶, but in summary –
- (a) The presumption that all maintenance staff start and finish work at the depot is unrealistic and would not represent efficient practice. The UR would expect any network business to take advantage of activity planning and remote work scheduling so that its staff, many of whom will not live in the vicinity of the depot, follow the most efficient work pattern.
 - (b) Even if the presumption was accepted for the purposes of ready comparison between FE and PNGL, the journeys attributed to PNGL staff require further highly simplistic assumptions to be made. FE's network is located in the area of each of the Ten Towns which are connected by a linear road network, and its depot is in the centre of its area, so that it is comparatively easy to map most of the journeys from one place to another. In contrast, PNGL's network is essentially radial, centred on Belfast, and its depot is in the north-east corner of the city. DNV.GL appears to assume that a journey from PNGL's depot into the centre of Belfast – a comparatively short journey on a major arterial route – serves as a proxy for all journeys within the Belfast area. In reality, it would be entirely unrepresentative of urban travel through the city centre and across the Belfast suburbs.
 - (c) The travel time required for a journey to central Belfast is highly sensitive to time of day and road traffic conditions. So is the travel time to Larne, which from PNGL's depot unavoidably requires travel through central Belfast, as any road map of Northern Ireland demonstrates. While there are no measurable congestion effects for travel in the FE area, due to the largely rural nature of the areas between the Ten Towns, independent surveys show that Belfast is

¹²⁴ DNV.GL Response to Utility Regulator's Draft Determination – **NOA-1 / Tab 21G / Pages 5027 - 5028**

¹²⁵ DNV.GL Response to Utility Regulator's Draft Determination – **NOA-1 / Tab 21G / Pages 5029 - 5030**

¹²⁶ McHugh-1, [para 8.25](#).

one of the most traffic congested cities in the UK, and on one measure *the* most congested. DNV.GL do not record any time of day assumptions, or show any recognition of the fact that traffic congestion is an important element in assessing traffic times within the urban area.

- 6.46 The effect of this is summarised by Mr McHugh: 'No-one with a passing familiarity with Belfast or with traffic conditions in the Belfast area on any normal working day would imagine that half of all journeys undertaken by PNLG staff from the company's depot would take only 15 minutes. No-one would imagine that 35 minutes was the average journey time from Belfast to Larne.'¹²⁷ DNV.GL's listed travel times within the Ten Towns' area may be broadly representative, but the times for PNLG's are highly unrealistic.
- 6.47 This points not only to a failure to reflect local knowledge on the part of DNV.GL, but to their failure to take any account of the costs associated with urbanity. Any analysis which adjusts only for the notional effect of sparsity without taking into account the effects associated with population density is neither balanced nor reliable.

Appendix B

- 6.48 An equivalent, and fundamental error, undermines from the outset DNV.GL's work in estimating the '*cost effect of asset concentration*'. DNV.GL note that no public data on this issue are available, and proceed to carry out a comparison using data from a '*large gas transmission pipeline network*', an exercise which they justify on the basis that: '*Although the network duty [sic] differs from firmus energy's the principle of maintaining a distributed asset is the same...*'.
- 6.49 In reality, differences between gas transmission and distribution networks preclude any such easy comparison. In particular, higher asset concentration on distribution networks is likely to be associated with urbanity (and its accompanying costs) whereas no such effect can be assumed in the case of transmission networks, the nature and location of which is unlikely to make them subject to any significant costs associated with the urban environment.
- 6.50 Even if this fundamental problem had not existed, it would have been difficult for the UR to place any weight on this part of the DNV.GL analysis. The relevant network is not identified, nor is the source of the underlying data. Those data are not available, so that their quality cannot be assessed and no further analysis can be carried out in relation to them.
- 6.51 Additionally, the twelve maintenance organisations are not identified. There may be any number of differences between them, their contract terms, the activities they were required to carry out, the circumstances in which they operated, their performance, or their quality, any of which might account for cost differentials that are unrelated to asset concentration. Nothing is known about the degree to which the network engaged in effective contract management of its contractors, or the

¹²⁷ McHugh-1, [para 8.26](#)

nature of any regulatory oversight or intervention. It is insufficient to say that the contractors used '*common maintenance requirements*' or that data were collected from them '*using common criteria*'; these factors by themselves cannot establish the reliability of the underlying data or their direct comparability¹²⁸.

- 6.52 In short, even if there were a sound basis for the comparability of distribution and transmission networks in respect of asset concentration, limited and anonymised data of the sort provided – which beg more questions than they answer – cannot be given any weight by a regulator for the purposes of setting a price control. The UR was both entitled and right to consider that the DNV.GL report could not be relied upon.

Decisions of Other Regulators

- 6.53 FE states that previous decisions by a number of UK regulators support its position on sparsity. Of these, the most directly relevant is Ofgem's decision on RIIO-GD1. The UR was aware of this and expressly took it into account in its Final Determination¹²⁹. None of the other examples now cited by FE was referred to by it during its extensive engagement with the UR during the GD17 process.

Ofgem RIIO-GD1

- 6.54 Two things are notable about Ofgem's treatment of sparsity in RIIO-GD1.
- 6.55 The first is that Ofgem made no sparsity adjustment in relation to maintenance opex. Instead, it concluded that: '*We consider sparsity effects to impact only on emergency and repair activities*' and '*The sparsity productivity impacts on both emergency and repair, but does not extend to other cost activities*'¹³⁰.
- 6.56 It is unclear what support FE claims to find in Ofgem's conclusion. Emergency and repair costs are dealt with under a separate head in the GD17 price control. They do not fall within maintenance opex, and they are not within the scope of this appeal. With regard to the costs which are appealed, Ofgem made no allowance for any sparsity effect. So far from supporting FE's case, the Ofgem precedent undermines it.
- 6.57 Second, Ofgem did not consider sparsity in isolation, but also considered its obverse – urbanity. Ofgem received submissions that there are additional costs associated with working in urban environments including '*street works issues such as additional requirements to close roads or put in place traffic controls, premium time working, requirements for full reinstatement of roads and congestion of underground assets*'. It accepted that this was the case and that a series of adjustments were necessary to

¹²⁸ It is unnecessary to develop the point in detail for the purposes of this submission, but the UR notes that there are also considerable problems with the nature of the regression analysis carried out by DNV.GL. Almost all the effect identified in the data is dependent on one data point which is both an anchor point and a cost outlier. A more rational treatment of outliers indicates that asset concentration has little or no discernible effect on maintenance costs

¹²⁹ GD17 Final Determination, [para 6.213](#) – **NOA-1 / Tab 7 / Page 1869**

¹³⁰ [Ofgem RIIO-GD1: Final Proposals – Supporting Document – Cost Efficiency](#), [para 2.13](#)

compensate for lower urban productivity¹³¹.

- 6.58 In consequence, in its Final Proposals, Ofgem made some adjustments for sparsity in relation to emergency and repair costs, and a much larger set of adjustments for the loss of productivity due to urbanity¹³². These are shown in the following table, which demonstrates that overall urbanity costs were much greater than overall sparsity costs.

Table 1: Annual average RIIO-GD1 sparsity and urbanity adjustment factors, £ million

Adjustment factor	EoE	Lon	NW	WM	NGN	Sc	So	WWU	Industry
Sparsity	- 0.8	0.72	0.5	0.07	-0.5	-1.3	0.44	- 2.6	- 3.5
Urbanity	- 0.5	-14	0.13	0.09	0.19	0.1	- 5.5	0.09	- 19.4

Source: *Ofgem: RIIO-GD1 – Final Proposals*¹³³

- 6.59 It is revealing that when FE refers to Ofgem's RIIO-GD1 Final Proposals, it cites only those references which relate to sparsity and excludes all references to urbanity¹³⁴, even though its own expert witness (Oxera) is aware of the urbanity adjustments in RIIO-GD17 and refers to them in its June 2015 report¹³⁵.

DPCR5 and RIIO-ED1

- 6.60 In the last two electricity distribution price controls, Ofgem has made adjustments in respect of the higher costs of Scottish and Southern Energy (SSE), which operates the electricity distribution network in the northern half of Scotland (which includes the Highlands and Islands region).
- 6.61 However, the position of SSE is unique. Unlike gas, electricity is subject to a universal service obligation¹³⁶. In the north of Scotland this requires the distribution system to extend to all premises, however remote, across the villages, hamlets, farms and isolated premises of the Highlands and Islands. In contrast, FE's network takes the form of several discrete distribution systems located only in the most populous parts of its Licence Area, the remainder of which continues not to be served by gas. This limited geographical extent of the network can be demonstrated quite readily by considering the map of the FE area¹³⁷.
- 6.62 No valid comparison can therefore be made between the maintenance costs of FE's gas network and the maintenance costs of the electricity network in the exceptional circumstances of SSE's area.

¹³¹ [Ofgem RIIO-GD1: Initial Proposals – Supporting Document – Cost Efficiency](#), Appendix 5, paras 1.11 – 1.17

¹³² [Ofgem RIIO-GD1: Final Proposals – Supporting Document – Cost Efficiency](#), paras 2.6 – 2.17

¹³³ [Ofgem RIIO-GD1: Final Proposals – Supporting Document – Cost Efficiency](#), Table 2.2

¹³⁴ Notice of Appeal, footnote 147

¹³⁵ Oxera Benchmarking and Efficiency Assessment, para 4.1.3 – AH-1 / Tab 3 / Page 63

¹³⁶ Article 3(3) of [Directive 2009/72/EC](#)

¹³⁷ FE Response to the GD17 Draft Determination, [Map 1](#) – NOA-1 / Tab 21 / Page 4861

6.63 Moreover, in both DPCR5¹³⁸ and RIIO-ED1, Ofgem also adjusted its benchmarking not only for sparsity in the north of Scotland, but for urbanity elsewhere, recognising the additional costs attributable to operation in urban areas.

NI Water (PC15) and WICS

6.64 Water and sewerage, which are also universal services, are even less comparable with gas distribution in the FE Licence Area. For the purposes of its most recent price control (PR14) Ofwat developed econometric cost models which revealed a series of complex relationships between cost and property/population density.

6.65 After considering different modelling options, Ofwat chose to use five water models and five sewerage models to determine cost allowances. All these models included the property density variable as a cost driver. The results can be summarised in the following table.

Table 2: Ofwat PR14: Parameter estimates and approximate marginal effect of density on costs

Cost Driver	Water Models					Sewerage Models				
	WM3	WM5	WM6	WM9	WM10	SW1	SW5	SW6	SW9	SW10
Density	(0.28)	0.21	0.28	0.27	0.41	0.58	(0.59)	(0.61)	0.04	0.05
Density ^ 2	1.15	1.07	0.94	0.24	0.35	(2.42)	(2.88)	(2.47)	(2.65)	(1.21)
Length x Density	0.65	0.51	0.56	0.36	0.45	(2.80)				
Density x Usage	(0.06)									
Load x Density							(3.59)	(4.51)	(2.07)	(3.79)
Overall marginal effect of density	2.62	2.86	2.72	1.11	1.56	(7.06)	(9.94)	(10.1)	(7.32)	(6.16)

Source: CEPA Analysis produced for Ofwat PR14¹³⁹

6.66 The estimated marginal effect of property density on costs was positive for all five preferred water models (WM3, WM5, WM6, WM9 and WM10). In contrast, the estimated marginal effect of property density on costs was negative for all five preferred sewerage models (SW1, SW5, SW6, SW9 and SW10).

6.67 In effect, Ofwat concluded that rurality imposed additional costs on the operation of water networks and urbanity on the operation of sewerage networks.

6.68 It follows that no simple comparison with the water and sewerage sector can reliably be made for the purposes of understanding the effects of rurality or urbanity on gas

¹³⁸ [Ofgem: DPCR5: Allowed Revenue: Cost Assessment Appendix, page 65](#)

¹³⁹ [CEPA: Ofwat: Cost Assessment: Advanced Econometric Models, pages 44- 55](#)

networks, beyond noting (as FE again declines to do) that both elements apply.

Anecdotal Evidence

- 6.69 FE invited the UR, as it now invites the CMA, to place weight on a piece of anecdotal evidence relating to a tendering process in 2015 from an '*engineering contractor*'¹⁴⁰, identified in the witness statement of Niall Martindale as McNicholas Construction¹⁴¹.
- 6.70 Aside from the general deficiencies of this type of evidence – second-hand, hearsay, anecdotal and unsupported by any data – it cannot be treated as having any direct relevance to allowances for maintenance opex since it is expressly related to '*construction team productivity*' (emphasis added), i.e. capex. The supporting paper referred to by Mr Martindale¹⁴² does not relate to maintenance costs¹⁴³.
- 6.71 The UR made no sparsity adjustment in respect of capex allowances in GD17, having seen no historic data which supported the suggestion that there was a sparsity effect on construction costs. SGN Natural Gas Limited (**SGN**) raised the issue, which was addressed fully in both the Draft Determination¹⁴⁴ and the Final Determination¹⁴⁵.
- 6.72 FE took no issue with the UR's refusal to make a capex adjustment for sparsity in its Response to the Draft Determination, and takes no issue with the allowed capex in this appeal. Its attempt to rely on anecdotal evidence as to construction costs in its argument for a higher maintenance opex allowance is, in this context, curious.

Top-Down Benchmarking

- 6.73 This has been answered fully in the representations on Ground 1A above.

UR Consultants

- 6.74 FE claims that the UR 'is also at odds with its own consultants'¹⁴⁶.
- 6.75 This argument is also curious. It appears to rely in the first instance on a partial quotation from the Final Determination. The full quotation, with the words that FE has omitted underlined, is as follows –

'We asked our consultants to review the bottom up estimate of costs prepared by FE. They concluded that the activities identified were reasonable and that the bottom up estimates of the unit costs was broadly reasonable with some exceptions. However, they highlighted opportunities

¹⁴⁰ Notice of Appeal, [para 4.51](#)

¹⁴¹ Martindale-1, [para 9.7](#)

¹⁴² Martindale-1, [para 9.8](#)

¹⁴³ FE Period Contract Overview – **NM-1 / Tab 7 / Pages 108 - 112**

¹⁴⁴ GD17 Draft Determination, [paras 7.50 – 7.56](#) – **NOA-1 / Tab 6 / Pages 866 - 867**

¹⁴⁵ GD17 Final Determination, [paras 7.92 – 7.97](#) – **NOA-1 / Tab 7 / Pages 1971 - 1972**

¹⁴⁶ Notice of Appeal, [para 4.50](#)

for synergies and efficiencies which could be achieved between the proposed activities by combining work into single visits or general economies of scale. This reflected similar comments made by FE in its own submission on opportunities to reduce costs through synergies between the activities.¹⁴⁷ (emphasis added)

- 6.76 As noted above, it was in the light of the opportunity for efficiencies highlighted here that the UR decided to carry out a benchmarking assessment of FE's proposed costs. A partial quotation from the Final Determination, omitting the statements which FE finds inconvenient, establishes nothing.
- 6.77 Similarly, a selection of quotations from work carried out by Deloitte¹⁴⁸ – concerned with top-down benchmarking (to which FE says the UR should have no regard) and expressly excluding consideration of '*special factors (both positive and negative)*'¹⁴⁹ that apply to both FE and PNGL – also does nothing to evidence FE's suggestion that the UR was at odds with its own consultants, which plainly it was not.

The UR's Position on Ground 1B

- 6.78 Ground 1B relates to an FE request for a very substantial increase in its maintenance opex allowance during GD17 – on an annual basis, three times greater at the end of the period than in the GD14 period.
- 6.79 The request had a legitimate basis, namely that FE is required to start carrying out a series of new maintenance activities in GD17 to give effect for the first time to a ten-year cycle of asset maintenance. Most of what was requested has been allowed, and it is clear from both the Draft and Final Determinations that – contrary to FE's legal case in this appeal – the UR understood perfectly well the need to give FE reasonable allowances for the performance of these activities, consistent with the UR's principal objective and general duties.
- 6.80 However, the UR is also required to have regard to '*the need to ensure a high level of protection of the interests of consumers of gas*'¹⁵⁰. It was therefore both necessary and appropriate for the UR to test the estimated costs put forward by FE by means of a bottom-up analysis and benchmarking against the other Northern Ireland gas distribution company, PNGL, which has prior experience of operating on a ten-year maintenance cycle.
- 6.81 FE claimed (and claims) that benchmarking should have been adjusted in its favour for the 'special factor' of low population and customer density in its area. However, the evidence that it submitted (and submits) in an attempt to substantiate that there

¹⁴⁷ GD17 Final Determination, [para 6.205](#) – **NOA-1 / Tab 7 / Page 1867**

¹⁴⁸ Notice of Appeal, [para 4.54](#)

¹⁴⁹ Deloitte: Relative Efficiency of Northern Ireland Gas Distribution Networks, [para 4.3](#) – **NOA-1 / Tab 7D – Page 2812**

¹⁵⁰ Article 14(2)(a) of the Gas Order. See also Article 40(g) of [Directive 2009/73/EC](#), incorporated by reference into the UR's principal objective at Article 14(1) of the Gas Order.

is a sparsity effect – principally the DNV.GL report, which is the only document that attempts to explain and quantify that effect – is entirely unreliable.

- 6.82 Moreover, in the closest regulatory precedent set by Ofgem during RIIO-GD1, which is a precedent on which FE itself relies, no sparsity adjustment was made in respect of maintenance opex.
- 6.83 Even if it had been appropriate to make such an adjustment, a range of regulatory precedents, including that of RIIO-GD1, demonstrate that it would also have been necessary to make compensating adjustments reflecting the costs experienced by PNGL operating in a densely populated urban area (the urbanity effect). On the basis of the work done by Ofgem, there is every reason to believe that this would at least have fully offset any possible sparsity adjustment that could have been justified.
- 6.84 FE is well aware of the urbanity issue, which was highlighted by its own consultants, Oxera, as well as by Ofgem in the RIIO-GD1 documents on which FE seeks to rely, but has selectively excluded it from its case as an inconvenient fact.
- 6.85 Ultimately, the UR was entitled to conclude that benchmarking FE's maintenance opex costs against those of PNGL was appropriate, and that adjusting for sparsity alone would have been unjustified and distortive of the outcome.
- 6.86 The UR engaged fully with FE on all other aspects of the benchmarking exercise, and demonstrably took FE's representations into account in the Final Determination. It also allowed a generous margin for error in FE's favour by setting the benchmarking adjustment at 15% when it would have been entitled to set it at a higher figure.
- 6.87 In all of these circumstances, the UR operated well within the scope of its legitimate regulatory discretion, and there is no credible case that the UR was 'wrong'.

Conclusion

- 6.88 For all of the above reasons, FE's appeal on Ground 1B should be dismissed.

SECTION 7. GROUND 1C – 'THE GIS OVERSIGHT ERROR'

Introduction

- 7.1 FE states that an allowance for professional and legal costs associated with the computerised mapping software (the Geographic Information System - GIS), has been omitted from the Opex allowance.
- 7.2 The particular category of costs with which this issue is concerned are professional and legal services costs relating to GIS support and maintenance, GIS licences, GIS development, software licences for other smaller IT systems, namely FME and FARR, Land and Property Services mapping, and to Landweb fees (collectively referred to as 'GIS costs').
- 7.3 The UR accepts that an allowance in respect of all GIS costs is not included within the Opex allowance. However, the UR has not made a substantive decision to disallow any such costs. This is accepted by FE as it does not contend that the UR made a substantive decision to disallow GIS costs.
- 7.4 The reasons why the UR did not make a substantive decision on the total allowance for GIS costs are explained by Brian McHugh in his witness statement¹⁵¹.
- 7.5 It follows that as the UR has not disallowed GIS costs, there is no decision which can be the subject of FE's appeal.
- 7.6 Moreover, the UR is minded to modify Condition 4.7 of FE's licence by amending the Determination Value $O_{E,t}$ such that it is increased to include an additional amount in respect of GIS costs.
- 7.7 Before making that modification, the UR is required to undertake a statutory consultation. In this respect it is aiming to give the notice required under Article 14(2) of the Gas Order by no later than Friday 27 January 2017.
- 7.8 It considers a 28 day consultation period to be sufficient for this purpose and will, having taken due account of any representations made within that period, make its decision as soon as possible thereafter, aiming to publish its decision by no later than Friday 3 March 2017.
- 7.9 Should, when that decision is made by the UR, FE consider it to be wrong on any one or more of the grounds set out in Article 14D of the Gas Order it can appeal that decision to the CMA under and in accordance with Article 14B(2)(a) of the Gas Order.
- 7.10 For these reasons the UR respectively asks that the CMA makes an early decision that it need not, at least for present purposes, consider the issues raised by FE under Ground 1C.

¹⁵¹ McHugh-1, [section 9](#).

Background to 'the GIS Oversight Error'

- 7.11 The reasons why the UR did not make a decision in respect of a total allowance for GIS costs as part of the GD17 Decision are confirmed by Brian McHugh¹⁵² and explained below for context.
- 7.12 In submitting its business plan and supplementary papers in September 2015, FE had allocated GIS costs to one cost line, namely 'customer management (emergency call centre)' in its business plan template¹⁵³ but its commentary was covered under a different cost line, namely 'network maintenance' in a supplementary paper¹⁵⁴.
- 7.13 A central feature of the engagement undertaken by the UR with FE prior to the Draft Determination involved seeking clarification on and requesting further information in respect of FE's business plan submissions.
- 7.14 In response to the UR's information request relating to professional and legal fees, FE stated that it had incorrectly allocated GIS costs to the cost line 'customer management (emergency call centre)' and that they should have been allocated to the cost line 'customer management (non-emergency call centre)'¹⁵⁵.
- 7.15 Notwithstanding this, the UR proposed an allowance for these costs within the 'network maintenance' cost line in its Draft Determination¹⁵⁶, consistent with the FE supplementary paper to the business plan submission.
- 7.16 In the period between the Draft Determination and the Final Determination, a significant level of engagement and clarification took place. One outcome of that clarification process was that both the UR and FE recognised that allocating GIS costs to the 'network maintenance' cost-line was incorrect. Accordingly, the Final Determination did not propose an allowance for GIS costs within the 'network maintenance' cost line.
- 7.17 As explained by Brian McHugh¹⁵⁷, having reviewed the UR's analysis on maintenance as provided to FE shortly after the publication of the Final Determination, on 28 September 2016 FE sought information from the UR on how the GIS costs had been treated/allowed for.
- 7.18 The UR interrogated its systems and files and concluded that it needed further information from FE on the historical reporting of GIS costs (including the cost line to which they were allocated) for the purposes of making a decision on the total amount to be allowed in respect of GIS costs. It sought that further information from

¹⁵² McHugh-1, paras 9.7-9.15.

¹⁵³ FE GD17 Business Plan Template - **NOA-1/Tab 18/Worksheets 3.8 and 3.10.**

¹⁵⁴ FE Supplementary Paper, GD17 Proposed Maintenance Activities - **NOA-1/Tab 20L/Pages 4790 -4821.**

¹⁵⁵ FE Response to UR Information Request number 44 - **NOA-1/Tab 8/Page 114.**

¹⁵⁶ GD17 Draft Determination, paragraphs 6.123 to 6.126 and Table 34 – **NOA-1/Tab 6/Pages 788 and 789.**

¹⁵⁷ McHugh-1, para 9.13.

FE on 19 October 2016¹⁵⁸.

- 7.19 UR did not have the information on the matter in advance of the deadline for the GD17 Decision¹⁵⁹. As outlined in our representations to the CMA in respect of permission, the GD17 Decision made it clear that these costs had not been disallowed and the UR would make a final decision on the total allowance for GIS costs after further engagement with FE.

Updated Position

- 7.20 As explained by Brian McHugh¹⁶⁰, since submitting its Notice of Appeal, FE has, on 10 January 2017, provided the UR with the information that the UR had initially sought on 19 October 2016.
- 7.21 The UR has considered the information provided and is satisfied that it should propose an additional amount in respect of GIS costs to be reflected within the total Opex allowance for GD17.
- 7.22 In its early deliberations following the publication of the Final Determination, the UR indicated to FE¹⁶¹ that if an additional allowance was required it would deal with it through the opex uncertainty mechanism¹⁶² in the FE licence.
- 7.23 On further reflection, the UR believes that while the opex uncertainty mechanism could certainly be utilised for delivering an additional allowance required in respect of GIS costs, the better option is to modify the Determination Value $O_{E,t}$ in Condition 4.7 of the FE Licence.
- 7.24 The UR believes it will be in a position to give notice, under Article 14(2) of the Gas Order, of its proposal to modify the Determination Value $O_{E,t}$ in Condition 4.7 of the FE Licence by no later than Friday 27 January 2017 (the **Proposed Modification**).
- 7.25 Accordingly, subject to any representations received, the UR considers that it should be in a position to publish, under Article 14(8) of the Gas Order, a decision in respect of the Proposed Modification by no later than Friday 3 March 2017.

CMA's Consideration

- 7.26 The UR considers that FE's appeal on this ground is therefore misguided and in any event certainly premature.
- 7.27 In light of all of the above, it is the UR's view that it would be appropriate for the CMA to make an early decision that it need not consider the issues raised by FE

¹⁵⁸ UR e-mail to FE - **NM-1/Tab 10/ Page 122**.

¹⁵⁹ This by virtue of Article 14(10) of the Gas Order needed to be published at least 56 days before 1 January 2017 (the start date of GD17).

¹⁶⁰ McHugh-1, para 9.16.

¹⁶¹ E-mail exchange between the UR and FE - **NM-1/Tab 10/ Pages 123 and 124**.

¹⁶² GD17 Decision - **NOA-1/Tab 9A/Pages 3432 to 3467**.

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under Ground 1C unless and until such time as one of the following events occurs -

- (a) The UR informs the CMA that it has not published a notice in respect of the Proposed Modification by the date noted in paragraph 1.24 and is no longer minded to do so.
- (b) The UR informs the CMA that, in light of representations to its statutory consultation, it will not be proceeding to make the Proposed Modification.
- (c) FE brings an appeal against the UR's decision to make the Proposed Modification to the CMA.

SECTION 8. GROUND 1D – 'THE MANPOWER SCALE ERROR'

Introduction

- 8.1 FE says that it is expected to deliver significant growth in its network and number of connections during GD17, and that its manpower allowance fails to keep pace with the corresponding increase in the size of its business. It argues that, in setting this allowance, the UR failed to take proper account of the cost drivers associated with the scale of a gas distribution network¹⁶³.
- 8.2 The argument is misconceived. The manpower allowance relates to activities that might best be described as central business services, and not to activities associated with the physical construction, connection or maintenance of assets (all of which are the subject of separate allowances). FE implies the existence of a linear relationship between the growth of its business and its manpower requirement for these central services. This is unsupported, indeed contradicted, by historic data.
- 8.3 In practice, an appropriate assessment of FE's manpower requirements required a bottom-up analysis of the needs of each of the central business functions. This was the exercise carried out by the UR. It involved a full process of engagement with FE, and led to a material increase in FE's manpower allowance for the GD17 period that was reasonable in relation to FE's needs.
- 8.4 The UR was right to take that approach, and FE's arguments on this ground of appeal are unsustainable for the reasons developed in detail below.

The Decision on Manpower

- 8.5 The GD17 price control does not make a general cost allowance for manpower, i.e. there is no cost line associated with it. Instead, the manpower requirements for each of the activities represented by the individual cost lines in the ACRT were considered by the UR as part of its bottom-up assessment of the needs of FE in respect of each activity¹⁶⁴.
- 8.6 The section in the Final Determination which related to manpower¹⁶⁵ therefore did not establish a discrete opex cost line, but was an aggregation of the Full Time Equivalent (FTE) positions implied in the allowances for each of the individual activities¹⁶⁶.
- 8.7 The UR did this because it recognises that manpower is an important opex element and is a useful proxy in determining how a growing company incurs additional costs. Nonetheless, it is important to note that the areas covered in the manpower section of the Final Determination all relate to central business services, and do not concern

¹⁶³ Notice of Appeal, [paras 2.13 - 2.14](#) and [paras 4.64 - 4.77](#)

¹⁶⁴ GD17 Final Determination, [paras 6.170 - 6.283](#) – NOA-1 / Tab 7 / Pages 1860 - 1881

¹⁶⁵ GD17 Final Determination, [paras 6.103 - 6.114](#) – NOA-1 / Tab 7 / Pages 1850 - 1851

¹⁶⁶ GD17 Final Determination, [Table 55](#) – NOA-1 / Tab 7 / Page 1882

field staff working on network construction, maintenance or connections. Costs associated with personnel engaged in those activities (either employed by FE or its contractors) are covered by the separate activity-specific allowances.

- 8.8 With regard to the central business services, the number of FTEs for which allowance was made in each cost category is summarised by Brian McHugh¹⁶⁷. It is represented in the following table, which compares FE's actual manpower numbers in 2014 with the manpower allowances set by the UR for GD17.

Table 3: Manpower Allowances, 2014 and 2017, FTEs

Opex Cost Items	2014	2017	Increase/(Decrease)
Asset Management	1.8	1.8	-
Operations Management	11.6	13.8	2.2
Customer Management	8.9	9.3	0.4
System Control	3.1	4.5	1.1
Emergency	0.3	0.55	0.25
Metering	0.5	0.85	0.35
PRE Repairs	0.9	1.2	0.3
Maintenance	1.0	2.05	1.05
IT & Telecoms	0.75	0.75	-
Property Management	1.0	1.0	-
HR & Non-Ops Training	0.6	1.2	0.6
Audit, Finance & Regulation	7.4	7.4	-
Procurement	0.2	0.33	0.13
CEO & Group Management	0.6	0.8	0.2
Advertising & Market Development (OO)	8.1	8.35	0.25
Advertising & Market Development (Non-OO)	5.9	3.4	(2.5)
Trainees & Apprentices	1.0	1.0	-
Total	53.7	58.3	

Source: UR calculations for the purposes of GD17 allowances¹⁶⁸

- 8.9 As this table demonstrates, the UR provided for increases in manpower allowances across almost all of the cost lines for which FE was considered to have requirements for central staff. The sole example of a decrease related to the non-OO advertising and market development category, where the reduction in headcount of 2.5 FTEs was consistent with FE's own proposal and reflects a change of marketing focus¹⁶⁹.

¹⁶⁷ McHugh-1, [para 10.5](#)

¹⁶⁸ McHugh-1, [Table 1](#)

¹⁶⁹ GD17 Final Determination, [para 6.166](#) – NOA-1 / Tab 7 / Page 1860

- 8.10 Overall, this involved an increase in manpower of 8.6% against 2014 actual numbers, or 13% excluding the reduction in the non-OO advertising and market development category (the personnel from which were available for redeployment elsewhere).
- 8.11 When FE claims that the UR was wrong to conclude that '*FE could sustain a 11.3% decrease in its requested manpower allowance*' for GD17¹⁷⁰, the words '*sustain*' and '*decrease*' are misleading, implying a lower manpower allowance than before. In fact all this means is that the UR, after a careful assessment of each cost line, did not accept that FE had a need for everything it asked for.
- 8.12 In addition, it should be noted that FE has flexibility within the allowances given for each of the relevant cost lines. It may if it wishes choose to allocate more or less of its allowance to manpower. In particular, in relation to OO advertising and marketing – where the UR has given a significant increase in allowances overall – it is a matter for FE how it spends the additional allowance, and it may choose if it wishes to allocate it to the recruitment of more FTEs than the UR has assumed in the above table.

The Ground of Appeal

- 8.13 Although the aggregate FTE allowances provided for in the Final Determination were composed of FTEs for individual opex cost lines, each of them deriving from a bottom-up assessment of FE's requirements in relation to the relevant activity, FE's challenge under this ground of appeal is brought on a broad brush basis.
- 8.14 FE does not highlight any individual cost line, or say why the FTEs allowed in respect of it are inadequate, or say what the manpower allowance in respect of that activity should be. Instead it invites the CMA to draw some very general conclusions about the aggregate manpower required by FE in GD17 from some broad statements about its growth as a company. The argument is essentially –
- (a) FE '*anticipates material growth*' in particular in size of network and number of connections¹⁷¹;
 - (b) scale is a principal driver of costs¹⁷²;
 - (c) therefore FE's manpower allowance must increase '*significantly*'¹⁷³.
- 8.15 In addition, FE says that the UR was wrong to provide for a '*flat manpower profile*' in GD17, and that manpower should not be '*static*' while FE's connections '*continue to increase year on year*'¹⁷⁴.

¹⁷⁰ Notice of Appeal, [para 4.73\(b\)](#)

¹⁷¹ Notice of Appeal, [para 4.67](#)

¹⁷² Notice of Appeal, [paras 4.65 – 4.66](#)

¹⁷³ Notice of Appeal, [para 4.71](#)

¹⁷⁴ Notice of Appeal, [paras 4.69 and 4.73](#)

8.16 FE attributes a value to the supposed '*manpower scale error*' of £1.2m, but discloses no details of how it calculated that figure¹⁷⁵.

Response to the Ground of Appeal

8.17 FE produces a graph which shows cumulative numbers of connections rising steadily while manpower stays (in relative terms) flat¹⁷⁶, and invites the CMA to conclude that there is a '*clear disconnect*' between the two things¹⁷⁷. It is implied that the lines on the graph ought to track each other more closely, but FE does not explain why that should be the case or what their relationship to each other should be.

8.18 FE also refers to statements made by both its and the UR's consultants which it sums up in the words of Alan Horncastle (of Oxera) that '*companies' scale of operations is the principle [sic] cost driver*'¹⁷⁸.

8.19 There is no dispute that, in high level terms, there is a relationship between the scale of a GDN and its costs. However, that does not assist FE's case. FE needs, and fails, to show that there exists a relationship between scale and the manpower needs of its central business services which is consistent with the allowances it seeks.

8.20 FE cannot show this because the actual relationship between business growth and the manpower required for these central functions is far more tentative and limited than it seeks to imply from its generic statements about scale and cost. This fact can readily be demonstrated by mapping FE's actual manpower numbers against growth in its network and connections during the period 2010 to 2015, represented in the following table.

Table 4: FE Manpower Allowances compared with Network Size and Connection Numbers, 2010 to 2015

Year	2010	2011	2012	2013	2014	2015	Increase (decrease) 2010 to 2015	% change 2010 to 2015
Actual FTEs (gross)	58	48	54.1	57	53.7	56	(2.0)	(3.5%)
Cumulative km laid	535	639	736.8	832.4	911.5	996.3	461.3	86.2%
Cumulative OO domestic connections	1,275	2,309	3,987	5,936	7,596	9,596	8,321	652.6%
Cumulative Total connections	8,034	11,540	15,776	20,009	24,028	28,178	20,144	250.7%

¹⁷⁵ Notice of Appeal, [para 4.77](#)

¹⁷⁶ Notice of Appeal, [para 4.10](#)

¹⁷⁷ Notice of Appeal, [para 4.75](#)

¹⁷⁸ Notice of Appeal, [paras 4.65 – 4.66](#)

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Source: UR calculations from data reported by FE¹⁷⁹

8.21 PNLG is a larger company in absolute terms, and more mature in terms of network development, but a consideration of the same categories of data in respect of its business over the period 2010 to 2015 leads to the same conclusion. Those data are represented in the following table.

Table 5: PNLG Manpower Allowances compared with Network Size and Connection Numbers, 2010 to 2015

Year	2010	2011	2012	2013	2014	2015	Increase (decrease) 2010 to 2015	% change 2010 to 2015
Actual FTEs (gross)	129.8	134.8	121	116.9	118.8	117.5	(12.3)	(9.5%)
Cumulative km laid	3202	3258	3261.3	3312.7	3359.4	3416.6	214.6	6.7%
Cumulative OO domestic connections	60,319	66,617	73,192	81,434	89,185	95,685	35,366	58.6%
Cumulative Total connections	138,755	148,474	158,997	171,020	182,114	192,217	53,462	38.5%

Source: UR calculations from data reported by PNLG¹⁸⁰

- 8.22 For both companies, and contrary to FE's appeal, significant increases in network size and/or connections were not associated with significant increases in manpower.
- 8.23 In these circumstances, the UR was correct to carry out a line-by-line assessment of FE's requirements in relation to each central business cost category, so as to set the manpower allowances as part of its bottom-up approach. It was also right to make reasonable and proportionate allowances for increased need in each category where it could be demonstrated.
- 8.24 FE says that the UR should not '*attempt to justify*' these manpower allowances by reference to the top-down benchmarking¹⁸¹. However, the UR does not seek to do so, for the reasons explained in relation to Ground 1A. It is an internal contradiction in FE's case that while claiming that benchmarking should have no downward effect on allowances (as it did not) it is to the top-down benchmarking that FE appeals when seeking to generate an upward effect on those allowances¹⁸².
- 8.25 It is also surprising to find FE asserting in this appeal that it was wrong for the UR to set '*static*' manpower allowances over GD17¹⁸³. This is not a credible objection to the UR's approach in circumstances in which FE's requested allowances, restated in its

¹⁷⁹ McHugh-1, [Table 2](#)

¹⁸⁰ McHugh- 1, [Table 3](#)

¹⁸¹ Notice of Appeal, [para 4.74](#)

¹⁸² Notice of Appeal, [para 4.68](#)

¹⁸³ Notice of Appeal, [para 4.73](#)

Notice of Appeal, had precisely the same '*flat manpower profile*'¹⁸⁴.

- 8.26 Similarly, it is not credible for FE to assert that it had 61 actual FTEs '*at November 2016*'¹⁸⁵ and that this demonstrates its need for more manpower than was allowed for GD17.
- 8.27 In GD14, FE's manpower allowance for 2016, which it did not challenge, was 55.5 FTEs. FE provides no explanation why its staff numbers would have spiked in 2016 far above both that allowance and the actual number of FTEs for 2015 (which was in line with the GD14 allowance for that year). Nor does it explain in which activities those staff are engaged.
- 8.28 The UR notes that in September 2015 FE provided a figure of 59.1 for its 2015 FTEs, and the actual number transpired to be 56¹⁸⁶. This suggests either significant short-term variability in the numbers or the unreliability of a snapshot picture. Whichever of these is correct, the UR was both entitled and right to base manpower allowances for GD17 on a detailed bottom-up assessment of each cost line which had regard to the specific needs of that area of business activity.

The UR Position on Ground 1D

- 8.29 For GD17, FE requested a 22.3% increase in its manpower allowance when compared with its 2014 actual manpower. Its assertion in this appeal that such an increase was required turns on high level statements about FE's growth, and implied relationships that it invites the CMA to make between that growth and manpower need.
- 8.30 In fact, the manpower in question is concerned with a group of central services, and not with FE's on-the-ground activities (for which allowance is made elsewhere). The staff requirements of these services may be expected gradually to increase over time as FE's network and customer base expands, but do not have the linear relationship to growth that FE seeks to imply. The historic data for network and customer growth show that there is no such effect on central manpower.
- 8.31 In these circumstances, the UR was right to look at the manpower requirements that were implied in each FE cost line, and to make appropriate allowances on the basis of a detailed bottom-up assessment. It did so following a full process of engagement with FE, and it allowed specific, reasonable and proportionate FTE increases for each activity. No challenge is made to those detailed assessments.

¹⁸⁴ Notice of Appeal, [para 4.69](#). The CMA may note the disparity between the requested FTEs stated here (65.7) and the requested number (67.2) stated in the Final Determination, para 6.104 – **NOA-1 / Tab 7 / Page 1850**. This is because FE's original request included 1.5 FTEs for non-executive directors, whose costs were required to be specified as professional and legal fees in accordance with the UR's guidance – Final Determination, [para 6.105](#).

¹⁸⁵ Notice of Appeal, [para 4.70](#)

¹⁸⁶ McHugh-1, [para 10.11](#).

Conclusion

8.32 For all of the above reasons, FE's appeal on Ground 1D should be dismissed.

SECTION 9. GROUND 1E – 'THE OMISSION ERROR'

Introduction

- 9.1 Under the broad heading of '*the Omission Error*', FE argues that in determining its opex allowance for GD17, the UR failed to properly take account of FE's efficient costs associated with audit, finance and regulation costs and central service costs which were previously accounted for in a '*parental recharge*' mechanism in FE's price control¹⁸⁷.
- 9.2 While this ground of appeal at first sight appears to be very broad and complex, on closer scrutiny the headed ground of appeal is made up of two separate grounds of appeal, each of which is distinct and is separately addressed below and neither of which is sustained.
- 9.3 The manner in which these grounds of appeal are presented is confusing and unhelpful. For example, FE stated that the errors to which it refers have resulted in its opex allowance being understated by £1.15 million¹⁸⁸. However, FE has not explained how this figure is calculated (whether by reference to each of the two grounds or otherwise). The UR has not been able to understand how it has been calculated.

The Ground of Appeal

- 9.4 FE states that the UR's bottom-up methodology for determining its opex allowance for GD17 '*failed properly to account of FE's efficient costs*' associated with '*audit, finance and regulation*' and '*central services costs previously accounted for in the parental recharge*'¹⁸⁹. In particular, the UR understands that this argument is based on the following two distinct grounds of appeal.
- 9.5 First, FE submits that, in using 2014 as the base year for its bottom-up assessment, the UR has omitted to include an allowance for audit, finance and regulation which is appropriate to cover FE's costs associated with the GD23 price control process. This is on the basis that '*engaging with the price control process is an unavoidable cost that FE must meet and these costs were not included within the 2014 cost dataset taken as the base year*'¹⁹⁰.
- 9.6 FE also submits that the UR was wrong to use 2014 cost data as the base year for the purpose of its bottom-up assessment of FE's operating costs in determining this allowance¹⁹¹, although we note that regulation cost is the only one it identifies as being omitted as a result of using this base year.

¹⁸⁷ Notice of Appeal, [paras 2.15 - 2.16](#) and [paras 4.78 – 4.102](#)

¹⁸⁸ Notice of Appeal, [para 4.102](#)

¹⁸⁹ Notice of Appeal, [para 4.78](#)

¹⁹⁰ Notice of Appeal, [paras 4.94 – 4.95](#)

¹⁹¹ Notice of Appeal, [para 4.80](#)

- 9.7 Second, FE submits that *'in removing the parental recharge allowance in GD17, the UR was... wrong not to make appropriate adjustments to other Opex cost lines to take proper account of the legitimate and necessary efficient costs which had previously been provided for within the parental recharge'*¹⁹².

Response to the Ground of Appeal

- 9.8 The UR's response on each point can be simply stated -
- (a) As supported by statements previously made by FE, in using 2014 as the base year for its bottom-up assessment of FE's operating costs, the UR used data which did include costs in relation to engaging with a price control process. The UR is satisfied that FE has received an appropriate allowance in this regard.
 - (b) It is a simple error of fact to state that the UR has omitted to include an allowance to cover costs which were previously accounted for in the parental recharge mechanism in GD14 in FE's GD17 price control allowances. The UR did include an allowance in relation to these costs.

Audit, finance and regulation allowance

- 9.9 The GD17 price control determination included an allowance for *'Audit, Finance & Regulation'* as part of the *'Business Support Activities'* opex allowance. As noted by FE in its Notice of Appeal¹⁹³, this allowance covers the costs of -

*'performing the statutory, regulatory and internal management cost and (business support activity) performance reporting requirements and customary financial and regulatory compliance activities for the network'*¹⁹⁴.

- 9.10 FE argues that the GD17 Final Determination contained an insufficient allowance in relation to this category of opex costs¹⁹⁵.

- 9.11 As a preliminary point, FE states that -

*'In its bottom-up assessment of FE's audit, finance and regulation costs, the UR reduced FE's allowance by 35% to £2,337,603. No clear justification was provided for this reduction in the GD17 Final Determination, other than the UR stating that it thought its reduction in the FTE employee allowance for this cost line was "appropriate".'*¹⁹⁶

¹⁹² Notice of Appeal, [paras 4.101](#)

¹⁹³ Notice of Appeal, [para 4.91](#)

¹⁹⁴ GD17 Final Determination, [paras 6.243 – 6.244 – NOA-1/Tab 7/Page 1874](#)

¹⁹⁵ Notice of Appeal, [paras 4.91 – 4.96](#) and Martindale-1, [paras 9.25 – 9.27](#)

¹⁹⁶ Notice of Appeal, [para 4.93](#)

9.12 This is misleading in two respects. First, the 35% reduction is a reduction between the costs claimed in FE's Business Plan and the costs determined in the GD17 Final Determination. It does not represent a reduction in FE's allowance. Second, it was made clear in the GD17 Draft Determination, and acknowledged by FE in its response¹⁹⁷, that the allowance was based on *'2014 staff costs and 2014 costs for professional and legal fees and accepted FE proposals for stationery, communications and billing costs'*¹⁹⁸. FE was perfectly clear on the UR's justification.

9.13 In its appeal, FE challenges that justification on the basis that using 2014 costs as a base year was inappropriate, because -

'the UR chose a year which was the first year after the GD14 price control took effect and before the GD17 price control process commenced', and

*'engaging with the price control process is an unavoidable cost that FE must meet and these costs were not included within the 2014 cost dataset taken as the base year'*¹⁹⁹.

9.14 That engaging with the price control process is an unavoidable cost is, of course, not contested²⁰⁰. However, in relation to FE's assertion that such costs were not included in 2014, as the first year of the GD14 price control -

- (a) FE's assertion is fundamentally undermined by a number of statements which FE itself has made during the GD17 price control process and its appeal (as well as being inconsistent with PNG's position).
- (b) FE has provided no evidence to support its assertion that no such costs are incurred in the first year of a price control.
- (c) FE ignores costs which it clearly did incur in relation to the GD14 price control in 2014 in particular and which were taken into account by the use of 2014 as the base year.

These points are developed further below.

9.15 First, despite the above statement that it did not incur costs in relation to the GD17 price control process in 2014, FE states twice elsewhere in its appeal that *'FE actually incurred costs of approximately £584,000 (in 2014) in connection with the GD17 price control process (excluding this appeal)'* (emphasis added)²⁰¹. If this statement were correct, FE's appeal on this ground is wholly erroneous.

9.16 In any case, there are two important parts of its GD17 Business Plan, which

¹⁹⁷ FE's Response to the GD17 Draft Determination, 3.6 – **NOA-1/Tab 21/Page 4866**

¹⁹⁸ GD17 Draft Determination, para 6.154 – **NOA-1 / Tab 6 / Page 794**

¹⁹⁹ Notice of Appeal, paras 4.94 to 4.95

²⁰⁰ McHugh-1, para 11.2

²⁰¹ Notice of Appeal, para 4.96 and Martindale-1, paras 9.27

contradict the position it takes in its appeal -

- (a) FE gave '*three principal reasons*' for overspending its GD14 opex allowances, including its overspend for 2014. The second reason for the overspend was '*additional consultancy costs, primarily resultant from the additional support required as part of the GD17 Price Control submission*'²⁰².
- (b) It can be seen from the completed template that the allowance which FE requested in this category was £603,435 for each of the six years of GD17²⁰³. This is entirely consistent with the position that FE would expect costs in relation to a price control process to be spread over a price control period and entirely inconsistent with FE's position that it incurred no price control costs in the first year of its previous price control (2014).

9.17 We note that, in its response to the GD17 Draft Determination, in requesting that the UR increase its allowance in this area PNGL made clear that one reason for this was '*additional consultancy costs forecast around each price control e.g. in 2015, 2016 and 2017 for the GD17 review; and in 2021, 2022 and 2023 for the GD23 review*'²⁰⁴. It is clear that PNGL's experience is that there are additional consultancy costs in the first year of a price control (such as 2014).

9.18 Second, FE has failed to evidence its assertion that no costs are incurred in relation to the price control during its first year either in its appeal or before this.

9.19 Third, due to the reopener of its price control determination in 2014, it is clear that FE did incur significant costs in 2014 in relation to a price control²⁰⁵. FE has failed to acknowledge that these costs were incurred in 2014.

9.20 In the absence of evidence to the contrary, it was appropriate for the UR to determine that the allowances in this area for GD17 as it did. FE has raised nothing which makes this determination wrong.

9.21 Finally, it should be noted that the UR does not accept that FE's Business Plan was submitted '*before much of the detail about GD17 and the UR's assessment of FE's costs was known*'²⁰⁶. Prior to this time, the UR had published a Key Approach document²⁰⁷, which set out much about the detail of the GD17 process.

Base year

²⁰² FE GD17 Business Plan Commentary, [para 2.2.6](#) – **NOA-1/ Tab 19/Page 4590**

²⁰³ FE GD17 Business Plan, [Worksheet 3.0 Opex Summary](#) – **NOA-1 / Tab 19**

²⁰⁴ GD17 Final Determination, [para 6.460](#) – **NOA-1/Tab 7/Page 1913**

²⁰⁵ McHugh-1, [paras 11.3 and 11.4](#)

²⁰⁶ Notice of Appeal, [para 4.96](#)

²⁰⁷ UR, *Discussion Document on Our Overall Approach: Price Control for Northern Ireland's Gas Distribution Networks GD17* - **NOA-1/Tab 3**

- 9.22 In reaching a determination on the appropriate opex allowance for GD17, the UR conducted a bottom-up analysis of the GDNs operating costs using their actual costs for 2014. This was explained in the GD17 Draft Determination in the following terms -

*'To assess operating expenditure (opex), we have undertaken a detailed bottom up assessment of the larger cost items taking into account the most recent actual level of expenditure and any changes as a result of changes in outputs. We reflect increases in revenue from latest actual figures where strong justification has been presented'*²⁰⁸.

- 9.23 In the GD17 Final Determination²⁰⁹ the UR determined that it was appropriate to select 2014 as the base year and to use FE's actual costs in that year as the starting point for determining its GD17 opex allowances.

- 9.24 FE argues that it was inappropriate for the UR to have selected only 2014 as the base year as the starting point for determining its GD17 audit, finance and regulation allowance. FE argues that this position is supported by the CMA's approach in its review of Ofwat's AMP6 price control determination²¹⁰.

- 9.25 However, the CMA's determination in that review does not provide any support for the principle that average figures are necessarily required to be used rather than a single base year. In that reference, the Bristol Water business plan forecasted opex costs based on an extrapolation of those costs in a base year (2013/14)²¹¹. Having considered the different options for base years which it considered could be adopted, the CMA concluded that -

*'On balance, we considered that using any one year might be unrepresentative and that an average was therefore a more robust approach'*²¹² (emphasis added).

- 9.26 As a justification for performing various sensitivity analyses to identify the impact of its approach to the base year, the CMA stated that -

*'While we have considered various approaches to the base year used... we recognise that other judgements than our own could be taken'*²¹³.

- 9.27 It follows that, having considered the different options for base years which could be adopted, the CMA came to a determination of what (on balance) it considered to be

²⁰⁸ GD17 Draft Determination, [para 1.13](#) – **NOA-1/Tab 6/Page 724**

²⁰⁹ GD17 Final Determination, [para 6.91](#) – **NOA-1/Tab 7/Page 1848**

²¹⁰ Notice of Appeal, [paras 4.89 – 4.90](#) and Martindale-1, [paras 11.7 and 11.17](#)

²¹¹ [CMA: Bristol Water plc, A reference under section 12\(3\)\(a\) of the Water Industry Act 1991](#) (6 October 2015), [para 29](#)

²¹² [CMA: Bristol Water plc, A reference under section 12\(3\)\(a\) of the Water Industry Act 1991](#) (6 October 2015), [para 5.55](#)

²¹³ [CMA: Bristol Water plc, A reference under section 12\(3\)\(a\) of the Water Industry Act 1991](#) (6 October 2015), [para 5.89](#)

most robust in that particular case, noting that other judgements could have been taken. There is nothing in the CMA's findings which suggests that an average should be taken across a number of years for setting base opex costs, regardless of the circumstances of the company and the price control.

9.28 Moreover, in the setting of different price controls, it is not uncommon for the UR and others to adopt a single base year for coming to a determination on opex. Indeed, there is significant regulatory precedent for this. Examples of price controls in which a single base year has been adopted include -

- (a) In the UR's PC10 price control determination for Northern Ireland Water, 2007/08 was used as the single base year²¹⁴.
- (b) In the UR's PC13 price control determination for Northern Ireland Water, 2010/11 was used as the single base year²¹⁵.
- (c) In the UR's PC15 price control determination for Northern Ireland Water, 2012/13 was used as the single base year²¹⁶.
- (d) In the UR's RP5 price control determination for Northern Ireland Electricity Ltd, 2009/10 was used as the single base year²¹⁷. In the subsequent reference to the Competition Commission, the Commission changed the single base year for some costs, but did not replace the single base year with an average²¹⁸.
- (e) In Ofwat's PR09 price control determination for water and sewerage charges, 2008/09 was used as a single base year²¹⁹.

9.29 In short, it is legitimate for a regulator to adopt a single base year and it was the most appropriate option to adopt in the GD17 price control.

9.30 FE's complaint in relation to the UR's selection of the base year for GD17 is that the UR did not take into account its actual costs for 2015. In the GD17 Draft Determination, the UR stated the following -

'In preparation of the GD17 final determination, we require GDNs to resubmit their business plan templates, updated with 2015 actuals, by 30 June 2016. We note that this is not intended as an opportunity to resubmit a fully revised business plan. Rather, it is a pragmatic approach designed

²¹⁴ [UR's PC10 Price Control Determination for Northern Ireland Water](#), para 6.1.2

²¹⁵ [UR's PC10 Price Control Determination for Northern Ireland Water](#), para 6.4.1

²¹⁶ [UR's PC15 price control determination for Northern Ireland Water](#), para 6.4.1

²¹⁷ [UR's RP5 price control determination for Northern Ireland Electricity Ltd](#), para 6.39

²¹⁸ [Competition Commission final determination on RP5 price control](#)

²¹⁹ [Ofwat's PR09 price control determination for water and sewerage charges](#), para 4.9

*to allow us to account, in our final determination, for 2015 actuals rather than estimates*²²⁰.

- 9.31 This made clear that the purpose of requesting 2015 actual cost data was so that estimates of these costs could be replaced with actual data, rather than because the UR proposed to change the base year. The UR did not consider that it would have been reasonable to request such data from the GDNs by an earlier date.
- 9.32 As explained by Brian McHugh in his witness statement²²¹, having received such data, the UR would have been able to replace estimated 2015 costs with actual costs in coming to its final determination. The UR would also have been able to use 2015 actual costs to test some of the proposed allowances.
- 9.33 However, there would not have been sufficient time, prior to the UR's committed date to publish the GD17 Final Determination (15 September 2016²²²), to interrogate the GDN's 2015 actual costs in adequate detail to determine whether it would be appropriate to include them in base year costs for both FE and PNG's price controls²²³. It would have been highly inappropriate for the UR to do so without having conducted such a proper interrogation. This was particularly the case given that FE's actual opex costs increased by approximately 14% from 2014 to 2015.
- 9.34 The UR made this clear in the GD17 Final Determination in the following terms -
- 'We have decided not to use 2015 costs as the basis for GD17 as the data was not available in a timely or detailed manner. We have however used it to verify at a high level, where appropriate, for some of the allowances*²²⁴.
- 9.35 FE argues that it is a growing business and that for this reason it is particularly important to use the more recent data available²²⁵. However, that FE is a growing business does not justify the selection of a base year using actual data which had not been subject to the required degree of scrutiny.
- 9.36 In considering what base year should be determined for GD17, the UR considered the available data and, in light of this, whether it would be appropriate to use a number of years to determine an average or to select a single year. The UR was well within its legitimate regulatory discretion to determine that it should not change the base year in between the GD17 Draft Determination and the GD17 Final Determination and that it was appropriate to select 2014 as the base year for the determination of opex allowances²²⁶.

²²⁰ GD17 Draft Determination, [para 3.11](#) – NOA-1 / Tab 6 / Page 746

²²¹ McHugh-1, [paras 11.5 to 11.7](#)

²²² GD17 Draft Determination, [para 1.62](#) – NOA-1 / Tab 6 / Page 735

²²³ McHugh-1, [paras 11.11 to 11.15](#)

²²⁴ GD17 Final Determination, [para 6.89](#) – NOA-1 / Tab 7 / Page 1847

²²⁵ Notice of Appeal, [para 4.88](#) and Martindale-1, [para 9.21](#)

²²⁶ GD17 Final Determination, [para 6.91](#) – NOA-1 / Tab 7 / Page 1848

- 9.37 FE had every opportunity to set out in its submission why 2014 might be an atypical year and failed to do so. Even within its appeal, it argues only that it incurred regulation costs which were not included in the 2014 base year. That FE would prefer to use 2015 as a base year because it incurred much higher costs in that year more generally is not a strong basis for claiming that UR should not have used 2014 as a base year.

Allowance to replace parental recharge allowance for central services

- 9.38 In the GD14 price control determination, a '*parental recharge*' allowance was provided to FE in respect of services which were provided to it by its parent company (BGE). As noted by FE in its Notice of Appeal²²⁷, this allowance was explained in the GD14 Final Determination in the following terms -

'Parental Recharges' are incurred by FE in settlement of the services provided by its parent company, BGE, in relation to the following:

Central corporate services covering matters such as HR support, training, procurement services (including tendering for the period contract and downstream installers), legal services, treasury / corporate finance and audit functions, maintenance and development of an IT platform, engineering project planning, payments / invoicing, tariff maintenance and billing, customer relationship management, secretariat services and costs associated with establishing and running the Board of Directors, etc....¹²²⁸.

- 9.39 The parental recharge allowance also covered a number of other services which BGE provided to FE, but only the above services are relevant to this ground of appeal.
- 9.40 FE notes that, following the sale of the business by BGE to iCON Infrastructure LLP in June 2014, FE ceased to obtain these services from BGE and now undertakes the services itself or procures them from third parties. FE asserts that -

'Failure to include any allowance whatsoever for activities previously covered by the parental recharge merely as a result of the sale of FE to funds advised by iCON Infrastructure LLP was a clear omission, and therefore erroneous¹²²⁹.

- 9.41 The UR's response is simple. This ground of appeal is based upon a fundamental error of fact and cannot be sustained – as explained in Brian McHugh's witness statement²³⁰, the GD17 price control determination does include an allowance for activities which were previously covered by the parental recharge. If FE had raised this point in its response to the GD17 Draft Determination, this would have been

²²⁷ Notice of Appeal, [para 4.97](#)

²²⁸ GD14 Final Determination, [para 6.11](#) – **NOA-1/Tab 11/Page 4044**

²²⁹ Notice of Appeal, [para 4.100](#)

²³⁰ McHugh-1, [paras 12.1 to 12.10](#)

explained (as was the case in relation to specific queries around non-executive Directors)²³¹.

- 9.42 Given that FE was sold in 2014, it would have been inappropriate for FE's GD17 price control determination to include a parental recharge allowance. However, the UR acknowledged that FE would continue to incur costs in relation to these activities after the sale. It consequently increased FE's allowances in a number of areas to take this into account.
- 9.43 FE appears to consider that an allowance to cover services previously covered by the parental recharge allowance has been disallowed on the basis that the UR considered these costs to be associated with the change of ownership of FE²³². This is not the case.
- 9.44 In both the GD17 Draft Determination²³³ and the GD17 Final Determination²³⁴, it was made clear that the UR did not consider that consumers should fund the cost of the change of ownership of FE. This meant in particular that consumers should not fund IT costs, in the context of a request in FE's Business Plan for costs relating to transitional IT arrangements²³⁵. It was these costs which the UR did not consider that consumers should be required to pay. Because of the inclusion of these costs, the UR does not agree that FE's Business Plan included '*no costs associated with the change of ownership*'²³⁶. But in any case, change of ownership was not given as a reason for excluding allowances to cover activities previously covered by the parental recharge.
- 9.45 As Brian McHugh explains, in considering the GD17 allowances, the UR did not carry forward into FE's allowances an amount of the £247,363, which was reported as a contractor cost in the '*CEO & Group Management*' line of FE's 2014 reporting. The UR considered it highly likely that this cost related to the parental recharge. While this cost was not carried forward²³⁷, this did not prevent the UR from determining an appropriate amount in the final allowances and it did so.
- 9.46 To determine this issue, the UR considered the cost lines relevant to the previous allowance for parental recharge for central services²³⁸. The UR then considered the appropriate increases in these cost lines between 2014 actual costs and 2017 GD17 allowances.
- 9.47 The table below shows the relevant cost lines and the increases as part of FE's GD17 allowances. The table is taken from Brian McHugh's witness statement²³⁹ -

²³¹ McHugh-1, para [12.10](#)

²³² Notice of Appeal, para [4.99](#) and Martindale-1, para [9.27](#)

²³³ GD17 Draft Determination, para [6.106](#) – **NOA-1/Tab 6/Page 784**

²³⁴ GD17 Final Determination, para [6.222](#) – **NOA-1/Tab 7/Page 101**

²³⁵ FE GD17 Business Plan Commentary, para [12.3.5](#) – **NOA-1/Tab 19/Page 4674**

²³⁶ Notice of Appeal, para [4.98](#)

²³⁷ McHugh-1, para [12.5](#)

²³⁸ McHugh-1, paras [12.3](#) to [12.6](#)

²³⁹ McHugh-1, para [12.8](#)

Table 6: Parental Recharge Cost Lines in GD17

ACRT and BP equivalent reporting lines	FE's GD17 allowance per annum	GD17 Allowance increase from 2014 Actual Figures
Audit Finance and Regulation	£462,533	£43,772
IT & Telecoms	£245,350 ²⁴⁰	£72,349 ²⁴¹
CEO and Group	£157,323	£67,152 ²⁴²
HR and Non ops training	£98,478	£32,318
Procurement	£21,416	£3,005
TOTAL	-	£218,596

Source: UR calculations for the purposes of GD17 allowances

9.48 FE notes that the GD14 Final Determination contained an allowance for parental recharges of £282,000 per annum (in 2014 prices)²⁴³. When that amount is adjusted to account for the parental recharge being incurred for the first six months of 2014, because of the sale of FE, the amount is £141,000 (in 2014 prices)²⁴⁴. We note that the above increases exceed £141,000.

9.49 For the reasons set out above, it is factually inaccurate to state that the UR did not include any allowance for activities previously covered by the parental recharge in the GD17 Final Determination.

Relief requested

9.50 FE asserts that the two grounds of appeal set out above have resulted in its opex allowance being understated by £1.15 million. However, FE has failed to provide any calculation to justify how it has reached this figure and the UR has not been able to understand how it is calculated.

9.51 As noted above, it is unhelpful that FE has sought to present these two distinct grounds of appeal as a single ground. FE does not break down how it considers that its opex allowance has been understated between the two grounds.

²⁴⁰ The UR adjusted the 2014 actual costs for IT and telecoms to take account of a cost associated with the sale of the business of £365,808.

²⁴¹ 2014 GIS costs

²⁴² This increase is based on 2014 actual CEO and Group Management costs after adjusting for contractor costs of £247,363.

²⁴³ Notice of Appeal, [para 4.97](#)

²⁴⁴ McHugh-1, [para 12.9](#)

Conclusion

9.52 For all of the above reasons, FE's appeal on Ground 1E should be dismissed.

SECTION 10. GROUND 2 - 'THE CONNECTION TARGET ERROR' AND 'THE NON-ADDITIONALITY ERROR'

Introduction

- 10.1 FE argues that the UR made errors in the Final Determination in relation to the connection incentive mechanism which is contained in its price control for GD17. In particular, FE argues that the connection incentive mechanism is based on unjustified and arbitrary assumptions and that it has been set at a level which fails to take proper account of the specific characteristics of the Licence Area²⁴⁵.
- 10.2 It should be noted at the outset that it is a key feature of the connection incentive mechanism for GD17 that the UR has increased the allowance available per connection (from that set for GD14), as a balance to setting challenging but achievable connection targets. FE now seeks to '*cherry-pick*' from its connection incentive mechanism by retaining the increased allowance, while at the same time decreasing the number of connections which are expected of it.
- 10.3 The UR's response to FE's appeal can briefly be summarised as follows:
- (a) FE mischaracterises the manner in which the UR has determined its connection targets for GD17. The manner in which the UR actually determined FE's connection targets took full account of the characteristics of the Licence Area and of FE's historical connections performance, including modelling against historical data.
 - (b) Where the UR's method was based on assumptions, these were not arbitrary, but were made taking the relevant circumstances into account (including the specific characteristics of the FE licence area and business) and using expert regulatory judgment to make appropriate estimates to predict future events²⁴⁶.
 - (c) The annual connection rate of 5% which the UR has adopted matches a connection rate assumed in FE's GD17 Business Plan.
 - (d) FE has not evidenced how it has calculated the connection rates it proposes. It appears to assume that connection rates will decrease over GD17, but this is contrary to the evidence of PNGL's network²⁴⁷.
 - (e) The UR has adopted an assumption that a number of properties would connect to FE's network in a year without any spend by FE on sales, marketing and incentives (1.25% of properties passed). That assumption is entirely reasonable, given the level of awareness of gas as a fuel in Northern Ireland and evidence from areas where no connection incentive is available.

²⁴⁵ Notice of Appeal, [paras 2.18 - 2.25](#) and [paras 5.1 – 5.78](#)

²⁴⁶ McHugh-1, [paras 13.26 to 13.58](#)

²⁴⁷ McHugh-1, [para 13.33](#)

- 10.4 In addition, given the costs involved in switching fuel, there will often be a key reason for the switch, including boiler replacement, property move and renovation²⁴⁸. FE fundamentally fails to address this important reason for considering switching and the UR considers that a significant number will switch to gas at this point.

The connection incentive mechanism

- 10.5 The connection incentive mechanism is a per connection allowance to encourage the connection of domestic owner occupier properties²⁴⁹. The mechanism can be summarised as follows:

- (a) *Connection Allowance* - A fixed allowance determined by the UR is added to FE's opex allowance for GD17 in respect of each qualifying domestic owner occupier connection (a **DOO Connection**). This allowance is determined on the basis of a simple economic test²⁵⁰.

For GD17, the UR has determined that an additional '*new area*' allowance should be introduced given the significant expansion which is planned to FE's network over the GD17 period²⁵¹. This additional allowance is added in respect of each qualifying DOO Connection.

- (b) *Connection Target* – The UR has determined the number of DOO Connections for FE which it expects to be achieved in each year of GD17²⁵².
- (c) *Non-additionality number* – Not all DOO Connections will be treated as connections which qualify for the connection allowance. The UR has determined that the number of DOO Connections equal to 25% of the determined connection target for FE for each year will not qualify. This number represents the assessed number of DOO Connections which would occur anyway, without any direct selling or marketing by FE. These DOO Connections are referred to as being '*non-additional*'²⁵³.
- (d) *Collar* - Where FE underperforms its annual connection target by more than 50%, a 25% collar will operate, meaning that FE will only qualify for 25% of the above connection allowance for DOO Connections made in that year²⁵⁴.

- 10.6 The connection incentive mechanism has been determined as an overall package, made up of these elements²⁵⁵. The connection target cannot be viewed in isolation, without considering the per connection allowance. Similarly, the non-additionality

²⁴⁸ McHugh-1, paras [13.40 to 13.47](#)

²⁴⁹ For further background on the mechanism, see McHugh-1, paras [13.13 to 13.25](#)

²⁵⁰ GD17 Final Determination, [paras 6.115 – 6.127](#) – **NOA-1/Tab 7/Pages 1851 - 1853**

²⁵¹ GD17 Final Determination, [paras 6.128 – 6.141](#) – **NOA-1/Tab 7/Pages 1853 - 1855**

²⁵² GD17 Final Determination, [paras 6.142 – 6.149](#) – **NOA-1/Tab 7/Pages 1855 - 1857**

²⁵³ GD17 Final Determination, [paras 6.157 – 6.159](#) – **NOA-1/Tab 7/Page 1858**

²⁵⁴ GD17 Final Determination, [paras 6.160 – 6.163](#) – **NOA-1/Tab 7/Pages 1858 - 1859**

²⁵⁵ McHugh-1, paras [13.20 to 13.25](#)

number represents the UR's reasonable estimate - it cannot be viewed in isolation from the per connection allowance.

Setting the GD17 connection incentive mechanism

- 10.7 The UR's approach to setting FE's connection targets for the purpose of the connection incentive was explained in the GD17 Draft Determination²⁵⁶ (and the GD17 Final Determination²⁵⁷) in the following terms:

'We have assumed that 85% of properties will connect to the network in the long run at a rate of 5% per annum of properties passed but not connected. This is generally in line with the long term connection rate that we have seen to date. It is higher than the connection rate assumed for GD14'.

- 10.8 The approach followed by the UR in setting FE's connection targets for GD17 is explained in greater detail in the witness statement of Brian McHugh²⁵⁸. The key principle in the UR's approach was to base future connection targets on FE's historical connections performance. To achieve this, the UR selected a conceptual model taking into account levels of development of and connection to the network to determine connection numbers.
- 10.9 Under the model, the number of connections made in a particular year is a fixed percentage of the number of properties which are available to connect in that year. In other words, a fixed annual connection rate is applied to the number of properties which are available to connect.
- 10.10 To determine the number of properties which are available to connect, the UR used an assumption that 15% of owner occupied properties passed by the network will never decide to connect to the network (the **15% Assumption**)²⁵⁹. Using the 15% Assumption, 15% of properties passed by the network at the start of a year but not connected would be disregarded. The remaining 85% (those who potentially will connect to the network at some point) less the number of properties already connected are the properties which are available to connect and the fixed annual connection rate is applied to these properties.
- 10.11 Using the 15% Assumption to determine the fixed annual connection rate, the UR conducted a simulation of FE's DOO Connections up to 2015, altering the fixed annual connection rate to lead to a good fit with FE's historical connection performance. The UR considered the reasons for any discrepancy and the appropriateness of the model in the round (including considering the model against PNLG's historical connection rates)²⁶⁰. The UR determined that the model should be

²⁵⁶ GD17 Draft Determination, [para 7.13](#) – NOA-1/Tab 6/Page 857

²⁵⁷ GD17 Final Determination, [para 7.21](#) – NOA-1/Tab 7/Page 1951

²⁵⁸ McHugh-1, [paras 13.17 to 13.39](#)

²⁵⁹ McHugh-1, [paras 13.28](#)

²⁶⁰ McHugh-1, [paras 13.32 to 13.36](#)

used, and that the fixed annual connection rate determined would be 5%.

- 10.12 As noted above, the UR determined that, as in GD14, the number of DOO Connections considered to be non-additional (for which no allowance would be available) would be 25% of the connection target. In other words, on the basis of a connection rate of 5%, the UR has assumed that 1.25% of owner occupied properties will connect to FE's network without any direct selling or marketing by FE (the **1.25% Assumption**).

The Ground of Appeal

- 10.13 FE states that the UR made the following errors in setting the connection incentive mechanism for GD17:

- (a) *Ground 2A (the Connection Target Error)* - FE argues that the UR used an unjustified assumption that 85% of properties passed by FE's network will connect to the network by 2045, and that the use of this assumption led to annual connection targets being determined for GD17 which fail to properly take account of FE's historical performance and the specific circumstances in the Licence Area and are unachievable.
- (b) *Ground 2B (the Non-Additionality Error)* – FE argues that the UR arbitrarily determined that 25% of new customers will connect to its network in the absence of any direct sales or marketing activities by FE and that in doing so the UR ignored evidence put forward by FE.

- 10.14 FE states that the combined effect of the alleged errors in this part of the price control was a £1.67 million reduction of FE's opex allowance for GD17 (in 2014 prices)²⁶¹. This figure has not been explained to the UR and the UR has been unable to replicate the figure from the concerns FE has raised.

Response to the Ground of Appeal

- 10.15 Prior to addressing FE's arguments as to why a different connection incentive mechanism should have been determined, it is important first to make a number of preliminary points:

- (a) First, the relief which FE requests in relation to Ground 2 is that changes should only be made to specific components of its connection incentive mechanism – that is, it does not challenge either the principle of having a per connection allowance or the determined per connection allowance for GD17.
- (b) Second, FE's appeal misstates the connection incentive mechanism which has been determined for GD17 and misrepresents both the manner in which it operates in practice and its purpose.

²⁶¹ Notice of Appeal, [para 5.10](#)

- (c) Third, FE's appeal misstates the basis on which the UR determined its connection targets for GD17. On this basis alone (explained further below), Ground 2A is fundamentally flawed.
- (d) Fourth, FE has explained that the connection targets it proposed in its GD17 Business Plan are based on setting itself a target penetration rate for the Licence Area of 65% of all properties passed by 2045, but it has not explained how this rate has informed its proposed connection targets and it has provided no methodology to allow it to be tested.

A number of these preliminary points are developed further below, before addressing the detail of FE's arguments as to why a different connection incentive allowance should have been determined.

FE's misrepresentation of the connection incentive mechanism

10.16 FE misrepresents the connection incentive mechanism in the following ways.

Housing Association properties

- 10.17 FE misstates the connection incentive mechanism by incorrectly stating that the UR has narrowed the class of properties covered by the connection incentive mechanism so that it now excludes domestic properties owned by Housing Associations²⁶².
- 10.18 Domestic properties owned by Housing Associations are excluded from the connection incentive in GD17²⁶³, but such premises were also excluded from the connection incentive in GD14. This was made clear in the GD14 Final Determination, where it was stated that the definition of owner occupier properties referred to '*privately owned*' properties²⁶⁴.
- 10.19 In addition, it was made clear in the regulatory instructions for the submission of FE's GD17 Business Plan and in the Annual Cost Reporting Template for 2014 that connections could be classified as three types and that 'owner occupied' was a different type to 'Northern Ireland Housing Executive (NIHE)', which was stated to include properties '*owned by the Northern Ireland Housing Executive or a housing association in Northern Ireland*'²⁶⁵.
- 10.20 In its GD17 Business Plan and in the Annual Cost Reporting Template for 2014, FE appeared to understand the above reporting instructions completely, stating that:

'For the purpose of this Business Plan submission all domestic premises which are owned by the Northern Ireland Housing Executive

²⁶² Notice of Appeal, [paras 5.35 and 5.41](#)

²⁶³ GD17 Final Determination, [Glossary – NOA-1/Tab 7/Page 1784](#)

²⁶⁴ GD14 Final Determination, [Glossary – NOA-1/Tab 11/Page 3962](#)

²⁶⁵ [Regulatory Instructions and Guidance for Business Plan Submission](#) (14 May 2015), [Appendix 2, page 184](#)

or a housing association in Northern Ireland (or will be when built) are classified as NIHE²⁶⁶.

- 10.21 FE did not raise anything in relation to this matter in its response to the GD17 Draft Determination²⁶⁷. In its appeal, FE now appears to state that Housing Association properties are captured in FE's historical performance figures²⁶⁸ as connections to which the connection incentive applied. They should not have been. This suggestion by FE raises serious questions about whether it has misreported the number of connections in its reporting to the UR. (The UR will take appropriate steps to investigate this matter outside the scope of the appeal.)
- 10.22 It follows from the above that any submissions made on the basis of such a change in GD17 are simply misplaced - there was no such change.

Penalties in the connection incentive mechanism

- 10.23 FE also misrepresents the connections incentive mechanism by consistently referring to the connection incentive mechanism as penalising it if it fails to meet its connection targets²⁶⁹. No penalty flows from the connection incentive mechanism if FE fails to meet its connection targets. There is only a penalty where FE fails to achieve 50% of its targets (under the 'collar' mechanism described above).
- 10.24 The connection incentive mechanism for GD14 included a mechanism whereby FE was penalised for failing to meet its connections target, because there was a reduction in the per connection allowance which was proportional to the failure to meet the target²⁷⁰. That mechanism was not carried forward to the GD17 connection incentive mechanism²⁷¹. The only direct consequence of failing to meet a connection target in GD17 is that the overall allowance will be reduced (because it is calculated on a per connection basis). In its September 2016 credit rating report in relation to PNGL, Fitch Ratings concluded that this change in the mechanism had the effect of '*substantially reducing the risks associated with underperformance on connections*'²⁷².
- 10.25 FE implies that it is penalised if it fails to meet its connections target, such that it must spend more to ensure that the target is met. This is not the case.
- 10.26 The purpose of the connection incentive mechanism is to incentivise GDNs to maximise the number of DOO Connections by linking the allowance that they receive to the number of connections achieved. The allowance is driven by results. While GDNs do not have complete control over the number of connections to their network, their marketing activities can have a significant impact. The incentive

²⁶⁶ FE GD17 Business Plan Commentary, [para 5.3.4](#) – **NOA-1/Tab 19/Page 4614**

²⁶⁷ FE's Response to the GD17 Draft Determination – **NOA-1/Tab 21**

²⁶⁸ Notice of Appeal, [para 5.41\(c\)](#)

²⁶⁹ Notice of Appeal, [paras 5.4, 5.12, 5.25 and 5.28](#)

²⁷⁰ GD14 Final Determination, [para 6.44](#) – **NOA-1/Tab 11 / Page 4034**

²⁷¹ GD17 Final Determination, [para 6.162](#) – **NOA-1/Tab 7/Page 1859**

²⁷² Fitch Ratings, *Fitch affirms Phoenix Natural Gas Limited at 'BBB'; Outlook Negative - RaO-1*

mechanism is intended to incentivise innovative marketing which is both effective and efficient.

- 10.27 FE submits that it is penalised under the connection incentive mechanism because the mechanism involves a number of '*inherently fixed costs*'²⁷³ in respect of which allowances are contingent on the achievement of connection targets.
- 10.28 It is up to FE how it spends its connections allowance. The UR accepts that some costs which FE incurs in its marketing activities – principally staff costs – may be fixed in the short term. But it does not accept that costs generally are fixed. FE has not provided any analysis of the marketing costs which it considers to be fixed, and the UR considers that there is a broad range of costs where there is flexibility. There are several options as to how FE conducts its advertising and marketing campaigns and FE is expected to evaluate the effectiveness and value of these different options.
- 10.29 FE notes that one way in which costs are incurred are as an incentive provided to a new connectee to its network. FE notes that its existing connections incentive to connectees is £300 - £500²⁷⁴. Of course, this is a cost which is only ever incurred if there is a new connection to the network and so FE cannot be said to be at risk in relation to such costs, since the per connection allowance will necessarily be payable in respect of that connection.
- 10.30 In PwC's report prepared for the purposes of this appeal, in which it refers to the risk in relation to the connection incentive mechanism, it makes an assumption that '*owner occupied (OO) sales related staff, shared overheads, advertising/marketing/PR are all fixed in nature*'²⁷⁵. That assumption is clearly incorrect. In particular, if FE is treating advertising, marketing and PR as fixed costs, it has failed to understand the very purpose of the connection incentive mechanism, which is to encourage GDNs to adopt innovative approaches to maximise DOO Connections.
- 10.31 It is not correct to portray FE's marketing spend simply as a number of fixed costs which are contingent on a target being met²⁷⁶ and where FE will be penalised if it does not achieve its target.
- 10.32 Finally, in relation to FE's references to being penalised, FE refers to the connection incentive mechanism as containing an '*underperformance penalty*'²⁷⁷. It does so by referring first to the fact that the non-additionality number is a set percentage of the connections target (rather than a percentage of the number of connections achieved) and second by reference to the '*collar*' mechanism which applies where FE fails to achieve its connections target by more than 50% and which means that it is only eligible to receive 25% of the connection allowance for the properties it connects.

²⁷³ Notice of Appeal, [para 5.25](#)

²⁷⁴ Martindale-1, [para 11.4](#)

²⁷⁵ PwC Report, [para 2.69 - NF-1/Tab 1/Page 15](#)

²⁷⁶ Notice of Appeal, [para 5.25](#)

²⁷⁷ Notice of Appeal, [paras 5.27 to 5.28](#)

- 10.33 The UR does not accept that the non-additionality element of the connection incentive mechanism can properly be viewed as a penalty. It represents the number of properties which the UR considers would have connected irrespective of any advertising, marketing and other such activities being carried out by FE. The reasons why that number is appropriate are set out below.
- 10.34 The 'collar' element of the connection incentive mechanism is properly a penalty for underperformance. However, it represents a connections floor, in place to avoid the risk that a GDN fails to focus on connections. Taking the connection incentive mechanism as a whole, FE should easily be able to avoid the collar element from applying. In particular, no GDN (including FE) has ever failed to meet 50% of the connection target which the UR has set for it under a connection incentive mechanism.

Gas as the fuel of choice

- 10.35 FE misrepresents the purpose of the connection incentive mechanism, by stating that its purpose is to raise awareness of gas as a fuel because it is not the '*primary fuel of choice*'²⁷⁸ in Northern Ireland. This misrepresents the leading role that gas has played in recent years in new fuel installations²⁷⁹.
- 10.36 Gas is now the primary fuel used in new build properties, Northern Ireland Housing Executive properties and major industrial businesses. Thousands of customers spend considerable sums to connect to gas, even in years where there are challenging economic conditions and where gas is at the time more expensive than oil. Irrespective of cost, as stated in FE's advertising²⁸⁰, there are many benefits of switching to gas as a fuel, including efficiency, security of supply and the environmental impact.
- 10.37 Indeed, the Northern Ireland Executive supports the expansion of the gas network in Northern Ireland and has recently consulted on a programme for government which includes that expansion as a priority.
- 10.38 Gas is not the primary fuel used in owner occupier properties in FE's area. The connection incentive was introduced due to initial difficulties in driving gas connections in Northern Ireland²⁸¹. However, it does not give the full picture to state that gas is not the '*primary fuel of choice*'²⁸² or that this is the reason for the connection incentive. The purpose of the incentive mechanism is to continue the growth which has already been achieved²⁸³.

FE's misrepresentation of how the connection incentive mechanism was determined

²⁷⁸ Notice of Appeal, [paras 2.18 and 5.3](#)

²⁷⁹ McHugh-1, [paras 13.6 to 13.12](#)

²⁸⁰ McHugh-1, [para 13.6](#)

²⁸¹ GD17 Final Determination, [para 6.115](#) – **NOA-1/Tab 7/Page 1851**

²⁸² Notice of Appeal, [paras 2.18 and 5.3](#)

²⁸³ McHugh-1, [paras 13.11 to 13.12](#)

10.39 FE misrepresents the manner in which the UR determined its connections targets for GD17 in the following ways.

The 15% Assumption

10.40 Ground 2A is fundamentally flawed, because FE argues that the UR used an unjustified assumption that 85% of properties passed by FE's network will connect to the network by 2045. The UR used no such assumption. The UR was clear in the GD17 Final Determination in stating that the 85% figure referred to '*is not a penetration rate*'²⁸⁴.

10.41 As set out above, the 15% Assumption used by the UR was an assumption that 15% of owner occupied properties passed will opt not to connect in the long term, leaving 85% of properties which will potentially connect in the future and to whom the determined connection rate should be applied²⁸⁵.

10.42 On this basis, FE's entire argument on Ground 2A is based on a false premise. It challenges a penetration rate of 85% at 2045 using various data, when no such penetration rate has been proposed by the UR or forms any part of the determination of the connection targets for GD17. It also does not bring any challenge against the reasonableness of the 15% Assumption (properly construed).

10.43 To the extent that FE seeks to draw a comparison between the 15% Assumption and the assumption, set out in FE's Business Plan²⁸⁶, that 65% of all properties passed by its network will be connected by the end of 2045, no such comparison can validly be drawn.

10.44 Using the model adopted by UR to assess historical connections performance and determine future targets, the percentage of owner occupied properties passed by the network which will be connected by the end of 2045 is approximately 63%²⁸⁷.

10.45 In any case, FE overstates the importance of the 15% Assumption to the overall determination of connection targets. This is because a simulation was conducted to determine the appropriate connection rate, using FE's DOO Connections up to 2015. If the 15% Assumption was changed, the connection rate determined would change. A sensitivity analysis shows that if a percentage of 30% were adopted instead of 15%, the subsequent modelling and calculation would lead to FE's connection target for GD17 reducing by approximately 2.5%.

Historical connection figures

10.46 FE argues that the UR increased the connections targets for GD17 which it had proposed in its GD17 Business Plan without any reliable evidence and without having

²⁸⁴ GD17 Final Determination, [para 6.149](#) – **NOA-1/Tab 7/Page 1857**

²⁸⁵ McHugh-1, [para 13.28](#)

²⁸⁶ FE GD17 Business Plan Commentary, [para 3.3.2](#) – **NOA-1/Tab 19/Page 4590**

²⁸⁷ McHugh-1, [para 13.39](#)

taken proper account of its historical performance or the characteristics of its area²⁸⁸. This is incorrect because, as noted above and explained in Brian McHugh's witness statement²⁸⁹, FE's connection targets are based on FE's own historical connection figures. The methodology was specifically designed to ensure that the calculation of connection targets for GD17 mapped appropriately to FE's historical connection performance.

- 10.47 FE argues that the connection targets failed to have regard to the specific characteristics of its area, making reference to a number of factors including the maturity of its network, the cost of connection and the income of potential connectees and the sparsity of its network. The reasons why the UR does not agree that the factors set out make the connection targets inappropriate are delineated further below. However, in any case, these factors were inherently taken into account in the setting of the connection targets, because they were based on FE's historical connections data.

The use of UK wide figures

- 10.48 FE misrepresents how its connections targets were determined by assuming that the 15% Assumption was selected because 85% is similar to the percentage of domestic properties in the UK that are connected to the gas network and use gas central heating²⁹⁰. This assumption is not correct.
- 10.49 The UR acknowledges that it would be inappropriate to base its connections targets on this UK figure. This is because, as noted by in the Oxera report it prepared for the purpose of the appeal²⁹¹, the figure includes properties (such as housing association owned properties) which are excluded from FE's connection incentive and because the figure covers all domestic properties (whereas the 15% Assumption relates only to properties passed by the network).
- 10.50 The 15% Assumption is not taken directly from any particular penetration rate, but is the UR's expert judgement of an appropriate figure given the various information available.

FE's connections targets

- 10.51 FE requests that the CMA substitutes connections targets at the level proposed in its GD17 Business Plan. In its Business Plan FE proposed that it should have a target of growing its DOO Connections by 16,724 over the course of GD17²⁹². This is based on

²⁸⁸ Notice of Appeal, [para 5.8](#)

²⁸⁹ McHugh-1, [paras 13.29 to 13.30](#)

²⁹⁰ Notice of Appeal, [para 5.30](#) and Oxera, *Economic assessment of the GD17 connection target*, para 3.20 – **NOA JK1/Tab 1/Page 8**

²⁹¹ Oxera, *Economic assessment of the GD17 connection target*, para 4.10 – **NOA JK1/Tab 1/Page 11**

²⁹² Notice of Appeal, [para 5.5](#)

an assumption that 65% of total properties passed by FE's network will be connected by 2045. FE explains that this target is derived from:

- *Analysis of historic firmus energy connection performance*
- *Infill area pilot studies, that are described in further detail in an appendix to this document*
- *Review of gas market penetration rates achieved in Northern Ireland and Great Britain*
- *Expert advice from our consultants Oxera*²⁹³.

10.52 Notwithstanding this explanation, FE has not provided the UR with a calculation of how it reached its proposed connections target and the UR has been unable to replicate how FE has reached this figure from the information which it has available²⁹⁴. The UR has consequently been unable to properly test the appropriateness or otherwise of FE's proposal during the price control process. FE has similarly not provided the UR with a calculation of why it assumes that 65% of total properties passed by its network will be connected by 2045 and so the UR has not been able to test this either. Further, it has not been explained what role the assumption of 65% properties passed by 2045 plays in determining connection targets for GD17 (2017 – 2022).

10.53 FE had a full opportunity to provide such calculations in its response to the Draft Determination and in the significant period of engagement which preceded it. It did not do so.

10.54 In terms of the expert advice which FE has obtained, a draft report prepared by Oxera (dated 25 June 2015) supplemented FE's response to the UR's discussion document dated 10 February 2015. However, the report *'focuses on the forecast level of penetration at a single point in time (2045) and is not intended to review the trajectory by which FE forecasts it will reach this point'*²⁹⁵.

10.55 A further draft report prepared by Oxera (dated 25 September 2015) accompanied FE's Business Plan. However, the stated aim of that report was to *'provide a high-level sense check of the connection forecasts and a benchmarking analysis of the resulting penetration rate'*²⁹⁶.

10.56 Neither of the above reports covered the modelling or calculations underlying FE's forecasts. Both reports focused on the penetration rate by 2045, rather than on the connection rate for GD17. In conclusion, each report stated no more than that FE's long term penetration rates *'appeared'* to be *'reasonable'*²⁹⁷.

²⁹³ FE GD17 Business Plan Commentary, [para 3.3.2](#) – NOA-1/Tab 19/Page 4590

²⁹⁴ McHugh-1, [paras 13.59 to 13.60](#)

²⁹⁵ Oxera, *Peer review of firmus energy's gas penetration forecasts* – NOA-1/Tab 20J/Page 4776

²⁹⁶ Oxera, *Peer review of firmus energy's gas penetration forecasts* – NOA-1/Tab 17H/Page 4487

²⁹⁷ Oxera, *Peer review of firmus energy's gas penetration forecasts*, para 3 – NOA-1/Tab 17H/Page 4489 and Oxera, *Peer review of firmus energy's gas penetration forecasts*, para 6.4 – NOA-1/Tab 20J/Page 4782

10.57 A further report has been prepared by Oxera for the purposes of this appeal. However, the stated purpose of this report is to '*consider the methodology, assumptions, and conclusions of UR as well as related evidence concerning the connection targets that it set*²⁹⁸. This report does not give any further support to the connection target proposed by FE.

Further Response to Ground 2A

10.58 FE argues that the UR has provided no evidence quantifying FE's determined connection targets. However, FE's consultant seems to have had no difficulty in reproducing²⁹⁹ the methodology which was used³⁰⁰.

10.59 FE then draws attention to a number of matters which it says lead to the connection targets being unachievable. As noted above, historical connections performance formed a key part of the UR's approach to setting FE's connection targets. In setting parameters for the model which created a good fit with historical connections, the UR took account of the specific circumstances of the Licence Area. However, in any case, the matters raised by FE do not justify the submission that the connection targets are unachievable, and this is addressed further below.

Annual 5% connection rate

10.60 In determining a connection rate of 5% per annum of properties passed but not connected, it should immediately be noted that this figure aligns with FE's own previously stated view. In its Business Plan, FE stated that:

*'Working to the assumption that we will convert 5% of customers per year, we forecast a steady rise in connections across the GD17 period and beyond'*³⁰¹.

10.61 Further, in a report provided in support of FE's Business Plan, Oxera stated that:

'The FE forecast documentation suggests that the connection rate will be 5% of Owner Occupied connections in new infill areas per year, although experience in other parts of Northern Ireland has been double this rate due to effective targeting, marketing and allowances'.

10.62 It can be seen that, under Ground 2A, FE now seeks to challenge a connection rate which aligns with the connection rate advocated for in its Business Plan and which its consultant has summarised as supported by FE's documentation for connections in new infill areas and as a rate which can be exceeded with effective marketing in other areas. This strongly calls into question FE's submission in its appeal that the

²⁹⁸ Oxera, *Economic assessment of the GD17 connection target*, para 1.2 – NOA JK1/Tab 1/Page 1

²⁹⁹ It appears to the UR that the slight difference between the targets calculated by Oxera and those calculated by the UR is because Oxera used average historical connection numbers to estimate a number for 2016, whereas the UR used the number set out in FE's GD17 Business Plan.

³⁰⁰ Oxera, *Economic assessment of the GD17 connection target*, para 3.5 – NOA JK1/Tab 1/Pages 5 - 6

³⁰¹ FE GD17 Business Plan Commentary, para 3.3.2 – NOA-1/Tab 19 / Page 4590

connection targets which have been determined for GD17 are 'unachievable'³⁰².

Overspend on GD14 allowances

- 10.63 FE argues that it failed to meet its connection target in 2014, despite having significantly exceeded the GD14 allowance³⁰³.
- 10.64 The UR had requested further information from FE in relation to its specific costs and has not received a satisfactory explanation that its costs were efficiently incurred³⁰⁴. In particular, the UR has also not been provided with an adequate explanation for the volatility of FE's costs in this area over GD14. The increase between its forecast of £377 per connection (as provided in the GD17 submission) and actual DOO Connection costs for 2015 and 2016 are both in the region of 100%³⁰⁵.
- 10.65 In addition, once non-additional properties are disregarded, in 2014 PNGL spent £365 per connection, in contrast with £1,471 per connection spent by FE³⁰⁶. PNGL met its connection target, while FE did not.
- 10.66 In its GD17 Business Plan, PNGL's explanation for its performance levels during 2013 and 2014 was as follows:

*'2013 and 2014 produced the highest owner occupied connections levels since the peak in 2003. We believe these performance levels were the result of (i) a continuation of many of the market conditions experienced between 2011 and 2012; (ii) the impact of the introduction of the Northern Ireland Executive Boiler Replacement Allowance in September 2012; and (iii) the rapidly rising cost of home heating oil and the associated publicity'*³⁰⁷.

- 10.67 While there are differences between FE's performance and PNGL's networks, the UR agrees with PNGL that the above will all have been factors in driving its level of performance. Importantly, each of these factors applied similarly to FE's network.
- 10.68 The broad discrepancy between FE's performance and PNGL's performance over the same period does call into question FE's efficiency in this area³⁰⁸. Since the UR did not receive a more detailed explanation of FE's costs in response to its January 2016 information request, the UR has not been able to test this further.
- 10.69 However, one possible explanation is that FE's costs have not been efficiently incurred. In particular, despite an expectation set in the GD14 Final Determination³⁰⁹,

³⁰² Notice of Appeal, [para 5.69](#)

³⁰³ Notice of Appeal, [paras 5.34 to 5.36](#) and Martindale-1, [paras 11.7 and 11.17](#)

³⁰⁴ McHugh-1, [para 13.66](#)

³⁰⁵ McHugh-1, [para 13.66](#)

³⁰⁶ McHugh-1, [para 13.67](#)

³⁰⁷ GD17 Draft Determination, [para 6.217](#) – **NOA-1/Tab 11/Page 806**

³⁰⁸ McHugh-1, [paras 13.68 to 13.75](#)

³⁰⁹ GD14 Final Determination, para 16.9 – **NOA-1/Tab 11/Page 4131**

the GDNs have not worked together to adopt a common marketing approach for connecting gas, which would have increased its efficiency³¹⁰. In addition, it appears to the UR that the focus of FE's advertising strategy has been such that at least some its allowance has in effect been used to benefit its group supply business.

Maturity of network

- 10.70 FE states that the connection targets which have been determined fail to properly take account of the maturity of its network and that, in particular, the UR has failed properly to account for the differences between the maturity of its network and PNGL's network³¹¹.
- 10.71 The UR acknowledges that there are significant differences in the maturity of FE's and PNGL's respective networks. However, the conceptual model used to set FE's connections target for GD17 is based on historical data for FE, rather than for PNGL. The UR used data available in relation to PNGL's network and its connection performance to test whether or not the targets being considered for FE were appropriate, taking into account the relevant differences.
- 10.72 Further, the differences in the maturity of FE's and PNGL's networks are taken into account in the different amounts which are available per connection under their respective connection incentive mechanisms for GD17. Assuming that connection targets are met:
- (a) For FE, the average connection allowance determined is £635, giving an average connection allowance of £477 once the non-additionality number is taken into account.
 - (b) For PNGL, the average connection allowance determined is £545, giving an average connection allowance of £365 once the non-additionality number is taken into account.
- 10.73 Given that, as noted above, the connection incentive mechanism can only properly be considered taking into account both the target and the allowance per connection, it is important to note that a significantly higher allowance per connection has been determined for FE than for PNGL. FE's allowance is on average higher by approximately 31%.

Sparsity

- 10.74 FE argues that the low population density in the Licence Area (referred to as 'sparsity') has an impact on its sales and marketing activities and that this has not

³¹⁰ McHugh-1, [para 13.72](#)

³¹¹ Notice of Appeal, [para 5.66](#) and Martindale-1, [para 11.4](#)

properly been taken into account³¹². As noted above in section 8, the UR does not dispute that FE's Licence area has a lower population density than PNGL, although no evidence is put forward by FE in relation to the extent of the impact of this and the influence of sparsity is overstated by FE in its appeal.

10.75 Despite having a lower population density in its area than PNGL, FE's marketing activities must focus only on the areas passed by its network. These areas include a number of sizeable towns and areas where residents commute to the Greater Belfast area on a daily basis and so benefit from billboard and other marketing in that area³¹³.

10.76 It is clearly incorrect to suggest that there are '*fewer... opportunities to socialise*' in the Licence Area, which will '*dramatically [reduce] the opportunity for potential customers to talk about natural gas*'³¹⁴. On the contrary, there will be benefits in relation to the characteristics of FE's area which it does not acknowledge. For example, the development of the gas network is likely to of itself cause a greater impact in smaller communities.

10.77 It is for FE to determine how it will be most effective for it to conduct sales and marketing activities to maximise the number of connections. To the extent that FE considers that the characteristics of its area mean that a particular method of advertising is inappropriate, this suggests that it should use other methods.

Income

10.78 FE argues that the connection targets which have been determined for GD17 do not take proper account of the income levels of the Licence Area³¹⁵. In particular, it refers to average household disposable income in its area as approximately £14,300 per year, compared with approximately £15,000 in PNGL's Licence Area. FE also refers to the average disposable income in the west and south of the Licence Area as £13,350 per year.

10.79 Because FE's connection targets are based on a conceptual model which has been simulated against historical connection figures, the average income of the Licence Area has properly informed those targets and it is incorrect to say that they have not been taken into account.

10.80 The UR in any case questions a number of statements which FE has made in relation to income in the Licence Area³¹⁶. First, the £13,350 annual disposable income to which FE refers relates not to the west and south of the Licence Area, but to the west and south of Northern Ireland. Most of the area to which this figure attaches is

³¹² Notice of Appeal, [paras 5.58 to 5.66](#) and Martindale-1, [paras 11.7 to 11.10](#)

³¹³ McHugh-1, [paras 13.77 to 13.80](#)

³¹⁴ Martindale-1, [para 11.9](#)

³¹⁵ Notice of Appeal, [paras 5.46 and 5.52 to 5.55](#) and Martindale-1, [paras 5.9 and 10.12](#)

³¹⁶ Figures taken from ONS statistics table, [Distribution of NUTS3 areas gross disposable household income per head](#) (2014)

outside the FE Licence Area. This means both that the figure is not generally relevant to consideration of incomes in the Licence Area and that the average disposable income in the Licence Area is almost certainly higher than FE claims (FE's number being skewed by the £13,350 figure, which has limited if any relevance).

- 10.81 Even if it were assumed that £13,350 were the average disposable income in parts of the Licence Area, this is not unduly low when compared with similar income figures across the UK. The national average figure is skewed by extremely high income in some parts of the UK - mostly in the southeast of England (for example, Westminster has an average annual income of £43,616). However, places which have a lower average annual income than the west and south of Northern Ireland include such cities as Hull, Nottingham and Leicester.
- 10.82 If it is assumed that £14,300 is a reasonable estimate of average disposable income in the Licence Area (which the UR doubts for the reason given above), such a figure would be similar to Belfast, Derby and Sheffield. Parts of the UK which have a lower average disposable income include Birmingham, Liverpool, Swansea and Glasgow. It is not meaningful to say that an area is '*low income*' if it has disposable incomes that are similar to or greater than many of the major cities of the UK.
- 10.83 FE submits that the cost required to fund a new connection will amount to a cost of 17% of annual disposable household income in the Licence Area, in comparison with 16% in PNLG's area. In either case, this is a significant proportion of that income (and not materially different in the two areas) and FE has not provided any evidence that such a difference in income would lead to a significant difference in approaches to connections between residents in its area and residents in PNLG's area.
- 10.84 To the extent it has such evidence, FE can properly give consideration to allocating a greater proportion of this allowance to direct incentives. As noted above a significantly greater allowance has been determined for FE than for PNLG over GD17.

Uniform distribution

- 10.85 FE notes that the modelling approach adopted by the UR operates on the assumption that there will be a uniform distribution of owner occupier property types within the Licence Area³¹⁷ and the report prepared by Oxera for the purposes of FE's appeal states that this is '*highly unlikely to be the case in practice*'³¹⁸. Its concern appears to be that, to the extent the modelling operates on the basis of the 15% Assumption and a 5% connection rate, properties which it is assumed will and will not connect will not be evenly distributed.
- 10.86 Of course, it is correct to say that, where modelling is based on an assumption which is an average over time, that assumption will not necessarily apply evenly. However, FE puts forward no evidence to suggest the propensity to connect of properties passed by its network in GD17 is such that the 15% Assumption should not be used

³¹⁷ Notice of Appeal, [para 5.40\(b\)](#)

³¹⁸ Oxera, *Economic assessment of the GD17 connection target*, [para 3.6](#) – NOA JK1/Tab 1/Page 6

as a basis of modelling over this period or that a 5% connection rate should not be used.

10.87 Further, the UR has no reason to believe that the propensity to connect of properties passed by the network in the years of GD17 will be lower than it has been in previous years (and which has been taken into account in the modelling).

10.88 Further, we note that, in its Infill Allowances Plan Methodology, FE stated that:

*'Demographic analysis of our network reveals that by the end of GD14, our network will have passed over half of the "low income" households in our development areas, whereas less than a quarter of "mid" to "high" income households will have the option of natural gas. Propensity to connect is higher in "mid" to "high" income households.'*³¹⁹.

10.89 The large number of properties which will be passed in GD17 as FE expands its network, and the greater proportion of larger properties which will become available to connect, suggests that the propensity to connect may generally become greater than has been the case previously³²⁰.

10.90 Through GD17, FE will still be in the first 20 years of its network. Over the 20 year history of PNG's network, there has been no substantial reduction in connection rate over time³²¹. FE does not evidence why its network should be any different in this regard.

Current/future economic conditions

10.91 Finally, having argued that the UR has not properly taken into account its historical connections performance, FE then takes the opposite approach and argues that changes in economic conditions mean that historical connections performance cannot be relied upon³²². Again, none of the matters raised by FE justify the submission that the connection targets which have been determined are unachievable.

10.92 First, FE refers to the significant upfront costs which are involved in switching from oil to gas³²³. The UR accepts that £2,000 to £3,000 is a reasonable estimate of the costs involved in switching and also accepts that this is a significant figure. However, as noted above, the connection targets which have been determined for FE for GD17 are based on a conceptual model which has been simulated against historical connection figures. The cost of switching has therefore been fully taken into account in the process. FE has not stated that this cost will increase over the GD17 period.

³¹⁹ FE Infill Allowances Plan Methodology, [para 3.3.2](#) – NOA-1/Tab 17G /Page 4590

³²⁰ McHugh-1, [paras 13.85 to 13.89](#)

³²¹ McHugh-1, [para 13.33](#)

³²² Martindale-1, [para 11.13](#)

³²³ Martindale-1, [para 11.6](#) and Oxera, *Economic assessment of the GD17 connection target*, [paras 5.3 to 5.8](#) – NOA JK1/Tab 1/Pages 13 - 14

- 10.93 Second, FE refers to the importance of government incentives in incentivising switching and states that there is uncertainty over the availability of incentives over the GD17 period and beyond³²⁴. Oxera states that the incentives which it considers will be available *'alone are not likely to meet the long-term connection target set by the UR'*³²⁵, but no calculation or other evidence is provided in support of this view.
- 10.94 In the long term, particular government incentives to connect are withdrawn and other incentives are introduced. We cannot predict with any certainty precisely what incentives will be available over the GD17 period, but it seems more likely than not that incentives will continue to be available. In particular, in consulting on its Programme for Government in October 2016, the Northern Ireland Executive's draft programme referred to the delivery of boiler replacement schemes as a policy objective³²⁶.
- 10.95 FE noted in its GD17 Business Plan that:
- '...an important part of our on-going stakeholder engagement programme is to focus Government policymakers and decision-makers on the need to retain if not expand this support if they want to maximise the benefits of gas to the community...'*³²⁷.
- 10.96 The UR agrees that this is an important role for FE to play to help to ensure that adequate incentives remain available.
- 10.97 Third, FE provides evidence of the price fluctuations for oil and gas in recent years and submits that the decline in oil prices is leading to a general decline in new connections³²⁸. The evidence put forward by Oxera shows that there have been significant price fluctuations in both the oil and gas markets since the start of 2006 and there have been times when gas has been cheaper and times when oil has been cheaper. The latest figures show oil prices currently recovering from a low level in January 2016.
- 10.98 But FE fails to acknowledge that the data shows that there can be significant price variation over the course of a price control and even over the course of a year. These are essentially short term price fluctuations and are therefore unlikely to be the primary factor in a decision to switch from oil to gas, which will be taken following a consideration of a number of factors, including the benefits of gas other than costs³²⁹. FE's determined connection targets are based on its historical connection numbers, which have included connections over periods where oil has been cheaper than gas and when it has been more expensive.

³²⁴ Martindale-1, [para 11.13](#) and Oxera, [paras 5.9 to 5.12](#) – NOA JK1/Tab 1/Pages 14 - 15

³²⁵ Oxera, [para 5.1](#)– NOA JK1/Tab 1/Page 15

³²⁶ [Northern Ireland Executive, Programme for Government Consultation Document](#), page 40

³²⁷ FE GD17 Business Plan Commentary, [para 5.5](#) – NOA-1/Tab 19/Page 4619

³²⁸ Martindale-1, [para 11.14](#) and Oxera, [paras 5.13 to 5.16](#) – NOA JK1/Tab 1/Pages 16 - 17

³²⁹ McHugh-1, [para 13.6](#)

- 10.99 While the fluctuation of oil and gas prices into the GD17 period and beyond cannot be known, the above data shows that oil prices have generally been higher than gas prices.
- 10.100 FE states that it has experienced a year on year decline of 11% in new connections from January to October 2016 compared to the same period in 2015 and it attributes this largely to the fall in oil prices³³⁰, although it does not put forward evidence in support of this proposition in its appeal.
- 10.101 Finally, FE points to the wider economic outlook for GD17 as a matter which will affect future connection numbers and notes that, in particular, FE points toward the referendum vote in June 2016 for the UK to leave the EU as already having an impact on connection numbers, with a UK exit from the EU likely to have a further impact³³¹.
- 10.102 In its report prepared for the purposes of this appeal, Oxera uses evidence of past expenditure on maintenance and repair across the UK to evidence a link between consumer confidence and discretionary spending on properties³³². It also uses the Northern Ireland property prices index to support a statement that any negative effect on property prices (such as because of an exit from the EU) will have a negative impact on the number of connections.
- 10.103 The evidence put forward by Oxera shows that the financial crash of 2007/2008 had an impact on property prices and discretionary spending on properties, but that there has been a steady recovery in recent years. Of course, because the connection targets which have been determined for FE for GD17 are based on a conceptual model which has been simulated against historical connection figures, the targets take into account this period of economic downturn and recovery. If this recovery continues, on the basis of Oxera's analysis, we would expect propensity to connect to increase above the modelled rate over the GD17 period, rather than decrease.
- 10.104 Even it is assumed (which cannot be certain) that the UK will exit the EU during the GD17 period, it is far too speculative to suggest that such an exit would have a particular impact on the propensity to connect during that period and that this can be taken into account in FE's price control in any reasonable manner. With any price control, there will always be a broad range of events which could occur and (through an impact on the economy) could have an impact on a company's performance against targets set in its price control. We do not consider that the impact here is sufficiently certain that it can properly be taken into account.

Ground 2B

- 10.105 The non-additionality element in the connection incentive mechanism is calculated as 25% of the annual connection target for the price control period. This is exactly

³³⁰ Martindale-1, [para 11.14](#)

³³¹ Martindale-1, [para 11.15](#) and Oxera, *paras 5.17 to 5.24 – NOA JK1/Tab 1/Pages 17 - 19*

³³² Oxera, *paras 5.17 to 5.23 – NOA JK1/Tab 1/Pages 17 - 19*

the same approach as was taken for FE's price control mechanism in GD14³³³, an approach which FE did not appeal at that time. In GD17, this equates to 1.25% of available properties per year connecting without FE spending anything on sales or marketing (the 1.25% Assumption).

10.106 In challenging the 1.25% Assumption, used to determine the non-additional number of DOO Connections for GD17, FE repeats a number of points, including referring to FE's historical overspend on its sales and marketing activities and the average income in the Licence Area. Our response to these points is set out above.

10.107 In addition, FE presents two pieces of evidence in support of its argument that the non-additionality element which has been set is not appropriate.

Loughgall Trial

10.108 The first is a trial conducted by FE in Loughgall, County Armagh, which FE states demonstrated that essentially no customers switched to gas where no marketing activities were conducted³³⁴.

10.109 In the trial, having laid pipes to pass 200 owner occupier properties in Loughgall in January 2016, FE purposely undertook no sales visits and no other advertising for the first 5 months of 2016. FE notes that, despite its contractor being highly visible for six weeks during the mains construction, it received no sales enquiries and has secured no connections to date.

10.110 In our view, the area covered by this trial was so small that it cannot be taken to be a robust representation of how households which are newly passed by the network will react. Indeed, according to the data provided by FE³³⁵, it selected the village with the smallest total population across the Licence Area for the purpose of conducting the trial. As FE acknowledges³³⁶, the trial also had a short time frame.

10.111 Further, the trial covers only newly passed properties, and therefore provides no data in relation to the large number of properties which have been passed by FE's network for a number of years, but have not yet connected (noting that at the end of 2015 only 19% of owner occupier properties passed by FE's network are connected³³⁷).

10.112 The UR notes that, viewing the connection incentive in the round, the new areas allowance is intended to be used to benefit connections in areas such as this example.

Marketing research

³³³ GD14 Final Determination, [para 6.32](#) – **NOA-1/Tab 11/Page 4031**

³³⁴ Notice of Appeal, [para 5.72](#), Martindale-1, [paras 11.21 and 11.24](#)

³³⁵ Martindale-1, [para 5.7](#)

³³⁶ FE Response to the GD17 Draft Determination, [section 2.4.1.3](#) – **NOA-1/Tab 21/Page 4849**

³³⁷ GD17 Final Determination, [para 6.146](#) – **NOA-1/Tab 7/Page 1856**

- 10.113 The second piece of evidence in support of FE's argument is some local market research which was undertaken for FE by third party marketing consultants³³⁸. FE states that this research found a very low propensity to switch among oil customers. It compares the number of respondents who had seen advertising who were interested in switching (24%) with the number of respondents who had seen no advertising who were interested (3%).
- 10.114 The marketing consultants acknowledge in their report that this research is taken using a '*small base*'³³⁹. The total number of respondents engaged in the exercise were 150. The number of respondents who had seen no advertising and so were giving their interest in switching from that perspective was only 35. These numbers are so small given the overall number of properties in FE's area its output cannot be a robust representation.
- 10.115 To the extent FE relies on this research to evidence a very low propensity to switch, the question asked by the marketing consultant which is linked to the above figures was '*Would this advertising make you more likely to look into getting natural gas?*'³⁴⁰. That question directly tests the effectiveness of advertising. It does not test the propensity to switch.
- 10.116 That the vast majority of respondents who had not seen or heard FE's advertising before were not persuaded by it in the research study is not surprising. They may well not have noticed it previously on the basis that they did not consider it to have a particular impact on them.
- 10.117 Further, FE fails to refer to a further study undertaken by the same marketing consultants in September 2015 and submitted with its GD17 Business Plan. In particular, this study found that 80% of respondents inquired about gas either because they '*heard it was good*' or because it had been '*recommended*' and stated that '*Word of mouth was the primary driver of interest in natural gas*'³⁴¹.
- 10.118 Although this study still had a small number of respondents (200), it should be noted that FE's own research undermines the position which it now adopts in this appeal.
- 10.119 It should be noted that, in determining the non-additionality element of GDNs' respective price controls, the UR has taken full account of the different levels of maturity and other circumstances in the relevant licenced area. In particular, the non-additionality element which the UR has determined for PNGL for GD17 is 33% of the annual connection target³⁴². This accounts for the relative greater awareness of gas in PNGL's area, taking into account the circumstances of the Licence Area.

Regulatory Determination on the connection incentive

³³⁸ Notice of Appeal, [para 5.75](#), Martindale-1, [para 11.23](#) and **NM-1/Tab 16**

³³⁹ **NM-1/Tab 16/Page 204**

³⁴⁰ **NM-1/ Tab 16/Page 204**

³⁴¹ **NOA-1/Tab 20D/Page 4703**

³⁴² GD17 Final Determination, [para 6.359](#) – **NOA-1/Tab 7/Page 1895**

10.120 As noted above, FE does not challenge the principle of having a connection incentive mechanism such as that determined for GD17. It seeks to challenge the connection target which has been determined and the non-additionality mechanism.

10.121 The setting of the connection incentive mechanism involves the determination of a challenging but achievable connection target and a determination of the number of DOO Connections which would occur without any intervention on the part of FE. Such determinations, are not certain, but involve estimation and prediction in relation to future events.

10.122 Contrary to what FE asserts³⁴³, the UR has made this determination, taking into account its statutory objectives and has set a target which it considers is achievable, taking into account the evidence which is available. In particular, in exercising its expert regulatory judgement, it was entirely rational and appropriate for the UR to make each of the following determinations:

- (a) To determine that it could set connection targets based on historical connection rates.
- (b) To develop a model using a simulation against FE's historical connection performance, altering the parameters of the model to lead to a good and explainable fit to that performance.
- (c) To determine that the 15% Assumption was valid for the purpose for which it would be used in the conceptual model. For the reasons set out in the witness statement of Brian McHugh³⁴⁴, the 15%% Assumption was an appropriate (and on any view rational) exercise of regulatory judgement. In particular, the UR took full account of available information in relation to the factors which influence switching³⁴⁵ (including in particular boiler replacement), the benefits of gas as a fuel and available connection figures in relation to a range of gas networks.
- (d) To apply that model, including retaining the resulting connection rate, in calculating GD17 connection targets.
- (e) To determine that a number of DOO Connections equal to 1.25% of the total owner occupier properties passed would connect without any direct selling or marketing by FE. For the reasons set out in the witness statement of Brian McHugh³⁴⁶, that mechanism was not arbitrary, but was again an appropriate (and on any view rational) exercise of regulatory judgement. In coming to this determination, the UR took full account of the awareness of gas in Northern Ireland, the factors which influence switching (including in particular boiler replacement) and the evidence of other networks where connections

³⁴³ Notice of Appeal, [para 2.25](#)

³⁴⁴ McHugh-1, [paras 13.48 to 13.49](#)

³⁴⁵ McHugh-1, [paras 13.40 to 13.47](#)

³⁴⁶ McHugh-1, [paras 13.53 to 13.58](#)

continue in the absence of any connection incentive allowance for the network operator.

Relief requested

10.123 As noted above, FE does not explain why the alleged errors lead to a £1.67 million reduction of FE's opex allowance for GD17. The UR notes that the figure appears to have been taken from a table in its appeal³⁴⁷. However, this table does not explain the amount and, confusingly, the amount in the table is negative.

10.124 In its appeal, FE seeks to reduce its connections targets and the applicable non-additional number of properties, while retaining the per connection allowance which has been determined in the GD17 Final Determination³⁴⁸.

10.125 As noted in Brian McHugh's witness statement, given the difficulties involved in practice in estimating the non-additional number of properties, the connection incentive mechanism must properly be viewed in the round. If the connection targets and non-additional number of properties had been lower, the UR would have determined a lower per connection allowance. In particular, the UR would seriously have questioned whether the new area allowance would have been appropriate.

10.126 FE's appeal therefore involves significant 'cherry picking' to keep the benefits of a per connection allowance, without the challenges that come with it. FE cherry picks further in this regard, because it seeks to challenge its determined connection targets in this area but, had lower connection targets been determined, this would have had a knock-on impact on other areas of the GD17 price control determination³⁴⁹. In particular:

- (a) If connection targets were lower, the economic level of mains laying would reduce. This would impose greater restrictions on FE in the selection of infill in GD17 and indicate that a number of properties in the developed areas of the main towns served should not be passed.
- (b) The connection target is a driver in the estimation of call centre and emergency call-out. A lower connection target would have resulted in a lower determination of emergency response opex costs.
- (c) The number of new connections is a driver in the benchmarking of maintenance and metering costs. A lower number of connections would have resulted in a modelled benchmark factor changing and this would have suggested a lower allowance of maintenance and metering costs overall.

10.127 It should also be noted that FE now adopts a position which involves it receiving greater allowances than it argued for in response to the GD17 Draft

³⁴⁷ Notice of Appeal, [para 4.11](#)

³⁴⁸ GD17 Final Determination, [para 6.141](#) – **NOA-1/Tab 7/Page 1855**

³⁴⁹ McHugh-1, [para 13.90](#)

Determination³⁵⁰. In its response, it sought to have its connections targets reduced or, alternatively, its per connection allowance increased. FE has been given an increased per connection allowance, but now seeks to keep this and still decrease its connection targets.

Conclusions

10.128 In summary, in relation to this ground of appeal:

- (a) FE's appeal in relation to Ground 2A is fundamentally flawed, because it is based on a number of serious misconceptions as to how the UR determined FE's connection targets. In any case, the matters which are raised by FE as making the connection targets unachievable do not justify that statement either in relation to the circumstances existing previously (which have by the nature of the modelling process been taken into account) or in relation to circumstances expected to arise in GD17. The manner in which the connection targets was determined for GD17 was entirely appropriate.
- (b) FE's appeal in relation to Ground 2B is based on limited evidence which is used to assert that the non-additionality number is inappropriate. The UR's determination in this regard was not arbitrary, but was a reasoned estimate of the position adopting the same position adopted for GD17 (a position which was not previously challenged). The limited evidence put forward does not justify an allegation that the determination made was inappropriate. On the contrary, an assumption that 1.25% of properties will connect per year without sales or marketing is reasonable and cannot be said to be wrong.

10.129 By the relief requested in Ground 2, FE would be allowed to 'cherry-pick' part of its connection incentive mechanism by retaining a per connection allowance which has been determined to accompany challenging connection targets, while significantly reducing the number of properties for which the connection allowance would be unavailable.

10.130 For all of the above reasons, FE's appeal on Ground 2 should be dismissed.

³⁵⁰ FE's Response to the Draft Determination, [para 2.3](#) - NOA-1/Tab 21/Page 4844 - 4845

SECTION 11. GROUND 3 – TREATMENT OF UNDER-RECOVERIES

Introduction

- 11.1 An '*under-recovery*' arises where FE has charged its customers less than the permitted maximum in a given year. FE has been allowed to '*accumulate under-recoveries*' – in other words, to transfer such unused allowances to a future year. The result is that FE can charge future customers more than might otherwise be permitted. Allowing FE to accumulate significant under-recoveries could potentially cause unfairness to those future customers. Such potential unfairness is compounded by the fact that FE's licence conditions under GD14 have inflated FE's total accumulated under-recoveries annually by a 7.5% rate of return. Ground 3 of FE's appeal relates to the equivalent rate of return for GD17.
- 11.2 By ground 3 of its appeal, FE argues that its accumulated under-recoveries should be inflated under GD17 at a rate equivalent to FE's allowed cost of capital³⁵¹ (4.3% p.a. for GD17). Instead, the UR has set the inflation rate as tapering from LIBOR + 4% in 2017 to LIBOR + 3% in 2018 to LIBOR + 2% thereafter.
- 11.3 The UR's decision on this issue is explained in paragraphs 11.75 to 11.99 of the Final Determination³⁵². It is an appropriate and responsible decision. It accords with the UR's statutory duties. Ground 3 of the appeal should be dismissed, for the reasons detailed below.

Ground 3A – regulatory uncertainty / breach of the principle of non-retroactivity

No commitment, let alone a clear or ambiguous commitment

- 11.4 FE says that the GD17 Decision '*withdraws previous commitments in FE's Licence regarding the applicable rate*'³⁵³.
- 11.5 Ground 3A rests on a mistaken premise. There was no commitment by the UR not to vary the applicable rate in circumstances (which have arisen) where the UR considered variation to be the proper course in pursuance of the UR's statutory duties. Indeed, the UR considers that it would have been inappropriate as a matter of public law for it to have fettered its discretion in the way suggested by FE. It is the UR's public law duty to monitor licences and make modifications.
- 11.6 The UR accepts that there may be circumstances where a public body makes a commitment from which it is not entitled to resile. This topic is exhaustively covered by the public law on legitimate expectations. Notably, FE's appeal does not even refer to this. Any claim of legitimate expectation would fail at the first hurdle,

³⁵¹ Notice of Appeal, [paras 2.26 - 2.31](#) and [paras 6.1 - 6.53](#)

³⁵² GD17 Final Determination, [paras 11.75 - 11.99](#) - **NOA-1/Tab 7/Pages 2074 – 2077**

³⁵³ Notice of Appeal, [para 2.28](#)

because there was no clear or unambiguous representation³⁵⁴. If it surpassed the first hurdle, it would fail at the second, because it is not unreasonable for the UR to vary the rate as it has done as circumstances have changed.

- 11.7 FE's appeal focuses on condition 4.10.4 of the licence as granted in 2005. However, condition 4.2.17 of the licence as granted in 2005 specifically foresees circumstances in which it might be necessary to change the rate of return applicable to accumulated under-recoveries. It states -

'The secondary purpose of the term \bar{r}_{t-1} is to provide a mechanism by which the rate of return ... may be adjusted so as:

- (a) to either increase or decrease the value of any accumulated under-recovery or over-recovery of revenue that is carried forward; and*
- (b) thereby to provide an incentive or disincentive (as the case may be) in respect of the accumulation of such under-recovery or over-recovery of revenue.'*³⁵⁵

- 11.8 Accordingly, FE cannot say that the 2005 licence terms contained a clear or unambiguous representation that accumulated under-recoveries would continue to be inflated at any particular rate, nor indeed can FE say that it had any guarantee that it would be allowed to carry forward all of its accumulated under-recoveries.

It is inappropriate to cherry-pick from the 2005 licence

- 11.9 It is inappropriate for FE to pick and choose which aspects of the 2005 licence it wishes to set in stone. Other aspects of the regime for under-recoveries have changed significantly since, which make it wholly sensible to revisit the rate of return for accumulated under-recoveries.
- 11.10 First, the 2005 licence contained terms whereby the UR could constrain FE's ability to over-recover. In other words, in the 2005 licence, FE had no guarantee that it would be allowed by the UR to make use of its accumulated under-recoveries. Condition 4.3.3 describes the effect of this '*Supplemental Constraint*' as follows –

*'The effect of the Supplemental Constraint is to limit the ability of the Licensee to set its charges so as to give rise to an aggregate over-recovery of revenue, notwithstanding that it may have accumulated an under-recovery in previous years against which that over-recovery may be set-off for the purposes of the Primary Constraint.'*³⁵⁶

³⁵⁴ *R (Association of British Civilian Internees: Far East Region) v. Secretary of State for Defence* [2003] QB 1397 at [72]: 'It is clear that it will only be in an exceptional case that a claim that a legitimate expectation has been defeated will succeed in the absence of a clear and unequivocal representation.'

³⁵⁵ FE Licence at March 2005 - **NOA-1/Tab 1/Page 107**

³⁵⁶ FE Licence at March 2005 - **NOA-1/Tab 1/Page 115**

11.11 This Supplemental Constraint was relaxed under GD14 by increasing the weighting factor used in the Supplemental Constraint (α_t) from 0.1 to 0.4. This relaxation was for the specific purpose of allowing FE to reduce its under-recoveries in preparation for GD17. This purpose is explained in paragraph 14.12 of the GD14 Final Determination, as follows -

'As part of dealing with under recoveries we are setting the designated parameter α_t at 0.4 which will allow firmus to significantly reduce this amount before GD17'.³⁵⁷

11.12 Secondly, the 2005 licence terms on under-recoveries provided for any accumulated under-recoveries remaining in 2034 to be completely eliminated³⁵⁸ (which is no longer the case³⁵⁹). Michael Lowry explained this in his email dated 22 September 2005 exhibited by FE to Mr Martindale's witness statement, as follows -

'... accumulated under-recoveries ... may be recovered up to 2034 after which any remaining un-recovered under-recoveries are written off'.³⁶⁰

11.13 Thirdly, in 2005, it was being assumed by the UR's predecessor and FE that under-recovery would cease entirely with supply exclusivity. FE's period of supply exclusivity ceased for large I&C customers in October 2012, and for domestic and SME customers in April 2015. Nevertheless, under-recoveries have continued. The assumption is apparent from the email from Michael Lowry of September 2005, which states -

'Under-recovery will cease to be generated post exclusivity ...'.³⁶¹

11.14 Contrary to FE's case, it can be seen from the above three points that the draftsman of the 2005 licence specifically envisaged the UR controlling accumulated under-recoveries in the run-up to under-recoveries being written off entirely in 2034. It is accordingly impossible to extract from the 2005 licence any clear commitment on the part of the UR to allow FE the full benefit of its accumulated under-recoveries inflated at any particular rate of return.

11.15 Even if it were, that the 2005 licence terms are not set in stone is accepted by FE elsewhere, where it suits FE's convenience. Conditions 4.4 and 4.9 of the 2005 licence set the Forecast Horizon to 2035 yet FE proposed changing this to 2045 in its GD17 submission³⁶².

³⁵⁷ GD14 Final Determination, [para 14.12](#) - **NOA-1/Tab 11/Page 4114**

³⁵⁸ FE Licence at March 2005 - **NOA-1/Tab 1/Page 148** (namely by reference to $X_{U,t}$ which shall be zero until Formula Year 2034, when it shall be $(r_{t=2033} + 1)$)

³⁵⁹ UR: GD17 licence modification decision paper, [paras 3.19 and 3.22](#) (explaining the removal of $X_{U,t}$) - **NOA-1 / Tab 9 / Page 3168**

³⁶⁰ UR: E-mail to FE - **NM-1/Tab 17/Page 216**

³⁶¹ UR: E-mail to FE - **NM-1/Tab 17/Page 216**

³⁶² FE business plan dated September 2015 – **NOA-1 / Tab 19 / Page 4602**

Not retrospective

11.16 FE complains that 'the proposed rate applies to under-recoveries accumulated before the start of GD17 thereby having retrospective effect'³⁶³.

11.17 However, the effect is not retrospective. The new rate of return applies prospectively.

Notice of change

11.18 FE complains that it was given '*insufficient notice of the change*'³⁶⁴. FE quotes selectively from the GD14 Final Determination dated 20 December 2013, where fully adequate notice was given in the following terms -

'The FE licence contains a designated parameter which can be used to adjust the return allowed on under-recoveries below the allowed cost of capital. The licence has set this to zero until 2034 and it would require a licence change to enable us to set a value above zero which would have the effect of reducing the return on under-recoveries below the allowed cost of capital.'

We recognise that FE has adopted a policy of building up under-recoveries in the expectation of achieving a return on under-recoveries in GD14.

However, we will consider future licence modifications to reduce the return on under-recoveries in GD17 and we will also carefully review FE actions in reducing the under-recovery amount before 2017. We believe our determination contained herein provides a reduction in determined tariffs from 2014 which will provide flexibility for FE to considerably reduce or even to eliminate the under-recovery by 2017.

We received comments on this matter from FE who argued that they should be allowed to retain the full rate of return on under-recoveries. However nothing in the FE response has convinced us that allowing a full rate of return does not create perverse incentives to build up under recoveries. We also note that PNGL has a different rate of return applied to over recoveries.

*Therefore we note that we are minded to review the allowed return on under-recoveries in GD17 to ensure there are no perverse incentives and if this requires a licence modification we will consider this at that time.'*³⁶⁵

11.19 Accordingly, the UR's intentions were clear to FE over four years ago. FE's response to the GD14 Draft Determination consultation demonstrates this.

³⁶³ Notice of Appeal, [paras 2.28 and 6.28 - 6.29](#)

³⁶⁴ Notice of Appeal, [para 6.18](#)

³⁶⁵ GD14 Final Determination, [paras 10.48 - 10.52](#) – NOA-1 / Tab 11 / Pages 4091-2

- 11.20 In fact, the UR's concerns were made clear to FE even earlier. The UR does not accept Mr Martindale's suggestion to the contrary³⁶⁶.
- 11.21 Specifically, the UR had raised concerns about FE's approach to under-recoveries since 2010 (see paragraph 11.35 and 11.36 below).
- 11.22 After several discussions over a number of years between FE and the UR on FE's policy of under-recovering³⁶⁷, this was escalated to the point that, as Mr McHugh recalls in his witness statement, that he wrote to Michael Scott of FE on 28 September 2012 to express serious concerns about the FE approach and to confirm that "*The continued policy of firmus to price below cap when gas prices are so far below oil raises issues and we will be looking to address those at the next price control.*"³⁶⁸
- 11.23 Furthermore, at the time of the sale of FE to iCON in 2013, which coincided with GD14, the UR made clear to all investors that it was very possible that the return on under-recoveries would be changed in GD17. In particular, this point was made to iCON at a meeting on 29 August 2013.³⁶⁹
- 11.24 FE alludes to harming investor confidence, but gives no concrete example of investors having specifically relied on this particular variable, or indeed on any particular strategy FE may have had not to unravel under-recoveries. FE gives no explanation of why any such alleged investors ignored the above passage in the GD14 Final Determination.

Consultation

- 11.25 It is not clear what FE means by its complaint of lack of consultation.³⁷⁰ FE appears to be complaining about the specificity of the statements made by the UR in the course of GD14. However, the UR conducted a full consultation exercise in the course of its GD17 decision-making process. Clearly, the UR was not going to conduct detailed consultation on the period 2017-2023 when deciding on GD14. If it had done, FE would doubtless now be complaining that the UR's consultation process was stale and outdated.

Not a penalty

- 11.26 FE suggests that the UR's decision 'can have no impact on incentives ... and will only act as a penalty for previous decisions'³⁷¹.
- 11.27 The UR's decision removes any incentive FE might have had to retain or accumulate under-recoveries based on receiving the full rate of return. Under-recoveries accrued

³⁶⁶ Witness statement of Neil Martindale, [para 12.50](#)

³⁶⁷ McHugh-1, [paras 14.48 – 14.51](#).

³⁶⁸ McHugh-1, [para 14.49](#)

³⁶⁹ McHugh-1, [para 14.52](#)

³⁷⁰ Notice of Appeal, [paras 6.2\(a\)\(iii\) and 6.26](#)

³⁷¹ Notice of Appeal, [para 6.17](#)

in the past are maintained. This cannot be characterised as a penalty.

11.28 The UR could alternatively have maintained the original 2005 licence terms and taken action under the provisions described in paragraphs 11.10 and 11.12 above to curtail FE over-recoveries such that FE's accumulated under-recoveries would have been written-off entirely by 2034, without FE acquiring any benefit from them. The UR chose not to do that. Instead, the UR took a more proportionate approach, which cannot be characterised as a penalty.

Ground 3B – disregarding the reasons for the licence condition in line with the UR's statutory duties

11.29 FE says that the UR has disregarded the reasons for the under-recoveries licence conditions³⁷². Specifically, in certain paragraphs of the Notice of Appeal, FE purports to disagree with the view that under-recoveries are about managing differences between the relative price of oil and gas³⁷³.

11.30 FE sets out its own view in paragraph 6.38 of the Notice of Appeal that under-recoveries were '*based on our assessment of the state of the market, competitor fuels, and to encourage connection and use of the network in the interests of all stakeholders*'.

11.31 The '*state of the market*' and '*competitor fuels*' clearly alludes to the relative prices of oil and gas. If gas is significantly cheaper than oil, there is less need to encourage gas connections.

11.32 FE reinforces this link between under-recoveries and the relative prices of oil and gas in paragraphs 6.39 and 6.40 of its Notice of Appeal. FE claims that it is inappropriate to be reversing under-recoveries at a time when oil prices are lower than gas prices.

11.33 However, history shows that FE accumulated substantial under-recoveries at a time when gas was cheaper than oil, which suggests that it was not using the under-recovery mechanism as intended. This can be seen from the graph at paragraph 6.39 of the Notice of Appeal. FE built up its under-recovery between 2008 and 2013 to the point that it reached 17% of its TRV. The timing is juxtaposed with a period when gas prices were historically competitive; at times oil was more expensive by a factor of over 50% during this period.

11.34 FE's actions in building up under-recoveries at this time did not go unnoticed by the UR. For example, in 2010 the UR was concerned at the level of under-recoveries in the context of a 25% gap between the domestic oil and gas prices.

11.35 The UR engaged with FE at a senior level to express concern that it was not increasing its prices at a time when oil prices had significantly increased. As Mr McHugh notes in his witness statement, there was e-mail correspondence in August

³⁷² Notice of Appeal, [para 2.29](#)

³⁷³ Notice of Appeal, [paras 2.29 and 6.34](#)

2010 between the UR and FE in which the UR asks FE *'would it not make more sense to put through some increase now when there is headroom against oil'*³⁷⁴

- 11.36 The email chain shows that the UR was not satisfied that FE's response addressed UR's concerns. These concerns ultimately lead to the licence modification in GD17 which has led to this appeal.
- 11.37 It appears to the UR that – whatever the reasoning behind including provision for under-recoveries in the licence – one incentive for accumulating under-recoveries has in fact been that this was effectively an investment option with no opex or capex risk offering a very healthy return. The only risk in enticing gas customers with lower prices is that, when prices rise, the customers may switch to an alternative fuel source. However, the likelihood of a customer switching back from gas to oil having relatively recently invested in a gas system can be assumed low.
- 11.38 FE refers to the public interest. The UR's decision on under-recoveries has indeed been influenced by the public interest. The UR recognises that FE may have had good reasons for under-recoveries in previous years, consistent with the public interest. However, the UR considers that the public interest also includes the interest of future customers not to be saddled with excessive bills caused by excessive under-recoveries from previous generations of customers. *'Helping to ensure consumer protection'* is one of the UR's general objectives under Article 40(h) of the Gas Directive, referred to in Article 14(1) of the Energy (Northern Ireland) Order 2003. Article 14(2) of the Energy Order also requires the UR to have regard to -

'the need to ensure a high level of protection of the interests of consumers of gas'

- 11.39 *'Consumers'* is defined in Article 2(2) of the Energy Order as including -

'both existing consumers and future consumers'.

- 11.40 FE refers to a so-called side letter dated March 2005.³⁷⁵ The letter is not part of the licence and does not appear to have been subject to consultation; it should not be read as such. The material text in the letter is as follows -

*'Subject to the constraints set out in the price control, any under-recovery of revenue will be accumulated on an annual basis at the Rate of Return'*³⁷⁶.

- 11.41 As to this text -

- (a) There is no reason to suppose that it was intended to last in perpetuity. It was describing the terms as they stood in 2005, not from 2017.

³⁷⁴ McHugh-1, para 14.48

³⁷⁵ Notice of Appeal, para 6.33

³⁷⁶ Letter from UR Chair to BGE - NoA-1/Tab 10/Page 3949

- (b) The words '*subject to the constraints in the price control*' make clear that the letter is to be read subject to the licence and the rules on licence modification. The licence does not contain a clear commitment to preserve a particular rate – see paragraphs 11.7 and 11.8 above.

11.42 In any event, the circumstances in which under-recoveries would accumulate have proved different from how they were envisaged in 2005. See paragraphs 11.9 to 11.13 above.

Ground 3C – errors in the selection of the new rate

11.43 FE considers the revised inflation rate to be '*inappropriate, arbitrary and disproportionate*'.³⁷⁷

11.44 FE claims that the UR has '*not provided any justification*' for the rate set.³⁷⁸ This is incorrect. See paragraphs 11.96 to 11.97 of the Final Determination, where the UR stated -

'We remain of the view that LIBOR plus 2% remains a reasonable rate to allow. This is consistent with the PNGL and SGN licences and reflects the fact that we view under recoveries as something which should be a short term arrangement that should not be incentivised in the licence.

*However in order to facilitate a glide towards the new rate we will apply LIBOR plus 4% in 2017 and LIBOR plus 3% in 2018. This will have some moderate benefit for FE and should see under recoveries largely dealt with by the time the enduring rate of LIBOR plus 2% is applied in 2019.*³⁷⁹

11.45 FE considers its new rate to be '*inappropriate*' because it considers that the rate should reflect '*the risks to the company of managing its under-recoveries*'³⁸⁰. FE is labouring under the misconception that the accumulation of under-recoveries is to be equated with an investment. The new rate is designed to encourage the unwinding of under-recoveries. FE has had time to prepare for this, and is given further time by the glide path described above.

11.46 FE considers its new rate to be '*arbitrary*'³⁸¹. In fact, it is identical to the rate FE was willing to sign up to when bidding for the Gas to the West extension³⁸². The rate for PNGL is a real rate of 2% p.a. The rate for SGN is LIBOR + 2% p.a. A rate 2-4% above LIBOR reflects typical financing costs over the relatively short-term. This is carefully considered, not arbitrary: the UR's intention is that under-recoveries are not likely to be required over the longer term.

³⁷⁷ Notice of Appeal, [para 2.30](#)

³⁷⁸ Notice of Appeal, [para 6.44](#)

³⁷⁹ Final Determination, [paras 11.96 - 1.97](#) – **NOA-1 / Tab 7 / Page 2077**

³⁸⁰ Notice of Appeal, [para 6.45](#)

³⁸¹ Notice of Appeal, [para 6.47](#)

³⁸² [The Gas to the West Applicant Information Pack](#), [para 3.56](#)

11.47 FE considers its new rate to be '*disproportionate*'. To the contrary, the rate beyond 2018 is in line with the rates for PNL and SGN referred to above. It is also in line with the rate of LIBOR + 1.5% applied to under-recoveries in the price controls for the incumbent gas suppliers in FE's area, namely Firmus (Energy) Supply, and in PNL's area, namely SSE Airtricity Supply³⁸³. Power NI (the incumbent electricity supplier) receives only the Danske bank base rate on its under-recoveries³⁸⁴. The rate Ofgem used in RIIO ED1 is based on the Bank of England base rate + 1.5%³⁸⁵. Moreover, in its response to the Draft Determination, FE stated that '*it can accept the lower rate of return for future under-recoveries post 2017*'³⁸⁶.

Another perspective

11.48 FE's appeal, understandably, is framed from its perspective. However, the UR, and the CMA, must also consider the broader public interests.

11.49 Some respondents to the Draft Determination invited the UR to take bolder action in relation to under-recoveries than the UR ultimately did. The Consumer Council of Northern Ireland asked the UR to consider returning to consumers some of the windfall gained by FE from inflating under-recoveries at a rate of 7.5% p.a.³⁸⁷

11.50 Mr McHugh confirms in his statement to Manufacturing NI's support to the proposal for the rate of return on under-recoveries to shift to LIBOR +2%³⁸⁸ - a position that was also supported by the Major Energy Users' Council (**MEUC**) who specifically welcomed the reduction in the rate.³⁸⁹

Conclusion

11.51 For all of the above reasons, FE's appeal on Ground 3 should be dismissed.

³⁸³ [UR: 2016 Final Determination, Price Control for SSE Airtricity and firmus energy \(supply\)](#), para 11.3

³⁸⁴ [Electricity Supply Licence: Power NI](#), Annex 2, para 1.1 (definition of the average specified rate)

³⁸⁵ [Ofgem – RIIO-ED1 slow-track CRC licence changes](#) (see Part 2A)

³⁸⁶ FE: Response to GD17 Draft Determination - **NOA-1 / Tab 21 / Page 4835**

³⁸⁷ [CCNI: Response to GD17 Draft Determination](#), para 5.12 ('the company' should read 'consumers')

³⁸⁸ McHugh-1, para 14.49

³⁸⁹ [MEUC: Response to GD17 Draft Determination](#), page 2

SECTION 12. GROUND 4A – 'THE ASSET BETA ERROR'

Introduction

- 12.1 FE argues that, in determining the WACC, the UR set an incorrect asset beta because it failed to take into account certain systematic risks facing FE which are not faced by comparator companies. In particular it argues that the UR has not taken account of the systematic risks arising from FE's connection targets and has placed insufficient weight on the scale of the company's capex programme³⁹⁰.
- 12.2 The UR observes that it set the asset beta within a range which FE's own consultants (Oxera) regarded as reasonable, which positions FE logically in relation to relevant comparator companies, and which is above the nearest GB comparators in order to take into account specific factors relating to Northern Ireland GDNs.
- 12.3 The criticisms now levelled at the choice of asset beta derive from evidence provided by FE's new consultants (PwC). They are not sustainable because they rely on several factual errors, unjustified assumptions and misapprehensions, as well as a failure to take into account relevant considerations.
- 12.4 Moreover, even to the extent to which the evidence provided by PwC represents the legitimate opinion of an expert, it does nothing to render the UR's decision '*wrong*' in the sense meant by the Gas Order³⁹¹. The UR made a decision that was objectively reasonable, and in any event within the proper scope of its regulatory discretion.

The Decision on the Asset Beta

- 12.5 The approach adopted by the UR to setting the asset beta is made clear on the face of both the Draft Determination³⁹² and the Final Determination³⁹³.
- 12.6 In brief, the UR adopted a standard CAPM methodology for determining the WACC, but in the absence of a stock market listing for either PNGL or FE it was required to arrive at an estimate for the asset beta by considering the position of a range of comparators across the gas, electricity and water sectors in Great Britain and Northern Ireland. In particular it was able to take account of the asset betas which Ofgem used in RIIO-GD-1 and which SGN identified as part of its competitive application for a gas distribution licence for the Gas to the West area.
- 12.7 The UR took account of advice from First Economics³⁹⁴ and of the submissions made by Oxera on behalf of FE³⁹⁵, and in the Draft Determination estimated the asset beta

³⁹⁰ Notice of Appeal, [paras 2.32 - 2.35](#) and [paras 7.1 – 7.47](#)

³⁹¹ As explicated by the CMA in Northern Powergrid, [paras 3.26 – 3.30](#) and British Gas, [paras 3.27 – 3.31](#)

³⁹² GD17 Draft Determination, [paras 10.23 – 10.35](#) – **NOA-1 / Tab 6 / Pages 933 - 935**

³⁹³ GD17 Final Determination, [paras 10.26 – 10.40](#) – **NOA-1 / Tab 7 / Pages 2046 - 2049**

³⁹⁴ First Economics: An Estimate of the GD17 Costs of Capital – **NOA-1 / Tab 6G / Pages 1716 - 1740**

³⁹⁵ Oxera: GD17 price control parameters: allowed rate of return – **NOA-1 / Tab 17A / Pages 4337 – 4385** and Oxera: GD17 price control parameters: allowed rate of return: September update – **NOA-1 / Tab 20H / Pages 4726 - 4755**

at 0.40, within (though at the bottom of) the range proposed by Oxera and central to the range proposed by First Economics. This was above the nearest comparator – the asset beta of 0.38 set by Ofgem in RIIO-GD1 – in recognition of specific features of the Northern Ireland GDNs.

- 12.8 Following the Draft Determination, the UR subjected its assessment of the cost of capital to peer review by the UK Regulators Network (**UKRN**)³⁹⁶, and considered a number of further representations made on behalf of the companies, including a submission by Oxera on behalf of FE³⁹⁷.
- 12.9 In the Final Determination, the UR determined that there was no reason for it to change its initial point estimate of 0.40 for the asset beta, and set the beta for FE at that level.

The Ground of Appeal

- 12.10 FE says that the UR has set an incorrect asset beta because it relied on 'a limited comparator set of companies that are not subject to the same degree of systematic risks as faced by FE, as well as being of a significantly greater scale'³⁹⁸. In consequence it asserts that 'an asset beta of 0.40, as set by the UR, does not capture FE-specific risks'³⁹⁹.
- 12.11 In legal terms, the UR is said to be wrong because it failed to act in accordance with its principal objective and/or failed to give appropriate weight to its statutory duty to secure that licence holders are able to finance their licensed activities⁴⁰⁰.
- 12.12 FE relies for this purpose on alleged 'errors in the approach adopted by the UR' which are identified by Nicholas Forrest of PwC⁴⁰¹. Specifically, this includes two risks which PwC claims were not adequately included in the UR's application of CAPM – the 'capex risk' and the 'connections incentive risk'⁴⁰² – together with a number of additional non-CAPM factors⁴⁰³.

Response to the Ground of Appeal

- 12.13 FE faces two fundamental problems in relation to this ground of appeal, which it is unable to overcome in its submissions.
- 12.14 The first is that FE's own expert economic consultants (Oxera) advised (and then

³⁹⁶ UKRN: Peer review of the Utility Regulator's estimate of the cost of capital for GD17 – **NOA-1 / Tab 7G / Pages 2882 - 2889**

³⁹⁷ Oxera: response to the Utility Regulator's draft decision: allowed rate of return – **NOA-1 / Tab 21E / Pages 4969 - 4995**

³⁹⁸ Notice of Appeal, [para 7.18\(a\)](#)

³⁹⁹ Notice of Appeal, [para 7.47](#)

⁴⁰⁰ Notice of Appeal, [para 7.18](#)

⁴⁰¹ Notice of Appeal, [paras 7.27 – 7.28](#)

⁴⁰² Notice of Appeal, [para 7.34](#)

⁴⁰³ Notice of Appeal, [para 7.42](#)

maintained throughout the GD17 process) that a range for the asset beta of 0.40–0.50 was both reasonable and appropriate. FE quoted that range in its own GD17 submissions. The UR set the asset beta within that range. In consequence, it is not credible for FE to argue that the asset beta was 'wrong'.

- 12.15 FE does not even acknowledge this difficulty in its Notice of Appeal. Nor does the economic expert on which it now relies (in substitution for Oxera) – Nicholas Forrest of PwC – make reference to Oxera's work, express the view that they were mistaken, or offer any rationale for differing from their conclusion.
- 12.16 FE's sole attempt to address this issue took the form of a letter sent to the CMA by its legal advisers, Freshfields Bruckhaus Deringer (**Freshfields**) after the matter had first been raised by the UR at permission stage in this appeal⁴⁰⁴. This is vitiated by factual misstatements, and provides no answer to the question.
- 12.17 The second problem faced by FE is that the report of PwC on which it now bases this ground of appeal is unreliable because it contains several factual errors, unjustified assumptions and misapprehensions, as well as a failure to take into account relevant considerations.
- 12.18 The UR addresses each of these difficulties in turn below.

The Oxera Problem

- 12.19 FE seeks to establish that the UR was 'wrong to set FE's asset beta as low as 0.40'⁴⁰⁵. It can only succeed, in an area 'where arriving at precise figures necessarily requires one to exercise an element of judgment'⁴⁰⁶, if it can show that the UR's judgment was outside the legitimate area of discretion that was open to it.
- 12.20 It is therefore fatal to FE's appeal on this ground that the asset beta set by the UR fell within the range that FE's own expert economic consultants (Oxera) asserted was reasonable and appropriate, and that FE adopted as part of its GD17 submissions.
- 12.21 This expert opinion is in evidence before the CMA in this appeal, since it formed part of FE's submissions to the UR during the GD17 process. Specifically –
- (a) Oxera first said it, in its June 2015 submission on the rate of return, where reference is made to the range four times⁴⁰⁷. On three of these occasions the range is explicitly referred to as '*reasonable*' in the following terms:

'An asset beta range of 0.40-0.50, at the top end of the sample for regulatory precedents, and higher than the current asset betas for GB

⁴⁰⁴ Freshfields: Letter to Gavin Knott, 16 December 2016

⁴⁰⁵ Notice of Appeal, [para 7.27\(b\)](#)

⁴⁰⁶ Earwaker-1, [para 3.5](#)

⁴⁰⁷ Oxera: GD17 price control parameters: allowed rate of return, [executive summary](#), [Table 1](#), [paras 3 and 3.3.9](#) – [NOA-1 / Tab 17A / Pages 4340, 4342, 4349, 4368](#)

*comparators, appears reasonable to reflect the latest market evidence, and the risk differentials between FE and its GB comparators.*⁴⁰⁸

- (b) Oxera repeated the range in its September 2015 submission, again referring to it four times, and describing it as the '*appropriate*' range⁴⁰⁹. In particular:

*'Oxera assessed that an appropriate asset beta range for FE's allowed WACC in GD17 is 0.40–0.50'*⁴¹⁰;

and, considering the latest market evidence,

*'Combined with FE's risk differentials analysis (see June report, section 3.3), this evidence remains consistent with an asset beta range for FE of 0.4–0.5'*⁴¹¹.

- (c) FE adopted this range in its September 2015 Business Plan⁴¹².
- (d) Oxera continued to rely on this range (albeit arguing that the beta should be set towards the top end) in its submission of May 2016⁴¹³.
- (e) FE continued to rely on the range in its own submission of May 2016⁴¹⁴.

12.22 In short, the argument that the '*reasonable*' or '*appropriate*' range for the asset beta was 0.40 – 0.50 was maintained by Oxera, and relied on by FE, consistently across a number of submissions over a twelve month period throughout the GD17 process, including in response to the Draft Determination.

12.23 It is revealing that, for the purposes of making submissions on the asset beta in this appeal, FE produces a different expert witness (PwC) – even while continuing to rely on Oxera for other matters – who now specifies a different range with a lower bound of 0.45.

12.24 No attempt has been made to explain the late-stage change of expert. In their letter to the CMA of 16 December 2016, Freshfields insist that it is '*unrelated to any difference of opinion*'⁴¹⁵. The UR suggests that the situation speaks for itself, but it is unnecessary to ask the CMA to draw any conclusions from it. Instead it is sufficient

⁴⁰⁸ Oxera: GD17 price control parameters: allowed rate of return, [executive summary](#), [paras 3 and 3.3.9](#) - **NOA-1 / Tab 17A / Pages 4340, 4349, 4368**

⁴⁰⁹ Oxera: GD17 price control parameters: allowed rate of return, September update, [pages, 4, 6, 10 and 11](#) – **NOA-1 / Tab 20H / Pages 4729, 4731, 4735 and 4736**

⁴¹⁰ Oxera: GD17 price control parameters: allowed rate of return, September update, [page 10](#) - **NOA-1 / Tab 20H / Page 4735**

⁴¹¹ Oxera: GD17 price control parameters: allowed rate of return, September update, [page 11](#) - **NOA-1 / Tab 20H / Page 4736**

⁴¹² FE: Business Plan Template Commentary, [Figure 4.5](#) – **NOA-1 / Tab 19 / Page 4604**

⁴¹³ Oxera: Response to the Utility Regulator's draft decision: allowed rate of return, [page 1](#) – **NOA-1 / Tab 21D / Page 4938**

⁴¹⁴ FE Response to the GD17 Draft Determination dated May 2016, [para 5.6](#) – **NOA-1 / Tab 21 / Page 4897**

⁴¹⁵ Freshfields: Letter to Gavin Knott, 16 December 2016, [para 7.5](#)

to invite the CMA to consider Freshfields' attempt to prove that there is no contradiction between the work carried out by Oxera and PwC.

- 12.25 For this purpose, Freshfields say that *'It is clear from Oxera's previous analysis that Oxera always supported an asset beta at the "top end" of the 0.4-0.5 range...'*⁴¹⁶.
- 12.26 In the first place, this is nothing to the point. FE say that the UR was 'wrong' to set the asset beta at 0.4. It is a complete response to this for the UR to draw attention to the fact that a beta of 0.4 falls within the range that was considered *'reasonable'* and *'appropriate'* by FE's own consultants. Even if Oxera had always contended for a beta towards the top end of the range, it would not change the fact that the determined beta fell within its own proposed range, which was consistently maintained by it.
- 12.27 Second, and in any event, Freshfields' statement is factually inaccurate. This can be demonstrated by considering two of the quotations on which they seek to rely for the purposes of their assertion that Oxera *'always'* supported an asset beta at the top end of the range.
- 12.28 The first quotation is from the Oxera June 2015 submission: *'An asset beta range of 0.40-0.50, at the top end of the sample for regulatory precedents, and higher than the current asset betas for GB comparators, appears reasonable to reflect the latest market evidence, and the risk differentials between FE and its GB comparators.'* (emphasis added)⁴¹⁷.
- 12.29 So far from establishing that Oxera supported a point value at the top end of the 0.40–0.50 range, what this says is that Oxera recognises that the entire range exists at the top end of the available regulatory precedents. The quote is clear on its face, and its obvious meaning is supported by the context in which it appears.
- 12.30 The second quotation relied upon is from the Oxera September 2015 submission, and as reproduced by Freshfields it reads: *'it remains appropriate to select an asset beta for FE at the top end of the range'*⁴¹⁸. However, in an attempt to fit the quotation to the argument, it has been necessary for it to be cropped. What Oxera actually said (with the omitted words underlined) was: *'it remains appropriate to select an asset beta for FE at the top end of the range of the comparator sample and regulatory precedents'*⁴¹⁹.
- 12.31 Oxera therefore was repeating the point made in its June 2015 submission. If there was any question about this, it is restated again in the main section of the September 2015 document: *'Oxera assessed that an appropriate asset beta range for FE's allowed WACC in GD17 is 0.40–0.50 (see June report section 3.3). This was based on*

⁴¹⁶ Freshfields: Letter to Gavin Knott, 16 December 2016, [para 7.3](#)

⁴¹⁷ Freshfields: Letter to Gavin Knott, 16 December 2016, [para 7.3\(a\)](#), quoting Oxera: GD17 price control parameters: allowed rate of return, [executive summary – NOA-1 / Tab 17A / Page 4340](#)

⁴¹⁸ Freshfields: Letter to Gavin Knott, 16 December 2016, [para 7.3\(b\)](#), quoting Oxera: GD17 price control parameters: allowed rate of return, September update, [page 6 – NOA-1 / Tab 20H / Page 2731](#)

⁴¹⁹ Oxera: GD17 price control parameters: allowed rate of return, September update, [page 6 – NOA-1 / Tab 20H / Page 2731](#)

the top end of the regulatory precedents, reflecting the risk differentials analysis for FE and market data (see next slide)⁴²⁰ (emphasis added).

- 12.32 What these quotes therefore establish is that in Oxera's view the entire range, top to bottom, existed at the outward reaches of regulatory precedent. Indeed the work of the UR's consultants, First Economics, demonstrates that even the bottom end of the range was higher than most comparators⁴²¹.
- 12.33 In short, so far from establishing that the UR has engaged in a '*misreading of Oxera's previous submissions*⁴²² as they claim, Freshfields' reliance on these quotations serve to emphasise that the UR correctly understood Oxera's work.
- 12.34 Oxera's recommendations are clear, and FE has no answer to the point that the UR's determined asset beta was consistent with the range they proposed.

The PwC Report

- 12.35 FE does not now seek to rely on the earlier work produced by Oxera, but attempts to establish that the UR was 'wrong' to set an asset beta of 0.40 by relying on the report of PwC which is placed into evidence by Nicholas Forrest⁴²³. PwC contends that the reasonable range for the asset beta is 0.45–0.50, and that the appropriate point estimate would be 0.47.
- 12.36 However, FE fails to make out its case, and the PwC report on which its arguments are based is flawed and unreliable because it relies on a number of factual errors, unjustified assumptions and misapprehensions, and fails to take into account several relevant considerations.
- 12.37 These are substantially addressed in the witness statement of Mr John Earwaker of First Economics, but the principal flaws are summarised below.

General Observations

- 12.38 FE claims that it is '*fundamentally different*' to the GB GDNs⁴²⁴, that the UR '*did not take sufficient account of any of these fundamental differences*' and that it '*assumed that it could simply rely on the results of exercises conducted by Ofgem*⁴²⁵.
- 12.39 None of these statements is accurate. It is clear that the UR carefully considered and took into account the potential differences between FE and the GB GDNs both in its Draft Determination⁴²⁶ and (with the advantage of a peer review by the UKRN) in its

⁴²⁰ Oxera: GD17 price control parameters: allowed rate of return, September update, [page 10](#) – NOA-1 / Tab 20H / Page 2735. The '*next slide*', already quoted above, highlights that Oxera has not changed its mind.

⁴²¹ First Economics: An Estimate of the GD17 Costs of Capital, [para 3.2](#) – NOA-1 / Tab 6G / Pages 1718 - 1719

⁴²² Freshfields: Letter to Gavin Knott, 16 December 2016, [para 7.6](#)

⁴²³ Notice of Appeal, [paras 7.27 – 7.28](#)

⁴²⁴ Notice of Appeal, [para 7.30](#)

⁴²⁵ Notice of Appeal, [para 7.31](#)

⁴²⁶ GD17 Draft Determination, [paras 10.25 – 10.34](#) – NOA-1 / Tab 6 / Pages 933 - 935

Final Determination⁴²⁷. The UR's consultants, First Economics, considered the same matters in their advice⁴²⁸.

- 12.40 The notion that the UR relied only on exercises carried out by Ofgem is unsustainable when it is clear that the comparators considered in these publications include the work of the CMA and a number of other regulators. In addition, and importantly, the UR considered the outcome of the SGN licensing process, where the beta for a Northern Ireland GDN was established by virtue of a competitive process which identified market perceptions of risk⁴²⁹.
- 12.41 The setting of an asset beta of 0.40 was higher than the nearest Ofgem comparators, explicitly in recognition of *'the fact that there are differences with PNGL's and FE's regulatory model from the standard model...[and] the possibility that investors may not be wholly familiar with these differences'*⁴³⁰.
- 12.42 In these circumstances, it is plainly an error, as Mr Earwaker identifies⁴³¹, for PwC to have taken 0.40 as a baseline for its assessment of the asset beta, and then suggest that it should be subject to an uplift to account for supposed differences between FE and the GB GDNs⁴³². Following PwC's own logic, the starting point should have been a beta of 0.38.
- 12.43 Further, PwC correctly states, in relation to the risks which it identifies and seeks to evaluate, that: *'The regulatory regime itself can mitigate some of these risks, either fully through true-ups and/or correction mechanisms, or partially through risk sharing and/or incentive mechanisms'*⁴³³. However, it appears unaware, and certainly takes no account, of the risk mitigation measures adopted by the UR in GD17, such as the uncertainty mechanism⁴³⁴. Moreover, it appears to consider, incorrectly and without citing any basis for such an assumption, that FE has a *'mandatory connection target and capital programme'*⁴³⁵, demonstrating no awareness of the *'risk sharing and/or incentive mechanisms'* which actually underpin FE's connections and capex activities⁴³⁶. There is in fact little evidence in its report that PwC has considered or properly understood the nature of the GD17 price control as it applies to FE.

CAPM – The Connections Incentive

- 12.44 In arguing that the asset beta for FE has been understated, PwC places the greatest weight on, and seeks to justify the largest uplift (0.06) by reference to, what it calls the *'connections incentive risk'*, namely the systematic risk which it claims will flow

⁴²⁷ GD17 Final Determination, [paras 10.28 – 10.38](#) – NOA-1 / Tab 7 / Pages 2047 - 2048

⁴²⁸ First Economics: An Estimate of the GD17 Costs of Capital, para 3.3 – NOA-1 / Tab 6 / Pages 1721 - 1726

⁴²⁹ GD17 Final Determination, [para 10.26](#) – NOA-1 / Tab 7 / Page 2046

⁴³⁰ GD17 Final Determination, [para 10.39](#) – NOA-1 / Tab 7 / Pages 2048 - 2049

⁴³¹ Earwaker-1, [para 3.14](#)

⁴³² PwC: Financial aspects of GD17, [paras 2.90 – 2.91](#) – NF-1 / Tab 1 / Page 20

⁴³³ PwC: Financial aspects of GD17, [para 2.36](#) – NF-1 / Tab 1 / Page 11

⁴³⁴ GD17 Final Determination, [Chapter 9](#) – NOA-1 / Tab 7 / Pages 2032 - 2042

⁴³⁵ PwC: Financial aspects of GD17, [para 2.15](#) – NF-1 / Tab 1 / Page 7

⁴³⁶ GD17 Final Determination, [Chapter 7](#) – NOA-1 / Tab 7 / Pages 1944 - 2018

from the connection targets set for FE in GD17⁴³⁷.

12.45 This conclusion is fundamentally undermined by PwC's reliance on several unjustified assumptions on which it bases its estimation of risk. Specifically –

- (a) It is assumed that '*a significant proportion*' (72.5%) of all connections related costs are '*fixed in nature*', including all '*sales related staff, shared overheads, advertising/marketing/PR*'⁴³⁸.

No evidence is provided for this assumption, nor could any credible evidence be provided. FE's own data shows advertising, marketing and PR costs to have been highly variable during GD14, falling by 37% in headline terms and nearly 50% on a per connection basis⁴³⁹. An efficient company should ensure that it is able to redirect its marketing budget, or to reallocate it to direct connection incentives, in reaction to customer response data.

Moreover, whether costs may be said to be fixed must depend on the time horizon over which the question is being considered. On this basis, even sales staff – the costs of whom may be fixed in the short term – cannot be said to represent a fixed cost over a six year time period. To the extent to which their remuneration includes bonus or commission payments, it will not necessarily be fixed even within a shorter time frame.

In short, the assumption relied upon is highly implausible, would require to be supported by evidence (of which there is none), and is contradicted by FE's own data.

- (b) It is assumed that '*connection numbers are influenced by the macroeconomic climate*', and implied that this means they will be reduced if growth, income or confidence falls⁴⁴⁰.

For the reasons described by Mr Earwaker, this assumption appears to be based on an unsophisticated understanding of the effects of macroeconomic circumstances on the potential for customers to switch to gas. These are self-evidently more complex than PwC appears to assume⁴⁴¹. Moreover, PwC also treats the cost of switching to gas as if it were entirely discretionary spend and as such highly responsive to the economic cycle⁴⁴², thereby displaying no awareness of the relevance of boiler replacements as a key factor in driving essential household spend. As Mr Earwaker concludes, without evidence for

⁴³⁷ PwC: Financial aspects of GD17, paras 2.42 – 2.44 and 2.66 – 2.76 – NF-1 / Tab 1 / Pages 11 and 15 - 17

⁴³⁸ PwC: Financial aspects of GD17, paras 2.66 and 2.69 – NF-1 / Tab 1 / Pages 15 - 16

⁴³⁹ FE: Owner Occupied Connections in GD14, Table 1 – NM-1 / Tab 15 / Page 144

⁴⁴⁰ PwC: Financial aspects of GD17, para 2.66 – NF-1 / Tab 1 / Page 15

⁴⁴¹ Earwaker-1, para 3.16 – 3.18

⁴⁴² PwC: Financial aspects of GD17, footnote 30 – NF-1 / Tab 1 / Page 15

the underlying assumptions made by PwC it is impossible to place any real weight on this part of its analysis⁴⁴³.

- (c) It is assumed that other GB and NI companies are not exposed to systematic risk similar to that created by the connections incentive⁴⁴⁴.

This assumption is demonstrably false. As Mr Earwaker identifies, there are clear elements of systematic risk that are attributable to GB GDNs in respect of customer satisfaction incentives and pensions liabilities under RIIO-GD1. These have no analogue in the case of FE, so that a full analysis of systematic risk relating to incentives could well support the conclusion that greater risk lies with the GB companies⁴⁴⁵.

- (d) The calculation of a 0.06 asset beta uplift relies on a series of unevidenced assumptions, each of which, in the expert opinion of Mr Earwaker *'is open to challenge'* and some of which *'are almost impossible to defend'*⁴⁴⁶.

12.46 For all of these reasons, John Earwaker is right to conclude that *'no real reliance'* can be placed on PwC's estimation of the supposed impact that the connections incentive has on the asset beta⁴⁴⁷.

CAPM – Capex

12.47 PwC additionally places weight on, and seeks to justify, a further uplift of beta (0.04) by reference to what it calls *'capex risk'*. It explains that this exists because *'FE's capex programme is large relative to its asset base, compared to other regulated industries'* and consequently that any systematic risks relating to capex are *'likely to be magnified for FE relative to GB GDNs'*⁴⁴⁸.

12.48 This conclusion is also fundamentally undermined by several unjustified assumptions and errors on which it is based. These are outlined fully in John Earwaker's witness statement, but in summary –

- (a) In seeking to demonstrate that FE's operational leverage is high when set against that of the GB GDNs, it uses data which fails to compare like-with-like. The Ofgem data upon which it relies do not consist of RIIO-GD1 forecast expenditure – which would be directly comparable with the GD17 forecasts – but of actual capex in the first year of the GD-1 period⁴⁴⁹. In that year the GB GDNs spent significantly less than Ofgem assumed when setting allowances. The results of an appropriate like-for-like comparison are set out by Mr

⁴⁴³ Earwaker-1, [para 3.19](#)

⁴⁴⁴ PwC: Financial aspects of GD17, [para 2.71 – NF-1 / Tab 1 / Page 16](#)

⁴⁴⁵ Earwaker-1, [para 3.20 – 3.22](#)

⁴⁴⁶ Earwaker-1, [para 3.24](#)

⁴⁴⁷ Earwaker-1, [para 3.25](#)

⁴⁴⁸ PwC: Financial aspects of GD17, [para 2.48 – NF-1 / Tab 1 / Page 12](#)

⁴⁴⁹ PwC: Financial aspects of GD17, [footnote 25 – NF-1 / Tab 1 / Page 13](#)

Earwaker, and show that FE's ratio of capex to TRV is similar to that of the GB GDNs⁴⁵⁰.

- (b) In seeking to demonstrate that FE's operational leverage is high, it focuses on a ratio of capex to assets, rather than totex to assets⁴⁵¹, since it acknowledges that '*FE has a similar totex:asset ratio to those of the GB companies*'⁴⁵². But as Mr Earwaker notes, there is no reason why investors would be concerned only with the scale of capex and not with that of opex – totex is the more appropriate measure, and no good reason is given for not relying on it⁴⁵³.
- (c) In seeking to demonstrate that FE's operational leverage is high it focuses on the value of DAV rather than TRV, arguing that this is more comparable '*to the conventional RAVs in GB*'⁴⁵⁴. However, there is no adequate justification for this approach.

First, PwC makes the factual error that under-recoveries are part of the TRV⁴⁵⁵. They are not. Second, there is no reason for treating the profile adjustment other than as part of the RAV – it represents part of the financial capital that investors have put into FE's business, and is subject to the rate of return set by the UR in the same way as other assets⁴⁵⁶. Third to exclude it is inconsistent with FE's own argument that both under-recoveries should be treated in the same way as '*the other elements [sic] of our TRV*'⁴⁵⁷. The UR does not accept that this is correct for under-recoveries (rather than the profile adjustment), but in any event FE cannot credibly seek to argue the same point in opposing directions, as it now does by its reliance on the PwC report.

12.49 In short, PwC's assessment of the '*capex risk*' is based on expenditure to asset ratios which involve a series of unjustified assumptions and choices, including in particular choices about the use of data in calculating FE's operational leverage. Conversely, the totex:TRV ratio is almost exactly equivalent to that of the GB GDNs. On a proper comparison with the GB GDNs, FE is not an outlier.

Non-CAPM Risks

12.50 PwC additionally seeks to rely on three supposedly '*asymmetric*' risks which are not captured by CAPM – namely '*asymmetric capex risk*', '*non-additionality risk*' and '*opex benchmarking*'⁴⁵⁸ – together with what it calls '*RPI forecasting risk*'⁴⁵⁹.

⁴⁵⁰ Earwaker-1, [para 3.31 – 3.32](#)

⁴⁵¹ PwC: Financial aspects of GD17, [para 2.54 – NF-1 / Tab 1 / Page 13](#)

⁴⁵² PwC: Financial aspects of GD17, [para 2.53 – NF-1 / Tab 1 / Page 13](#)

⁴⁵³ Earwaker-1, [para 3.34](#)

⁴⁵⁴ PwC: Financial aspects of GD17, [para 2.54 – NF-1 / Tab 1 / Page 13](#)

⁴⁵⁵ PwC: Financial aspects of GD17, [para 2.54 – NF-1 / Tab 1 / Page 13](#)

⁴⁵⁶ Earwaker-1, [para 3.33](#)

⁴⁵⁷ Martindale-1, [paras 12.4-12.5](#)

⁴⁵⁸ PwC: Financial aspects of GD17, [para 2.61 – NF-1 / Tab 1 / Pages 14 - 15](#)

12.51 As to each of these –

- (a) The argument on '*asymmetric capex risk*' relies on the assumptions: that '*For FE, investment towards the growth of the gas industry in NI is mandatory*' and that FE is exposed to asymmetric risk of '*penalties indirectly arising through missing connection targets*'⁴⁶⁰. Neither assumption is validated or valid. PwC appears to be uninformed about the nature of the incentive and risk sharing mechanisms relating to FE's capex, the extent to which (as explained above in respect of Ground 2) the connection targets were de-risked in GD17 so that failing to meet them does not give rise to anything that could properly be called a penalty, or the benefits available if those targets are exceeded.
- (b) The supposed '*non-additionality risk*' is premised on the potential for the UR to have incorrectly set the non-additionality rate in relation to connections. But it is not explained why this should amount to an asymmetric risk, since FE stands to benefit from any under-estimation of the non-additionality rate, by obtaining a connections allowance in respect of customers it has had to take no action to gain.
- (c) The claimed '*opex benchmarking*' risk appears to flow from PwC having been misinformed about the GD17 process, since it turns on the notion that the UR engaged in a process of '*benchmarking opex allowances to "upper quartile" GDN performance*'. This is factually incorrect for the reasons explained above in relation to Ground 1A.
- (d) The suggestion that there is an '*RPI forecasting risk*' is also, for reasons given by Mr Earwaker⁴⁶¹, unsustainable – the supposed risk is neither unusual in the case of FE nor asymmetric.

Benchmarking – SGN

12.52 PwC offers a point estimate for FE's asset beta of 0.47. It is a significant difficulty for PwC that this exceeds any possible beta for SGN, which will fall within the range 0.43 – 0.45, in particular given that: (i) this range was revealed by a competitive process; (ii) it was assessed by Oxera on behalf of SGN⁴⁶²; (iii) SGN has a price cap rather than a revenue cap form of price control (which PwC accepts increases risk⁴⁶³); and (iv) SGN currently has no customers and for that reason self-evidently bears greater risk than FE (as John Earwaker explains⁴⁶⁴).

12.53 PwC's attempt to address this point is unconvincing because it is based on a factual error. Specifically, PwC says that FE's asset beta should be subject to an uplift when

⁴⁵⁹ PwC: Financial aspects of GD17, [para 2.62 – NF-1 / Tab 1 / Page 15](#)

⁴⁶⁰ PwC: Financial aspects of GD17, [para 2.61 – NF-1 / Tab 1 / Page 14](#)

⁴⁶¹ Earwaker-1, [para 3.36\(d\)](#)

⁴⁶² Oxera: Gas to the West Cost of Capital, [para 4.2 – Annex C to \[SGN: Low Pressure Operational Business Plan\]\(#\)](#)

⁴⁶³ PwC: Financial aspects of GD17, [para 2.86 – NF-1 / Tab 1 / Page 19](#)

⁴⁶⁴ Earwaker-1, [para 3.40](#)

compared with that of SGN because of the *'impact associated with the connections incentive, as this beta risk was not factored into the calibration of the SGN beta'*⁴⁶⁵. Seeking to justify this statement, it says: *'We note that no documentation regarding the GD17 methodology would have been available to Oxera at the time of their report on the cost of capital (April 2014) – limiting their ability to incorporate the risks associated with this specific incentive mechanism'*⁴⁶⁶.

12.54 In other words, PwC derives from the chronological fact that Oxera must have been unaware of the GD17 methodology the conclusion that it did not take account of the connections incentive in its estimation of SGN's asset beta.

12.55 The problem with this logic is that -

- (a) the UR had in fact made it clear to all licence applicants in February 2014 that it intended to include a connections incentive in the Gas to the West low pressure licence⁴⁶⁷;
- (b) the UR had stated that this would be on the model of the incentive applied to PNGL and FE⁴⁶⁸ (i.e. to the GD14 connections incentive);
- (c) the UR *'hard wired'* the value of this incentive into the Data Input Workbook through which applicants were required to submit cost information⁴⁶⁹;
- (d) Oxera must therefore be taken to have been fully aware of the connections incentive and to have factored it into its analysis;
- (e) the UR changed aspects of the connections incentive in GD17 so that it gave rise to significantly reduced risks of penalty in comparison with the GD14 mechanism⁴⁷⁰;
- (f) in consequence the connections incentive that Oxera factored into its analysis would have given rise to greater risk than the GD17 equivalent to which FE is now subject.

12.56 In short, PwC's attempt to explain why the SGN beta should be benchmarked at the level 0.45-0.47 to take account of a connections incentive risk⁴⁷¹ does not withstand scrutiny. SGN's beta of 0.43-0.45 fully accounts for connections incentive risk, and the company demonstrably faces greater risks than FE for the reasons given by John Earwaker⁴⁷².

⁴⁶⁵ PwC: Financial aspects of GD17, [para 2.87 – NF-1 / Tab 1 / Page 19](#)

⁴⁶⁶ PwC: Financial aspects of GD17, [para 2.87 – NF-1 / Tab 1 / Page 19](#)

⁴⁶⁷ [UR: Gas to the West: Applicant Information Pack, para 3.47](#)

⁴⁶⁸ [UR: Gas to the West: Applicant Information Pack, para 3.40](#)

⁴⁶⁹ [UR: Gas to the West: Applicant Information Pack, para 4.36](#)

⁴⁷⁰ GD17 Final Determination, [paras 6.160 – 6.164 – NOA-1 / Tab 7 / Pages 1858 - 1859](#)

⁴⁷¹ PwC: Financial aspects of GD17, [para 2.88 – NF-1 / Tab 1 / Page 19](#)

⁴⁷² Earwaker-1, [para 3.42](#)

Benchmarking – Heathrow

12.57 PwC seeks to benchmark the FE asset beta against Heathrow. This comparison is, however, entirely unreliable given the significant differences between Heathrow and FE, as outlined by Mr Earwaker⁴⁷³.

Conclusion

12.58 For all of the reasons which are set out above, PwC's evidence cannot be relied upon to establish either the range or point estimate of the asset beta which it proposes.

The UR Position on Ground 4A

12.59 The determination of an asset beta in circumstances in which it is not possible to draw on stock market information entails an exercise of regulatory judgment which must be grounded in an analysis of the betas set of comparator companies.

12.60 The UR followed a careful and diligent process of engagement, setting a beta in line with the appropriate regulatory precedents, and making appropriate allowance for the particular circumstances of FE.

12.61 The determined beta fell within a range that was both reasonable and appropriate and squarely within the reasonable judgment open to the UR. It was within the range identified by Oxera – who were FE's consultants throughout the GD17 process – and which Oxera itself noted to be at the top end of the range of regulatory precedents. There is no basis on which it can credibly be said to be 'wrong'.

12.62 It is surprising that FE should now argue to the contrary. For this purpose it relies on a new expert report from PwC, to which no real weight can be attached in the light of the errors, misapprehensions and ungrounded assumptions which are identified in detail above. Nothing in that report disturbs the conclusions properly reached by the UR in its GD17 Final Determination.

Conclusion

12.63 For all of the above reasons, FE's appeal on Ground 4A should be dismissed.

⁴⁷³ Earwaker-1, [para 3.44 – 3.46](#)

SECTION 13. GROUND 4B – 'THE FINANCEABILITY ERROR'

Introduction

- 13.1 It is common ground that, in setting FE's allowances under GD17, the UR was under a duty to have regard to the need to ensure that the company will be able to finance the activities which are the subject of obligations under its licence ('financeability').
- 13.2 FE says that the UR failed to act in accordance with this duty, because it assumed that FE would be able to finance its business on terms consistent with maintaining an investment grade credit rating when in fact its own modelling indicates an outcome which is below investment grade. It says that the UR failed to take into account an 'appropriate' sensitivity analysis. It asserts that FE '*will not be in a position to secure an investment grade rating for its debt*'⁴⁷⁴.
- 13.3 These arguments are wholly misplaced. The UR did in fact carry out an appropriate sensitivity analysis. It concluded that FE would be able to finance its business while maintaining an investment grade credit rating if it adopted an appropriate capital structure, noting that a prudent company might choose to lower its gearing for that purpose.
- 13.4 The relief claimed by FE under this ground is a modification to the calculation of the WACC, including in particular an increase in the debt beta, for which purpose it argues for the first time in GD17 that the beta set by the UR of 0.1 is not appropriate. There is no merit in this argument, for the reasons clearly advanced by the UR's expert, John Earwaker of First Economics⁴⁷⁵.

The Decision on Financeability

- 13.5 The UR's considerations in relation to financeability were set out in detail in its Draft Determination⁴⁷⁶ and its Final Determination⁴⁷⁷.
- 13.6 Both documents are clear as to the approach adopted by the UR and the reasons for it, including its reasonable expectations as to the actions that the companies would take on their own behalf in order to relieve any pressures on interest cover, including in particular by adopting an appropriate capital structure.
- 13.7 Before arriving at these conclusions, the UR had engaged fully with the credit rating agencies in order to understand the position of the investor community, and had a number of meetings with FE and iCON specifically in relation to the issue, as outlined in the witness statement of Brian McHugh⁴⁷⁸.

⁴⁷⁴ Notice of Appeal, [para 2.36](#) and [paras 7.48 – 7.58](#)

⁴⁷⁵ Earwaker-1, [section 4](#)

⁴⁷⁶ GD17 Draft Determination, [paras 10.56 – 10.69](#) – [NOA-1/Tab 6/Pages 940 - 941](#)

⁴⁷⁷ GD17 Final Determination, [paras 10.60 – 10.79](#) – [NOA-1/Tab 7/Pages 2053 - 2057](#)

⁴⁷⁸ McHugh-1, [paras 15.1 - 15.18](#)

The Ground of Appeal

- 13.8 This ground of appeal is premised on three errors which the UR is alleged to have made –
- (a) thinking that FE could obtain an investment grade credit rating if it has 55% gearing;
 - (b) failing to distinguish between FE and PNGL; and
 - (c) failing to carry out an appropriate sensitivity analysis⁴⁷⁹.
- 13.9 FE then advances an argument relating to the consequences if the UR adjusts its gearing to 45%⁴⁸⁰. It seeks 'relief' by way of a reduction in its determined debt beta⁴⁸¹.

Response to the Ground of Appeal

- 13.10 The UR's response to each of the assertions contained in the Notice of Appeal is set out below.

The Three Alleged Errors

- 13.11 The first alleged error is that 'the UR has proceeded on an incorrect assumption that FE would be in a position to obtain an investment grade credit rating for its debt with a 55% gearing structure'⁴⁸².
- 13.12 This is factually incorrect. No such assumption can be found in the paragraph of the Final Determination which is cited as authority for the alleged error⁴⁸³, and there was no such assumption anywhere in the document.
- 13.13 The UR conducted some modelling on the basis of 55% gearing⁴⁸⁴, but this entailed no assumption about the ability of FE to obtain an investment grade credit rating at that level. On the contrary, the UR made it clear that it was a matter for FE to 'select a prudent capital structure'. If this, for instance, involved 'a more modest selection of gearing at, say, 45%', then FE's interest cover would sit above the threshold values for an investment grade credit rating⁴⁸⁵.
- 13.14 So far from establishing the claimed assumption, this demonstrates the opposite – the UR understood that FE would need to find 'a balanced mix of debt and equity

⁴⁷⁹ Notice of Appeal, paras 7.50 – 7.55

⁴⁸⁰ Notice of Appeal, para 7.56

⁴⁸¹ Notice of Appeal, para 7.60

⁴⁸² Notice of Appeal, para 7.50

⁴⁸³ Notice of Appeal, footnote 367, citing GD17 Final Determination, para 10.74 – NOA-1/Tab 7/Pages 2055 - 2056

⁴⁸⁴ GD17 Final Determination, paras 10.67 – 10.68 – NOA-1/Tab 7/Page 2054

⁴⁸⁵ GD17 Final Determination, para 10.78 – NOA-1 / Tab 7 / Page 2057

financing' that might involve gearing of less than 55%. Even leaving aside the positive financeability position set out in the Final Determination⁴⁸⁶, the UR's conclusion was that the cash flows emerging from its decision would be sufficient for FE to achieve threshold values in line with an investment grade credit rating if it adopted an appropriate capital structure⁴⁸⁷, and that the return on equity provided in the Final Determination 'will support any such restructuring'⁴⁸⁸.

- 13.15 The second alleged error is that 'the UR did not draw any meaningful distinction between the financeability positions of FE and PNGL in circumstances where the financeability metrics for FE are consistently less favourable than those of PNGL'⁴⁸⁹.
- 13.16 It is difficult to understand what supposed error is being asserted here. It is said that 'the UR should have taken proper account of the less favourable position of FE', but the UR did not benchmark the companies against each other or derive conclusions from the circumstances of one which it then applied to the other. Each company was considered on its own merits and by reference to its own circumstances, as is clear from the Final Determination⁴⁹⁰. The implication that the UR did not draw meaningful distinctions between the two companies does not survive scrutiny in the light of the FE-specific considerations recorded in this document.
- 13.17 The third alleged error is that 'the UR failed to conduct a properly calibrated sensitivity analysis'⁴⁹¹.
- 13.18 The UR did in fact conduct a sensitivity analysis, and by that means it considered the effect of a significant 'downside scenario' arising from increases in both opex and capex costs by 15%. That fact, the effect of the sensitivity analysis on the modelling, and the UR's observations in the light of it are recorded in the Final Determination⁴⁹².
- 13.19 What a 'properly calibrated' analysis means, and why what the UR did is inadequate and constitutes an 'error', are not explained in the Notice of Appeal.
- 13.20 In consequence, FE advances no argument that could possibly support a conclusion that the UR was in error on the basis suggested.
- 13.21 For these reasons, the three primary submissions of FE in relation to this ground are unsustainable.

Gearing

- 13.22 FE then proceeds to say that, since 'the UR did not choose to use a 45% notional gearing assumption in calculating the WACC', then 'This effectively means that the

⁴⁸⁶ GD17 Final Determination, [Table 196](#) – NOA-1 / Tab 7 / Page 2056

⁴⁸⁷ GD17 Final Determination, [para 10.78](#) – NOA-1 / Tab 7 / Page 2057

⁴⁸⁸ GD17 Final Determination, [para 10.79](#) – NOA-1 / Tab 7 / Page 2057

⁴⁸⁹ Notice of Appeal, [para 7.54](#)

⁴⁹⁰ GD17 Final Determination, [paras 10.69 – 10.77](#) – NOA-1 / Tab 7 / Pages 2054 - 2056

⁴⁹¹ Notice of Appeal, [para 7.55](#)

⁴⁹² GD17 Final Determination, [paras 10.75 – 10.77](#) – NOA-1 / Tab 7 / Pages 2054 - 2056

company – even on a notional basis – is being forced to fund the difference between the 55% and 45% debt financing assumption by using equity while only earning a return sufficient to recover the cost of debt⁴⁹³.

- 13.23 This is a curious argument. It is notable that no evidence is cited in support of it, and it is not advanced in the PwC report on which FE relies. Nor would Mr Forrest of PwC have been likely to make any statement in these terms, because he would have been aware that, using CAPM – a 'standard regulatory approach'⁴⁹⁴ – there is an assumed relationship between the cost of equity and gearing, specifically between the asset beta, debt beta, equity beta and gearing, which takes the form: $\beta_a = \beta_d(g) + \beta_e(1-g)$ (where g represents gearing and the subscripts a, d and e denote the asset, debt and equity betas respectively).
- 13.24 Applying this formula, if gearing is reduced while the asset and debt betas stay the same, the equity beta is also reduced. There are therefore two effects to consider when analysing the effects of lower gearing: (i) more of the capital requirement has to be financed by equity at an equity rate of return, but (ii) the equity rate of return as a whole falls across the whole of the equity capital base. These two effects offset one another.
- 13.25 In the UR's analysis, on an assumed change in gearing from 55% to 45%, FE's WACC would in fact fall slightly (by 0.03%) below that determined by the UR, as set out in Mr Earwaker's witness statement⁴⁹⁵.
- 13.26 This is why the UR observed in the Final Determination: '*We note that the weighted average cost of capital is insensitive to a choice of gearing within this sort of range, which means that such a recalibration would have no knock-on implications for allowed revenues resulting*'⁴⁹⁶.
- 13.27 As the UR also rightly identified, this is consistent with the conclusion that FE's cost of capital and allowed revenues have been calibrated in a way that is '*capable of supporting a range of possible capital structures – within certain limits*'⁴⁹⁷.
- 13.28 In short, FE's curious submission about being '*forced to fund the difference*' is entirely unsupported by its own expert or by regulatory economics.

The Debt Beta

- 13.29 The Notice of Appeal then shifts focus to the debt beta, asserting that '*a debt beta of 0.05 would be appropriate*'⁴⁹⁸. Indeed the main relief that it seeks in relation to the

⁴⁹³ Notice of Appeal, [para 7.56](#)

⁴⁹⁴ PwC: Financial aspects of GD17, [para 1.6 – NF-1 / Tab 1 / Page 3](#)

⁴⁹⁵ Earwaker-1, [para 4.13](#) and [Table 3](#)

⁴⁹⁶ GD17 Final Determination, [footnote 100 – NOA-1 / Tab 7 / Page 2057](#)

⁴⁹⁷ GD17 Final Determination, [footnote 100 – NOA-1 / Tab 7 / Page 2057](#)

⁴⁹⁸ Notice of Appeal, [para 7.58](#)

so-called '*financeability error*' is a reduction in the debt beta⁴⁹⁹. John Earwaker rightly says that this ground of appeal might more properly be called '*the debt beta error*'⁵⁰⁰.

13.30 FE states that: '*Applying a 45% notional gearing assumption and debt beta of 0.05 (while maintaining the asset beta at 0.4) increases the allowed rate of return for FE by 0.12%*'⁵⁰¹. The nature of this effect is grounded in CAPM, since, if the debt beta is reduced (other things being equal) the equity beta and therefore the cost of equity increases – an effect visible in the calculations of the PwC report⁵⁰².

13.31 It is self-evident why FE wishes to argue for a reduction in the debt beta. However, that argument lacks any merit for the reasons clearly advanced in the witness statement of John Earwaker⁵⁰³.

13.32 In particular –

(a) FE suffers in relation to its arguments on the debt beta from precisely the same problem that fatally undermines its arguments on Ground 4A. As outlined in the chronology prepared by Mr Earwaker⁵⁰⁴, FE at no stage in the GD17 process suggested that a debt beta of any less than 0.1 would be appropriate for BBB rated debt. The debt beta determined by the UR is the one Oxera itself identified.

(b) The argument in favour of a debt beta of 0.05, as made in the PwC report, is not persuasive and should be given no weight for the reasons identified by Mr Earwaker⁵⁰⁵.

13.33 In short, there is no basis on which FE, having previously advanced a debt beta of 0.1 with the support of its expert consultants, Oxera, can now credibly make a case for a different beta as part of this appeal. The beta established by the UR was in line with regulatory precedent and with FE's own expert opinion – it fell within the scope of the UR's reasonable judgment and cannot be 'wrong' in the sense in which FE must establish for the purposes of this appeal.

The UR Position on Ground 4B

13.34 This ground of appeal begins with a large statement about the UR having breached its financeability duty and FE being unable to maintain an investment grade rating, and ends with a request for the CMA to adjust the WACC upwards by 0.12% through

⁴⁹⁹ Notice of Appeal, [para 7.60\(b\)](#)

⁵⁰⁰ Earwaker-1, [para 4.17](#)

⁵⁰¹ Notice of Appeal, [para 7.58](#)

⁵⁰² PwC: Financial aspects of GD17, [Table C.1, column 5 – NF-1 / Tab 1 / Page 46](#)

⁵⁰³ Earwaker-1, [section 4](#)

⁵⁰⁴ Earwaker-1, [para 4.19](#)

⁵⁰⁵ Earwaker-1, [paras 4.23 – 4.29](#)

a small variation in the debt beta.

- 13.35 As to the statement about financeability, FE asserts that it 'will not be in a position to secure an investment grade rating for its debt'⁵⁰⁶. But its own expert witness says that 'a lower gearing assumption would improve financeability metrics such that they would be more consistent with the investment-grade assumption used in setting the allowed cost of debt'⁵⁰⁷. The UR had reached broadly the same conclusion – it was of the view that the financeability metrics were reasonable, but if it was necessary to do so, FE had the option of improving the position by reducing its gearing. There is no reason why FE cannot maintain an investment grade rating so long as it adopts a prudent capital structure⁵⁰⁸.
- 13.36 Moreover, as PwC also states, another standard means of improving financeability metrics is to re-profile revenues so that cash flow is brought forward⁵⁰⁹. But in GD17 FE argued for, and the UR allowed at its request, a move in the forecasting horizon to 2045⁵¹⁰, which has the opposite effect.
- 13.37 The UR highlighted this effect and asked FE on more than one occasion whether it wished to change its mind and withdraw its proposal for the forecasting horizon to be pushed back. As Brian McHugh outlines in his witness statement, the UR at no stage received a request for the horizon to be returned to 2035⁵¹¹.
- 13.38 It is not credible for FE to request this change to the forecast horizon in GD17 – its attention being expressly drawn by the UR to the effects of that change – and then, for the purposes of this appeal, seek to argue that there is an inherent financeability problem.
- 13.39 In reality, there is no such problem. Ground 4B presents instead as an attempt by FE to mask an unsustainable argument for a reduction in the debt beta (and therefore an increase in its WACC) by placing it in a financeability wrapper.
- 13.40 The requested relief relating to the debt beta needs to be considered on its own terms and by reference to the argument that FE – through its expert PwC – makes for it. The UR says that the claim is unsustainable, for the reasons and in all of the circumstances that John Earwaker so clearly outlines.

Conclusion

- 13.41 For all of the above reasons, FE's appeal on Ground 4B should be dismissed.

⁵⁰⁶ Notice of Appeal, [para 2.36](#)

⁵⁰⁷ PwC: Financial aspects of GD17, [para 3.77](#) – **NF-1 / Tab 1 / Page 34**

⁵⁰⁸ GD17 Final Determination, [para 10.78](#) – **NOA-1 / Tab 7 / Page 2057**

⁵⁰⁹ PwC: Financial aspects of GD17, [para 3.74](#) – **NF-1 / Tab 1 / Page 34**

⁵¹⁰ GD17 Final Determination, [paras 11.100 – 11.112](#) – **NOA-1 / Tab 7 / Pages 2077 - 2079**

⁵¹¹ McHugh-1, [paras 15.13 – 15.18](#)

SECTION 14. STATEMENT OF TRUTH

The Respondent believes that the facts stated in this Submission are true:

Signature of Authorised Representative

Name of Authorised Representative

Date

for an on behalf of NI Authority for Utility Regulation