BGN Response
To CER Consultation Papers
CER/12/057 and CER/12/058

09th July 2012

BORD GÁIS NETWORKS

Contents

1.0 Executive Summary

Bord Gais Networks (BGN) sets out in this document our response to the Commission for Energy Regulation (CER) Consultation Papers CER/12/057 and CER/12/058, representing the Commission's proposals on BGN's Transmission and Distribution Revenue for the next price control period October 2012 to September 2017[1]. In the remainder of this executive summary we set out:

- BGNs record of successful delivery over the last price control period
- BGNs principle targeted efficiency programmes for PC3
- The grave concern with the CERs proposed position on opex and its impact on maintenance and service standards
- Initial assessment of the impact of the CERs proposed position on maintenance and service standards
- BGNs serious concerns with the price control process

With regard to the CER draft decision on capex, the CER have outlined a reduced capital programme and revised policy position for PC3. While BGN is concerned with the deferment of key capital projects such as South West Scotland Onshore System (SWSOS), BGN will work with the CER to implement the CERs proposed capital programme and also a process for the approval of addition capital projects when required.

BGN notes and broadly accepts the proposals in the Consultation Paper in relation to the Cost of Capital and review mechanism, this is provided that the fundamental structures of the proposals in terms of the WACC level and the risk reward mechanism are implemented as designed and outlined in the proposals. BGN does not agree with the CER's proposal with respect to the treatment of embedded debt. If the CER moves to the use of embedded debt as proposed in the draft decision, it must clearly signal that this significant policy shift will be permanent and symmetrical.

<u>BGNs record of successful delivery 2007 – 2012.</u>

Across PC2 BGN operated a high-quality, safe and reliable network. BGN is pleased that this has been recognised by the CER who in their consultation documents highlight BGN's achievements. BGN would like to put on record our performance over the last price control period. We have met all the targets set for the business by the CER except for growth in new connections which of course was severely impacted by the downturn in the economy. Some of the key achievements over the PC2 period have included:

- reducing transmission tariffs in both real and nominal terms;

[1] As in (CER/11/070), the third Price Control (PC3) activities are prepared jointly on behalf of Gaslink and BGN. This response is also made on behalf of both parties and the reader of this document should interpret BGN as representing both parties as appropriate.

- Connecting new towns and customers to the network; Connection has been completed or near completion on 17 of these towns.
- the connection of large I&C customers such as Whitegate, Aghada, Merck and progression of the Endessa connection;
- Forecast to achieve circa 70,000 Distribution new connections, or 49% of the PC2 target. In the existing housing connection section, BGN has met nearly 95% of the target for PC2
- replacing 30,000 meters and installing prepayment meters across the country;
- adding over 2,000 kilometres to the distribution network;
- Completing the cast iron mains renewal programme. Replacement of 736km of cast iron mains with PE mains and 27,000 services
- Meeting the emergency response standard; BGN has achieved a response time of within 1 hour for 98.9% of responses over the course of the PC2 period, despite severe weather

As the CER are aware there also remains a number of outstanding items relating to PC2 period yet to be concluded, BGN will continue to liaise with CER directly on these.

BGN Efficiency Programmes

In preparing its expenditure plans for PC3, BGN has been conscious of the environment in which it operates and the state of the national economy. BGN has commenced engagement with its Unions to deliver significant payroll savings in the business. As the CER is aware, several initiatives are under active discussion including the removal of salary increments, reduction in on call allowances and changes in the expenses regime. The realisation of these savings represent a serious challenge to the management and staff of BGN but are considered entirely appropriate by BGN management. BGN has included the resultant savings in its PC3 submission. This represents a stretch target in the next price control period and one which will deliver large savings for consumers.

In addition BGN has recently concluded a major reconfiguration of its outsourcing framework and its procurement processes which will deliver major savings throughout PC3. The putting in place of a single Networks Service and Works Contract is the key initiative in this area as well as the expansion of the Supply Point optimisation programme.

BGNs grave concern with the CER Proposals on opex and its impact on services and standards

As BGN has made aware to the CER, the current opex allowances proposed will not enable BGN to continue with the level of service that the Irish Gas market has received up to the present time. The proposed allowances if left unchanged will impact adversely on operational activities across safety, reliability and customer service and will necessitate substantial cuts in services.

Investors and rating agencies require assurance that the regulatory contract in its entirety is in line with good regulatory practice and precedence, and to the fullest extent does not introduce additional risk. The level of cuts being proposed in opex and the consequent reduction in revenue gives rise to a real inability to operate the network efficiently and efficiently and will be perceived by investors as increasing regulatory uncertainty and regulatory risk.

BGN remains gravely concerned at the significant difference in views between BGN's revenue request and the CERs published Consultation papers particularly the large reduction in opex allowances of c €81m. Excluding labour, for which BGN has provided for the benefits of a challenging cost reduction programme within our submission, period contract (where a new contract covering the PC3 period is now in place) and pass through, this amounts to cuts of circa 43% to remaining opex, for the direct cost reductions. BGN believes it is untenable for the CER to propose a distribution allowance for the next five years which is below the allowance provided in PC2, given that the network has grown 21% in the intervening period and market activity has increased from that of a newly opened market to being one of the most active (120,000 change of shipper activities in 2011).

BGN wishes to work with the CER to address this gap, and to reach agreement with the Commission on an appropriate regulatory contract, which will allow BGN to continue to operate, maintain and develop the business safely and successfully. Indeed it is critically important in this regard that industry is fully informed of the impact and changes to service and standards arising from the final CER decision.

<u>Initial assessment of the impacts of these proposals</u>

The position which the Commission has adopted in terms of BGN's revenue requirement and opex will have a serious impact on services and safety. The CERs consultants' proposals, to allow a level of distribution direct Opex for PC3, which is 12% lower than actual PC2 expenditure at a time when the network grew by 21% is not sustainable. The scale of the cuts proposed cannot be achieved without a substantial reduction in activities, giving rise to serious concerns in meeting our safety and maintenance targets. Below we set out our initial assessment of the impacts of these proposals, as part of the finalisation of the CER decision.

<u>Impact on Transmission – (7.5% reduction in opex proposal)</u>

The CER proposes a 7.5% reduction in opex allowance against BGNs submission, this will have a;

- Direct impact on AGI asset maintenance and compliance with Irish Standard IS328, impacting system reliability
- Direct impact on Transmission pipeline inspection programme to IS328 – while consultants have agreed to requirement and schedule, the funding has not been provided
- Direct impact to compressor overhaul plan – again consultants have agreed to need and schedule, funding has not been provided – increased risk of compressor failures and impact on ICs

- Impact on ability to support activities on calibrations, SCADA alarms and CP surveillance, leading to inaccuracies in metering and network reliability
- Ability to participate in ENSTOG will be severely curtailed
- Maximum Operating Pressure reviews will move from 4 years to 6 outside of IS328
- Ability to support CAG, Joint Development Statement, Republic of Ireland Risk Assessment (RA) and the Preventative Action Plan (PAP) impacted.

Impact on Distribution – (14% reduction in opex proposal)

The CER propose a 15% reduction in our requested allowance for Distribution Service Delivery. This will impact

- Direct impact on PRE response times and current 1hr criteria will have to be reassessed
- Ability to support no gas and downstream meter issues impacted – current response criteria will have to be reassessed
- Direct impact on acceptable maintenance risk and service levels
- Cuts to Leak Repairs - categorisation of leak severity will have to be reassessed – lead times to repair will have to be extended
- Direct impact on DRI asset maintenance and compliance with Irish Standard IS328, impacting system reliability
- Impact on ability to support activities on calibrations, Distribution SCADA alarms, leading to inaccuracies in metering and network reliability

Impact on Reliability

The CER propose a 26% reduction in our requested allowance for Distribution Asset Management. This will result in the following impact

- Quality of asset policies will deteriorate / deviate from best practice
- Will impact comprehensive integrity studies to extend the life of the pipelines
- Will constrain the implementation of a pipeline integrity management system
- Reduced asset data and analysis will incur increased maintenance costs
- Inadequate asset management will lead to an overall increase in capital cost.

Impact on Safety and Customer

The CER propose a 32% reduction in our requested allowance for Distribution HSQE . This will impact

- Increase in Public Reported Escape and leak repair response times
- Ability to support safety audits, inspections and risk assessments
- Impact ability to monitor period contractors for safety and compliance
- Impact compliance with regulatory, environmental and health &safety requirements

- Will constrain ability to achieve PAS55 compliance.

<u>The CER propose an 11% reduction on Distribution Workflow areas which directly support Customer Facing Services and Service Levels. This will impact</u>

- Direct reduction in Shipper Key account and GPRO service levels
- Will be constrained in supporting CER and the Market
- The Customer Charter will need to be reviewed and standards lowered.
- Increased Call Centre Handling Times
- Site works charges will need to be fully cost recovered
- Will lead to an increase in times for Site Visits, Site works, and Reinstatements
- This will increase complaints from both Shippers and Customers to the CER

<u>Impact on Regulatory and Standards</u>

<u>The CER propose an 18% reduction in our Distribution Regulation & Commercial requested allowance for market related services. This will impact</u>

- Frequency of Code Mod., GMARG Fora & Mod implementation will have to be reduced
- Ability to meet the CER requirements for Smart Metering, Meter Replacement programmes and Pre-Payment Meter program will be compromised

<u>BGNs serious concerns with the price control process</u>

BGN / Gaslink have a duty to operate, maintain and develop a secure, reliable, economic and efficient network, with due regard to the environment and public safety. Conscious of these obligations, we prepared detailed submissions and presentations to the Commission on both our historic and forecast expenditure, structured clearly to explain the actual costs of the business. The CER are obliged to take due regard of the information which we have submitted and we believe the approach taken to date has not fulfilled this obligation. BGN believes that the process followed by the CER to date in arriving at their current position has not represented proper regulatory practice and the irregularities and deficiencies made should be corrected in advance of the final regulatory decision. BGN have received legal advice with regard to the process, this advice is included as an appendix to this submission.

BGN has serious concerns that the substantial information and data which was provided to the Commission over the course of this revenue review and which outlines the compelling evidence of the efficient nature of our price control submission, has not to date been taken with due regard in the CER's deliberations. Our revenue requirement submission represents the revenues necessary to efficiently operate the BGN business going forward and it is critical that this is understood.

In particular the consultants acting on behalf of the CER have not been in a position to review BGN's PC3 projected expenditure submission in the structure as presented. The CER accept that our dataset accurately represents the structure of the business as it now operates, however their Consultants chose to ignore this information and instead reviewed future expenditure plans using a tariff category structure which is no longer current. Such an approach is fundamentally flawed and denies the CER (and its consultants) the possibility of assessing activities against costs on a bottom up basis.

The reductions in allowances proposed by the CER cannot be directed against particular activities. The papers as published by the CER do not outline the areas or levels of service reduction which will be necessary. BGN believe failure to outline to industry these impacts represents a further inadequacy in the process and does not give industry the opportunity to fully assess the proposals published by the CER.

In addition BGN's PC3 expenditure request is supported by independent Benchmarking. This international benchmarking undertaken across several European TSOs in Transmission and several GB Companies in Distribution clearly shows BGN operating expenditure plans to be efficient. Our Transmission benchmarking submission has been given little consideration by the CER's consultants and our Distribution benchmarking has effectively been ignored. We believe the approach the CERs consultants have undertaken for Distribution benchmarking in particular is flawed. The CER consultants used a benchmarking methodology which has not been used by the CER heretofore, it was not signalled by the CER in advance of the price control and expert econometric advice clearly states that the application of such a benchmarking technique is not valid.

BGN provided this independent advice to the CER on the 16th April and is yet to receive a response on the issue. We note in the papers as published that the CER has not taken a position on benchmarking which is a highly irregular position for a regulator to take. BGN are not aware at this late stage of the price control process if the CER believes our expenditure plans to be efficient or inefficient, given their non pronouncement on benchmarking in their published documents. We urge the Commission to take proper account of the independent submission made on this topic and correct the errors made by their consultants. BGN has included in this response (Appendix 2) an independent review on the CERs consultants benchmarking.

The Commission's proposals, particularly in relation to reductions to BGNs requested levels of opex allowances is not appropriate, unproven and without evidence. Should the Commission confirm their draft position; the level of cuts proposed leaves BGN with no recourse open, other than to reduce service and reliability levels to all customers and consumers. The Commissions current opex proposals are inadequate for the continued operation of the network at existing performance levels.

2.0 Introduction

PC2 was an extremely challenging period for BGN. The unanticipated and unprecedented economic crisis has had a significant impact on the BGN business; in addition extreme weather conditions during the period severely tested all parts of the network.

BGN responded fully to these challenges by;

- **Delivering value for money for our customers** – BGN achieved savings in its opex allowances for transmission and distribution. We invested in improving and expanding our network, while at the same time efficiently under-spending our capex allowances.
- **Achieving our targets** – BGN met all achievable performance target agreed with CER for PC2 (connections target could not be met due to the economic downturn)
- **Operating a safe, secure and reliable network** – In PC2 we experienced record gas demand and 1 in 50 weather conditions. There was no major supply disruptions during the cold weather and throughout PC2 period safety was maintained on both the distribution and transmission network.
- **Delivering significant re-organisation to meet operational challenges and regulatory requirements –** Delivered ISO compliance under the 2nd Directive across transmission and distribution, delivered the NTP programme and underwent re-structuring to ensure Third Directive compliance
- **Increasing our customer focus** – BGN exceeded all our customer service targets, facilitated gas market competition and worked to help our customers who were facing difficulties paying their bills. We delivered our Customer Charter and Codes of Practice to all customers. BGN's drive and customer focus has been recognised by the award of numerous customer service awards over the period.

BGN is fully aware that PC3 will be an equally challenging period for all our customers, stakeholders and our business. BGN is committed to continuing to providing a safe secure and efficient service. We recognise that now, more than ever, it is important that as a Network utility business we lead on delivering value for money and service for all our customers in the current economic climate.

BGN believes that the implementation of our High Performance Utility Model (HPUM) and the development of an asset and customer centric culture and organisation over the course of PC2 has put us in a strong position to meet these challenges and deliver value across our business.

During PC3 BGN proposed to the CER to:

- promote competitiveness,
- maintain a strong focus on customer,
- deliver a safe and secure network,
- promote innovation and sustainability,
- deliver the European Third Directive unbundling and market arrangements,

In the remainder of this document we will provide an overview of:

- Section 3 – BGN's performance in PC2, our efficiency as a Network Utility and an outline of our proposals for PC3
- Section 4 - BGN's concerns with CER's process, analysis and conclusions on our revenue review submission; and
- Section 5 - BGN's view of the implications of the proposed CER allowances on services and activities for PC3

BGN understands the **Key Challenges** that must be faced in the PC3 period. We have provided the CER with an overview of the **Key Outputs** of the business and how these will meet the key challenges of the next price control period, whilst also providing the best possible **value for money.** We have outlined to the Commission the necessary capex, opex and benchmark requirements that as a reasonable, prudent and efficient network operator, is needed in order to run this business. The Commissions current opex proposals are wholly inadequate for this and for the continued operation of the network at existing performance levels.

3.0 Review of PC2 and BGN's proposals for PCR3

Performance in PC2

BGN operates a high-quality, safe and reliable network. BGN is pleased that this has been recognised by CER who in their consultation documents highlight BGN's achievements in PC2 and note that we have achieved all the targets agreed as part of the PC2 review[2]. Some of the key achievements over the PC2 period have included:

- Reducing transmission tariffs in both real and nominal terms
- Connecting new towns and customers to the network
- Connecting Large I&C customers such as Whitegate, Aghada, Endessa and Merck
- Replacing 30,000 meters and installing prepayment meters across the country
- Adding over 2,000 kilometres to the distribution network
- Replacing all remaining cast iron.

The Tables below provide a complete overview of BGN's performance against targets over PC2.

CER Transmission targets set for PC2:	Performance in relation to this target:
Facilitate ongoing cost efficiencies in transmission business operations, with increasing operational workload through improved asset management processes and optimised management of key cost drivers	**Achieved**: BGN has undertaken a number of steps to ensure that it is adopting best practice with regard to maintenance and inspection policies. In particular, BGN has: • moved away from scheduled maintenance towards a condition-based approach to maintenance; • delivered efficient under spend in a range of areas, both by utilising new technologies, innovative processes to deliver efficiencies and by efficiently deferring maintenance and inspection activities where there was a clear case for doing so. • Completed a Strategic Supply Chain Sourcing and Procurement programme, which strove to drive efficiency and cost improvement across the Networks organisation.
Ensure continued competitive tenders for outsourced activities	**Achieved**: BGN has put in place an improved tendering process, which has facilitated aggressive competition for outsourced activities.
Bring about reduction in Transmission tariffs, both in real and nominal terms	**Achieved:** Onshore capacity has dropped from €470.25 (06/07) to €440.66 (11/12) per peak day MWh. Interconnectors capacity has dropped from €273.6 (06/07) to €189.88 (11/12) per peak day MWh and Inch capacity has dropped from €74.41 (06/07) to €46.70 (11/12) per peak day MWh. Transmission tariffs have dropped across the PC2

2 The only exception being customer connections, which were severely impacted by the economic downturn

CER Transmission targets set for PC2:	Performance in relation to this target:
	period, in addition the tariffs are lower than those forecast at the start of the PC2 period. (All numbers in nominal monies)
Development of new products including Short term products and further development of the existing interconnector storage product	**Achieved:** Short-Term Tariffs have been put in place, with updates on short-term multipliers and IC Inventory products; Work is been undertaken on virtual flow, IC Inventory Products, and interruptible tariffs, as a part of CAG.
Facilitating the connection of Large Industrial & Commercial e.g. power generation loads with a typical peak demand of around 18GWh/d	**Achieved**: Large I&C loads have been supported (Whitegate, Aghada CCGT , and Great Island); Work has also been completed on Spencer Dock, Dublin Airport, Bailie Foods and Merck, Sharpe & Dohme relating to combined transmission and distribution connections.
Enhancing the ability to service storage providers such as Marathon	**Achieved:** A Code Modification was developed to establish the Inch Entry Point as a Bi-Directional Connected Systems Point and facilitate offtake of Natural Gas at Inch. This was delivered to facilitate an entry point in connection with the provision by Marathon Oil Ireland Limited (Marathon) of Storage Services upstream of the Inch Entry Point.
Continuing to meet pipeline safety standards and addressing risks associated with disruption to supplies from onshore network issues	**Achieved:** The Transmission Safety Case required by the CER under Energy (Miscellaneous Provisions) Act 2006 was approved by the CER in 2009. The Safety Case described the key aspects of gas safety and security of supply addressed by a natural gas Transmission undertaking within Ireland.
Improved technology communications with Shippers through the introduction of a common platform (called 'Gas MaP')	**Achieved:** In line with GMARG and RA approval, BGN established the Gas Messaging and Processes Project (Gas Map Project). This was successfully delivered during the PC2 period, and a reference was put in place to an agreed set of Market Processes and detailed information exchange requirements to underpin the gas market.

Table 1 - BGN Transmission Targets delivered in PC2

CER Distribution targets set for PC2	Performance in relation to this target
Implement a meter replacement strategy to improve meter data quality and customer billing accuracy	**Achieved:** BGN commenced its Meter Replacement Strategy and Programme during PC2, replacing the oldest domestic gas meters with meters that have 'Smart Ready' capabilities.
Roll out prepayment metering to the country (prepayment meters were only available in Dublin at the beginning of the PC2 period)	**Achieved:** PPM project successfully implemented and BGN has successfully supported nationwide rollout of PPM services. There are now over 400 outlets where gas card credit can be purchased. BGN proactively engages with all shippers to support and prepare them to offer PPM services to all

CER Distribution targets set for PC2	Performance in relation to this target
	customers. Given the economic downturn being experienced - CER instructed BGN to escalate the PPM rollout programme, which was also delivered.
Continue to drive benefits from the structural and organisational changes made during PC1 and deliver process efficiencies following the completion of IT investment	**Achieved:** In 2010, BGN successfully transitioned to new business systems, processes and organisational structure developed under the Networks Transformation Programme (NTP). The NTP programme optimises business processes, achieves greater cost efficiency and further improves customer service. Combined with BGN's commitment to continuous improvement, the NTP programme will ensure that BGN remains to the fore as a best-in-class networks utility provider into the future.
Achieve further reduction in the volume of leak repair activities through the completion of the cast-iron replacement programme	**Achieved:** The cast-iron replacement programme has now been completed. Leak repairs have been significantly reduced over the period as a result of the accelerated renewals programme – just 1,003 leak repair activities were carried out in 2009/10, compared to 2,132 in 2007/8
Meet the emergency response standard of attending emergency calls within 1 hour	**Achieved:** BGN has achieved a response time of within 1 hour for 98.9% of responses over the course of the PC2 period, despite severe weather during two consecutive winters (there were 1-in-50 events in January 2010 and again in November/December 2010) From an average response time of 37mins in 2001, BGN improved to an average response time of 28mins in 2006, and to 25 mins in 2010.
Connect 150,000 new customers	**Not achieved as a result of economic circumstances outside of BGN's control**: New housing completions plummeted from 90,000 to 10,000 per year. As a result, BGN is forecast to achieve circa 69,000 connections, or 49% of the target. However, In the existing housing connection section, BGN has met nearly 95% of the target for PC2.
The addition of over 1,500km of mains to the network	**Achieved:** Even given the challenging economic position **-** BGN Delivered circa 2,000km of economically viable Distribution Network growth across the PC2 period
Replacement of 490.5km of cast iron mains with PE mains between 2007/8 and 2009/10. Replacement of 22,563 services as part of the programme .	**Achieved:** Completed replacement of 736km of cast iron mains with PE mains. Replacement of 27,000 services.

CER Distribution targets set for PC2	Performance in relation to this target
The replacement of 28,500 domestic and I&C meters	**Achieved:** During the period, BGN replaced over 28,500 meters
Introduction of gas to a number of New Towns including those in Mayo-Galway	**Achieved:** New Towns Connected **-** Over 70 Towns assessed in three phases and reports published in the Phase 1, Phase 2 and Phase 3 New Towns Reports. The CER approved 22 Towns for connection. All towns were assessed based on economic criteria and only those which were economically viable were approved for connection. To date connection has been completed or is near completion on 17 of these towns.
Manage Customer Service levels to agreed customer performance charter.	**Achieved:** Customer Charter delivered in 2007 - Full explanation and process of compensation for Customer expectations of performance in line with Distribution Licence conditions delivered. Customer Codes of Practice delivered in 2007 covering - Customer Service Code, Vulnerable Customer Code, Complaints Handling Code, and Disconnection Code. Customer performance standards met and exceeded and reported on annually in the BGN Annual Performance Reports appended.
Improve Customer Service Culture, focusing on customer needs and requirements	**Achieved:** Delivery of the NTP programme and transformation of the Workflow operation to focus on Customer Service and needs. BGN Workflow were winners of a number of National and international customer service and contact centre awards for the innovative use of planning, performance and efficiency in progressing customer care work. One of the key benefits the CER has seen delivered in this work is in the reduction in complaint volumes by implementing performance initiatives; Delivering these customer needs and requirements - call volumes have risen from 65,000 contacts in 2006 up to 334,000 contacts in 2010.
Play a key role in facilitating the ongoing process of deregulation in the market in the context of full market opening in 2007	**Achieved:** Completion of Commercial Market Development (CMD) Project in 2007. Delivery of all process systems and organisation change to deliver market opening – delivery of all code modification processes in place. Completion of GasMap Market Messaging Project in 2008. Agreed set of National market processes, market messaging

CER Distribution targets set for PC2	Performance in relation to this target
	and market information exchange systems in place to grow market competition. Active Gas Point Registration Operator (GPRO) – providing ongoing competition support. Now four active competitors in the Domestic market – with an expectation of 120,000 changes of shipper.
Achieve ongoing improvements in cost efficiency	**Achieved:** Completion of the Supply Chain Strategic Sourcing and Procurement programmes. These drove efficiency and cost improvement across the Networks organisation.
Carry out the agreed safety activities and advertising consistent with the requirements of the Commission under the proposed Safety Regulatory Framework.	**Achieved:** Delivery of CER Safety Case Framework. Delivery of internal BGN Hazcon reporting performance. BGN have Completed 12 CER TSO & DSO safety audits and 16 quarterly KPI safety reports. BGN delivered all safety activities and advertising consistent with the requirements of the CER.
Assist developers and others in seeking information and quotations about the costs of connection to the Irish Gas Network	**Achieved:** Quotations and information issued to all customers who would have sought to connect to the network. Having issued the quotations/information, contact is then followed up (through the new connections team, 'Business Link' and the call back process) to assist the potential customers in connecting to the network. Following the insights gained from the commercial customer survey BGN established its direct line 'Business Link' (2008 onwards) service with dedicated agents whom it has been able to "buddy" with both connections representatives and construction engineers to provide a more seamless service to the customer.
Successfully establish and operate the ISO	**Achieved:** Delivery of 2nd Directive compliance in relation to Directive 2003/55/EC. – ISO formation. Gaslink established in 2007 – All necessary staff, resources and facilities in place. Gaslink Licences in place in 2008 and ISO fully operational.

Table 2 - BGN Distribution Targets delivered in PC2

It is also important to highlight that during PC2 we experienced record gas demand and 1 in 50 weather conditions. Despite this, there were no major supply disruptions during the cold weather whilst safety was maintained on both the distribution and transmission network. BGN also delivered fully on our Customer Charter, won numerous customer service awards, exceeded all our customer service targets, facilitated gas market competition and worked to help our customers who were facing difficulties paying their bills.

BGN also delivered significant value for money for our customers over the period:

- BGN operated efficiently within our transmission opex allowances. We under spent our total transmission opex allowance by €24 million.
- BGN operated efficiently within our distribution opex allowances. We have under spent our total distribution opex allowance by €8.2 million.
- We under spent our transmission capex allowance by €62 million as a result of a combination of efficiency savings and efficient deferral. We delivered our largest project – Curraleigh to West Midleton – at 80% of the allowed cost; and
- We under spent our distribution capex allowance by €39 million as a result of a combination of efficiency savings and efficient deferral.

Proposals for PC3

Looking forward to the next price control period, BGN submitted significant and challenging proposals to the CER that:

- Would allow BGN to deliver the quality of service and network required by our customers;
- Would Provided substantial cost savings to the customer; and
- Were efficient when benchmarked against the GB GDNs.

In particular, BGN set out detailed proposals to CER to ensure that in PC3 we would:

- **Maintain our absolute focus on customer service and delivery:** We would continue to meet our current performance standards and make continuous improvements to our customer service in line with customer needs. We would also help all customers reduce their bills by rolling out smart metering. We would also focus particular attention on helping customers who are in fuel poverty.
- **Deliver an increased scope of activities to ensure a safe and secure network:** The implementation of the HPUM has helped us develop a greater understanding of the condition of our network. In particular, it would allowed us in PC3 to identify areas where significant additional works are required to ensure our network meets adequate operational and safety standards.
- **Reduce unit costs and deliver efficiencies across the business:** As a result of the changes we have implemented, we would identify and deliver efficiencies across the business, including in relation to payroll and headcount, supply chain optimisation, contracting, and investment optimisation.
- **Step up market development and sales activities to grow the network:** We would continue to increasing customer numbers, allowing all our customers to enjoy the benefits of scale economies. During PC3 we would work to increase the usage of the existing network and at the same time extend the coverage of the network to new customers, where economically feasible.

- **Deliver European 3rd Directive Market Arrangements:** We would participate actively in ENTSOG to advocate for a set of arrangements appropriate to the Irish market and once finalised we would work with the Regulatory Authorities to implement these legally binding arrangements in Ireland. We would collaborate closely with CER in progressing of this work programme so that customer and shipper requirements are met to the fullest extent.
- **Contribute to the development of a sustainable energy sector:** In addition to rolling out smart metering, we were seeking to work with CER and other stakeholders to develop a Gas Innovation Centre.

BGN is pleased to note the CER's Consultants in their own analysis papers agree that

'Many of the high-level outputs BGN has proposed in its business plan for the PC3 period are, in our view, wholly appropriate for a gas ITO business seeking to operate as a HPUM similar to the GDN's'.

This is not consistent with the draft position that the Commission and its consultants have adopted on our allowed opex. The Commissions current opex proposals are wholly inadequate for the continued operation of the network at existing performance levels, and do not support any of BGNs business plan proposals put forward for the next period.

The Commission agree that BGN fully delivered on its set objectives in PC2 , our business plan proposals for PC3 are in line with their expectation and appropriate for a gas ITO business. However BGN will not be allowed to support the continued operation of the network at existing performance levels or deliver on any of our business plan proposals for PC3, with the current level of opex cuts being proposed by the CER.

BGN Forecast Outlook for PC3

In quantitative terms, while growth in PC3 is likely to be lower than in previous control periods, it will be necessary for BGN to continue to develop the network and to add more customers. In particular, BGN forecasts that:

- Over 40,000 new customers will be added to the network (growth of 5%);
- Demand will grow by over 5% (demand will increase by almost 3,000 MWh per year);
- Over 400 kilometres of pipeline will be added to the network.
- BGN anticipates that response activities will increase by 17% on average in PC3
- Installation activities will continue to grow by almost 8%

Continuing on the 21% growth to the network and activities from PC2, this will further add to the scope of activities required in order to maintain the quality, safety and reliability of the network for all our customers and consumers.

Overall therefore, BGN is anticipating a significant step up in network size and the scope of activity to be undertaken in PC3. Both of which are likely to put upward pressure on costs during the period.

Additionally, there are a number of other costs that are to a large extent outside BGN's control that are also likely to increase substantially during PC3.

These include:

- Pass through costs: BGN is anticipating that rates will increase substantially compared to PC2;
- **3rd directive compliance costs:** the 3rd Directive requires BGN to operate entirely separately from the rest of Bord Gais. The Commission has approved the ITO model as the most cost effective way of achieving directive compliance. The Directive, by design, will result in an increase in BGN's cost base, This is because BGN is no longer able to share IT and other support services, and must operate on a stand-alone basis;
- **Further European binding codes:** Work continues in Europe to develop a Europe-wide binding network code for gas. This revised network code will increase costs as a range of processes will need to be revised in order to ensure compliance.

We will deal with these further below:

<u>On Base Cost</u>

Mindful of these increasing cost pressures, BGN carried out an examination of our cost base, and set out in our submissions to the CER, the challenges and actions that we would take in order to reduce costs wherever possible.

BGN undertook a root-and-branch Performance & Competitiveness Review (PCR 11) to ensure that it continues to deliver the best possible value for money to its customers over the course of the PC3 period. PCR 11 has identified cost savings of €31.2m with regard to overall Network payroll.

In addition to this, BGE intends to introduce a competitive new pay model that will incentivise employee performance. Thus ensuring that BGE is able to attract and retain staff of the highest calibre. The combined effect of these actions is an opex payroll that is 9% reduced.

To take full advantage of the new systems and processes delivered through the Networks Transformation Programme, BGN conducted a substantial review and re-design of our contracting model. BGN will now contract with one party for the provision of the majority of its construction and maintenance activities across both transmission and distribution services. The contract will be run for a period of up to 9.5 years and will result in an opex cost saving of more than €29m over the next 4.5 years.

To ensure the business focuses at all times on driving efficiency BGN has included a further efficiency factor in its proposals of 0.5% in year 1, 0.75% in year 2, 1.0% in year 3, 1.25% in year 4 and 1.5% in year 5. This is applied to all costs aside from pass through costs and labour costs.

BGN's action in relation to cost savings have resulted in a baseline expenditure profile that has been flat in real terms over much of PC2 and which we estimate to be largely flat over PC3 also. This is set out in the Figure 1 below, which compares opex over the PC2 and PC3 period, once pass through and other non-controllable and cyclical costs have been excluded. This shows that:

- Within the BGN submissions costs in PC3 would be just 4% higher on average than in PC2, despite the growth in customers, network size and demand, and the significant increase in the scope of activity necessary to continue to provide the same quality and reliability of service.
- Average costs in PC3 would actually be lower than costs in the final year of PC2. This demonstrates the impact of the substantial efficiencies and cost reduction programme BGN has put in place.

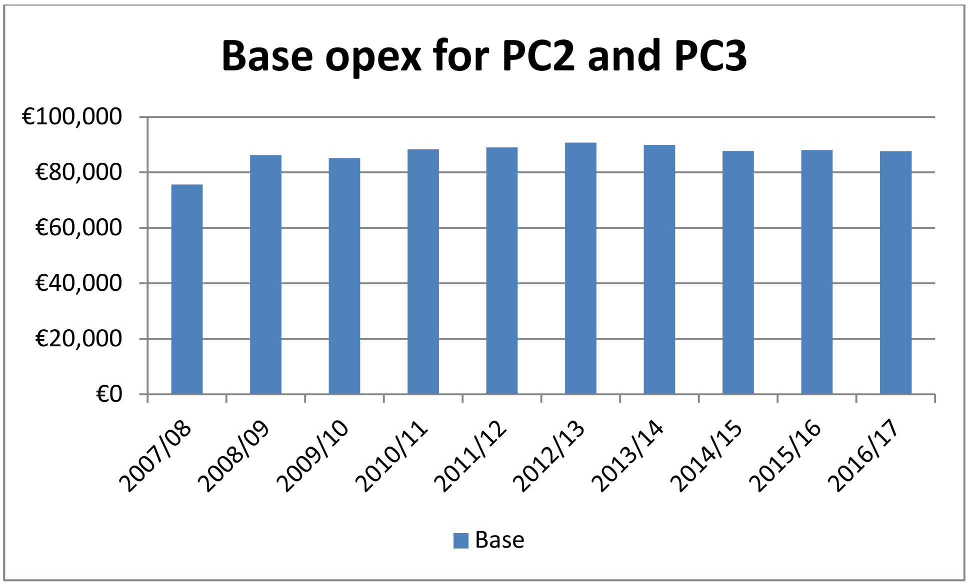


Figure 1- BGN Flat Base Opex Profile PC2 to PC3 (€,000)

<u>On Pass Through and Cyclical Cost</u>

Over the course of PC3 BGN will also face cost pressures in a number of areas that are largely outside of BGN's control:

- Pass-through costs are estimated to increase substantially in PC3;
- Incremental costs associated with the implementation of the Third Directive;
- Operating costs associated with the IT capital spend over PC3 has also been shown separately as this is a new activity which would not have been there in PC2;
- Innovation has been identified separately as this is new activity in PC3;
- The step change costs to include increases in maintenance associated with prepayment meters (this is expected to continue throughout PC3 given the continued increase in the prepayment meter population as directed by the CER).
- A reduction in third party reimbursements in addition to a reduction in opportunities to capitalise labour.
- There will also be some significantly cyclical operating cost spends in certain maintenance activities including Subsea Inspection, Compressor Overhauls and Online inspections. These

costs are driven by compliance with standards and legislation. As they are cyclical in nature will result in opex lumpiness which distorts the underlying base costs of the business. Therefore these have also been separately identified.

Figure 2 below, shows that the total opex for PC2 and PC3, when these costs are included. This shows that average opex is estimated to be 16% higher when these additional uncontrollable or cyclical costs are taken into consideration.

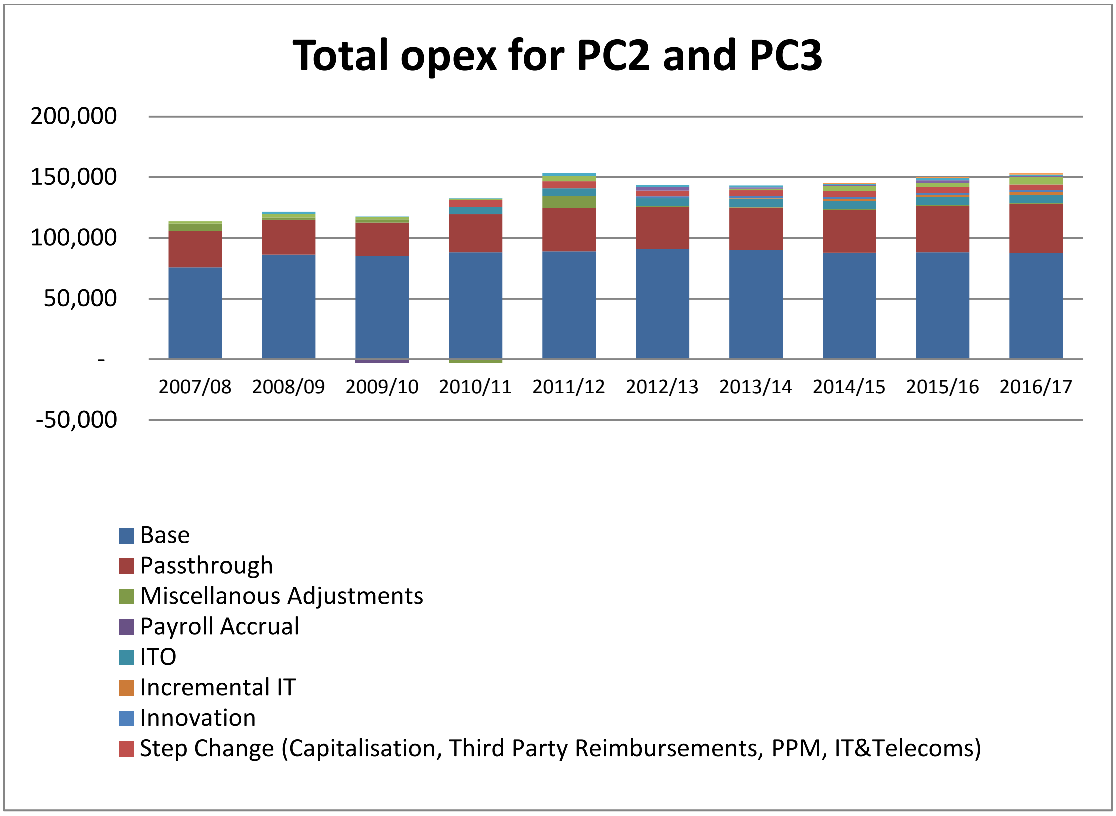


Figure 2 - Total Opex including Base, Passthrough and Cyclical (€,000)

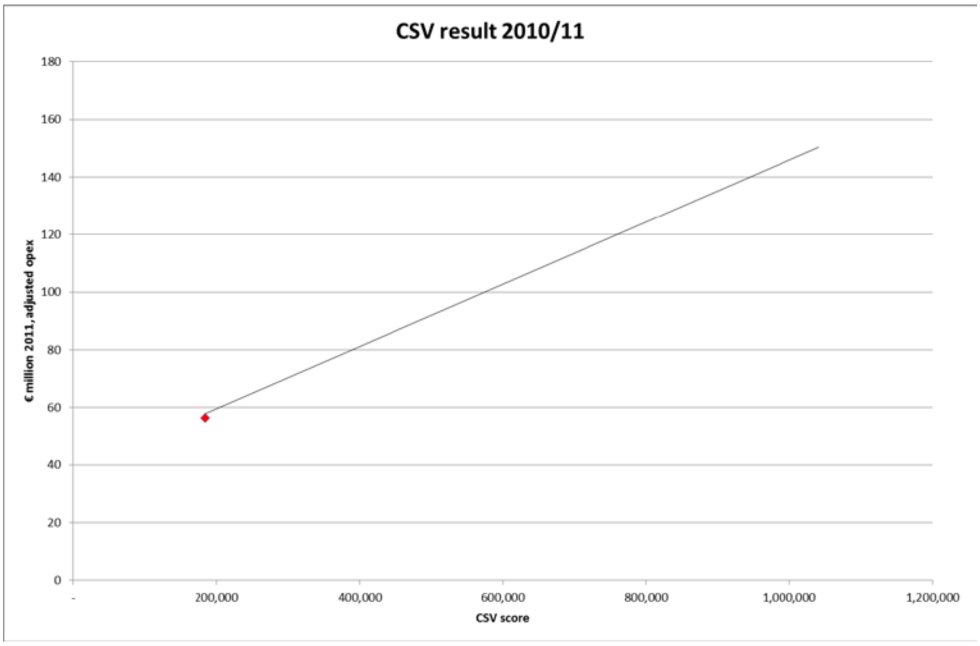
To validate that the proposed costs for the PC3 period were efficient, BGN carried out a detailed benchmarking exercise again the GB Gas DNOs. We submitted this benchmarking analysis to the CER, which showed that BGN is efficient in both PC2 and PC3 periods.

The benchmarking analysis undertaken by Frontier Economics on behalf of BGN was based on the standard approach to benchmarking that the CER has relied upon at every previous price control for both BGN and ESB. This approach:

- Takes data for a particular year
- Adjusts for underlying differences in the outturn data (e.g. to do with differences in scope across operators)
- Adjusts for exchange rates, inflation etc
- Graphs against CSV weights to take account of scale differences
- Draws an efficiency line and assess how far above or below the efficiency line BGN sits when compared to the GB DNs.

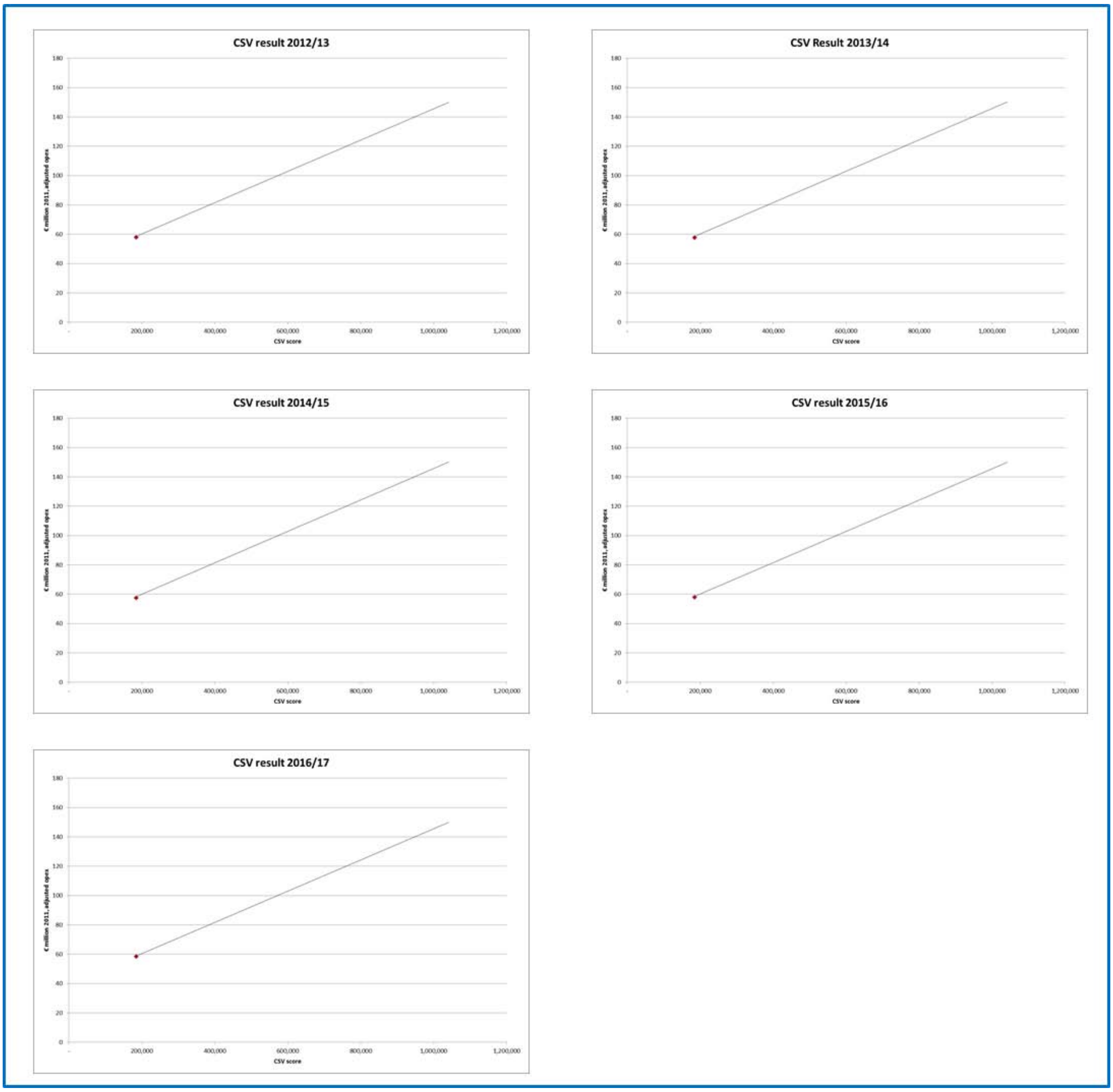
There were differences between Frontier and CERs consultants as to the appropriate adjustments that should be made to the data. However, for clarity Frontier used all of the CERs consultants assumptions for the 2010-11 gas year, and benchmarked the consultants adjusted BGN opex outturn against adjusted GB DN opex outturn. This was despite the fact that all of CER consultants adjustments (in relation to exclusions, pensions, wages, currency adjustments) had the effect of making BGN appear relatively more expensive compared to the GB DNs.

The graphs below presents the results of this benchmarking analysis for 2010/11. As can be seen, using CER consultants adjustments, BGN is below the average efficiency line (ie. more efficient) when compared to the GB DNs performance for 2010-11.



Graph 1 - Distribution Composite Scale Variable Analysis 2010/11

To assess the relative efficiency of BGN's PC3 proposals Frontier also benchmarked our PC3 submission proposals against GB DN outturn. To do so they used the same GB DN outturn data for 2010-11 and assumed it remained constant over the PC3 period. This is a particularly conservative assumption given that the GB DNs are seeking expenditure increases of 23% on average between 2010-11 and 2016-17. Frontier continued to the CERs consultants adjustments to BGN's opex. As can be seen from the graphs below BGN is below the average efficiency line in every year of PC3. In total, BGN's PC3 proposals are €3 million less than the analysis suggests an 'efficient' level of opex would be for BGN.



Graph 2 - BGN Distribution CSV Analysis - yearly PC3 submission

The network has grown by 21% across PC2. BGN forecasts that total opex costs will increase by 16% across PC3 due to an increase in uncontrolled pass through and cyclical costs. BGN has put forward challenging proposals in its submission to the CER to control costs and drive efficiency. Taking this into account BGNs proposals benchmark as efficient for every year of the PC3 price review.

4.0 Concerns with CER review process and analysis

In the last Section we set out BGN's proposals for the forthcoming price control period as it had been submitted to the CER. It highlighted the challenges facing BGN, in serving an ever-growing customer base, managing a larger network, and undertaking the increase scope of activities that are necessary to maintain the quality and reliability of the network. It set out the measures BGN has put in place to keep costs under control during PC3 and demonstrated that, on the basis of the CER's and other Regulators approach to benchmarking, BGN is efficient in every year of our price control submission relative to the GB DNOs (who themselves have driven substantial efficiencies during the last number of years).

Given this context, BGN is deeply concerned by the CER's proposed allowances for the PC3 period. The CER have not identified anywhere in their report the rationale for the cuts to BGN's proposed allowances for PC3. However, they appear to have based their proposals solely on the recommendations made by their consultants (CEPA) who conducted a review of BGN's PC2 costs and PC3 proposals.

BGN believes that there are a number of significant methodological and factual errors contained in CEPA's analysis that critically undermine the conclusions they reach with respect to the proposed allowances for BGN for PC3. This section of our response outlines in detail the concerns that BGN has with the CEPA's analysis. It is structured as follows:

- Process issues
- Determination of allowances – bottom up assessment
- Benchmarking
- Approach to efficiencies
- CERs approach to Capital Projects
- Cost of Capital

Process issues

Throughout the revenue review process, BGN submitted substantial and detailed information on Opex and Capex requirements to the Commission. BGN set out in detail the benchmarks used and validated that the proposals were efficient. BGN facilitated detailed workshops, weekly conference calls and closed out all CER Consultants additional questions and queries on agreement.

As we have identified to the Commission on a number of occasions throughout this review, BGN has serious concerns with regard to the process the Commission has followed for our PC3 revenue review. In engagement with the Commission even up to the draft decision consultation process, differing and conflicting messages were given by the Commission to BGN as to the form and nature of the intended consultation. These issues have included:

- No review of the current BGN cost centres in determining future allowances
- Trending undertaken from the lowest cost year in PC2
- No comparators for CEPAs normalised cost levels

- CERs Consultants proposals utilised unshared / unpublished data
- CERs draft proposals where shared with redacted and blanked sections
- CERs consultants benchmarking of Distribution totally flawed
- Evidence that CER and consultants ignored BGN Transmission benchmarking
- No independent benchmarking of levels of costs or activities – consultants assumptions all based on qualitative examples, and levels of cuts arbitrary.
- No account taken of growth in network – BGNs indicative assessment shows that using CSV cost drivers, BGN has delivered substantial savings.
- No account taken of scope increases – in many cases scope needed agreed with consultants but not provided for in allowance
- Inappropriate CER direction to consultants on required efficiency cuts
- CER proposed additional €2m efficiency cuts are totally arbitrary
- CER used inappropriate comparison to other utility service providers
- No evidence or argument provided for decisions
- BGN believes that CER acted outside of powers/taking factors into account that are inappropriate
- CER errors not corrected in papers and revenue models and many outstanding issues yet to be addressed
- CER departure from PC2 guidance

Concerns with determination of allowance – bottom up assessment

CEPA suggest that they have developed normalised distribution opex costs that represent the core historic business as usual opex which can then be revised to reflect additional items of core opex forecast to be incurred in future years. CEPA further suggest that

"normalised costs have been derived from a bottom up analysis of actual opex costs adjusted for efficiencies and one-off costs, an understanding of material activities and their drivers and consideration of the impact of allocation and related party profit issues"

BGN has very significant concerns over the way CEPA and the rest of the CERs consultant consortium developed their bottom up analysis. In particular, we are concerned that:

- CEPA have ignored the impact of key cost drivers such as increasing customer numbers, network length and demand on the costs to BGN of running the network – consideration of such cost drivers should have been factored in to CEPA's analysis;
- CEPA have mis-understood the ITO project and its impact on the BGN business;
- CEPA have provided no objective or independent bottom up analysis of BGN's business or any rational or evidence to support their proposed cuts; and
- CEPA in many cases appear to accept the scope of works that BGN have suggested is required, but not provided the funds to cover it.

We discuss each of these issues in turn below.

No consideration of network growth

CEPA's review of BGN's opex performance included the Figure 3 below. CEPA suggest that

"this illustrates the significant variation in expenditure profile from the first and last years in a price control. While this may demonstrate a degree of caution taken by the Network operator, it also shows that the operator is capable of delivering to the required service levels at varying levels of annual operating expenditure"

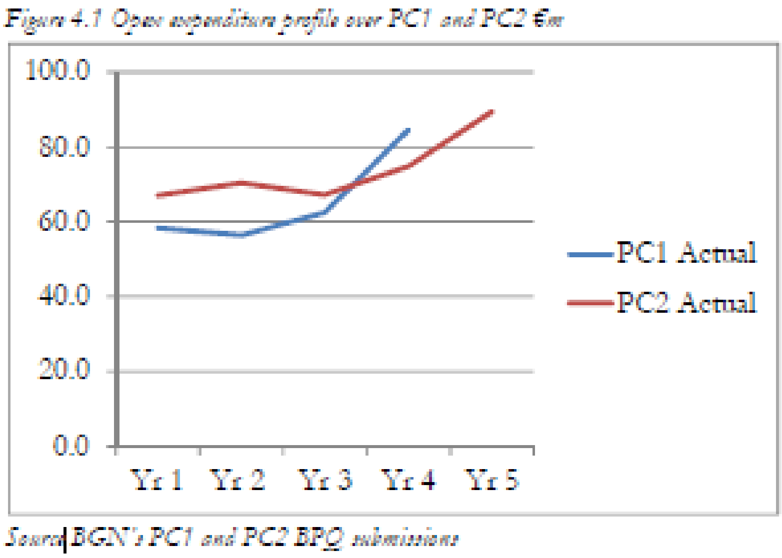


Figure 3 - CEPA Analysis Figure 4.1 P21 of Consultants Report May 2012

BGN believes that CEPA have fundamentally misunderstood the impact that growth and changing regulatory requirements have had on operating cost. BGN believes that what the Figure above shows is that there has been substantial growth over the period in terms of customer numbers, gas demand and network length – the three factors that are typically relied upon to explain cost changes in the gas networks business. For example, over PC2:

- Customer numbers increased by over 10%;
- Network length increased by over 20% (since 2006); and
- There was a 12% increase in the number of AGIs.

It is noteworthy that CEPA does not set out in any of its analysis what the impact in these core cost drivers might be on BGN's opex, or take them into account when setting the PC3 allocations based on the so-called 'normalised' 2009/10 costs.

To illustrate the impact of these cost drivers on BGN's business we have carried out the following analysis:

- We have calculated the composite scale variable (CSV) cost driver for BGN for each of 2007/08, 2008/09, 2009/10 and 2016/17. As set out in CEPA's analysis this is the formula used by the CER to benchmark the GDNs and the formula used by CEPA to benchmark BGN against the GDNs. In consequence, this CSV cost driver is used to 'explain differences in opex for the operators. The CSV cost driver is based on customer numbers, network length and throughput;

- We have plotted BGN's direct opex for 2007/08, 2008/09 and 2009/10. We have used only these years as the CER has not disputed that BGN's opex was efficient in these years;
- The figure shows the change in opex associated with an increase in the CSV variable (i.e. the impact of network growth)
- Using this relationship we have calculated the CSV variable for 2016/17 based on forecast connections throughput and network length;
- Using this 2016/17 CSV figure we have predicted the impact that these growth factors should have on BGN opex
- This shows that BGN should have direct opex in 2016/17 of €72.1 million (excluding pass through items). BGN's actual opex in 2016/16 is €60.4 million[3].
- This indicates that BGN's actual costs by the end of PC3 will be **€12 million** or almost 17% less than the cost driver analysis suggests they should be.

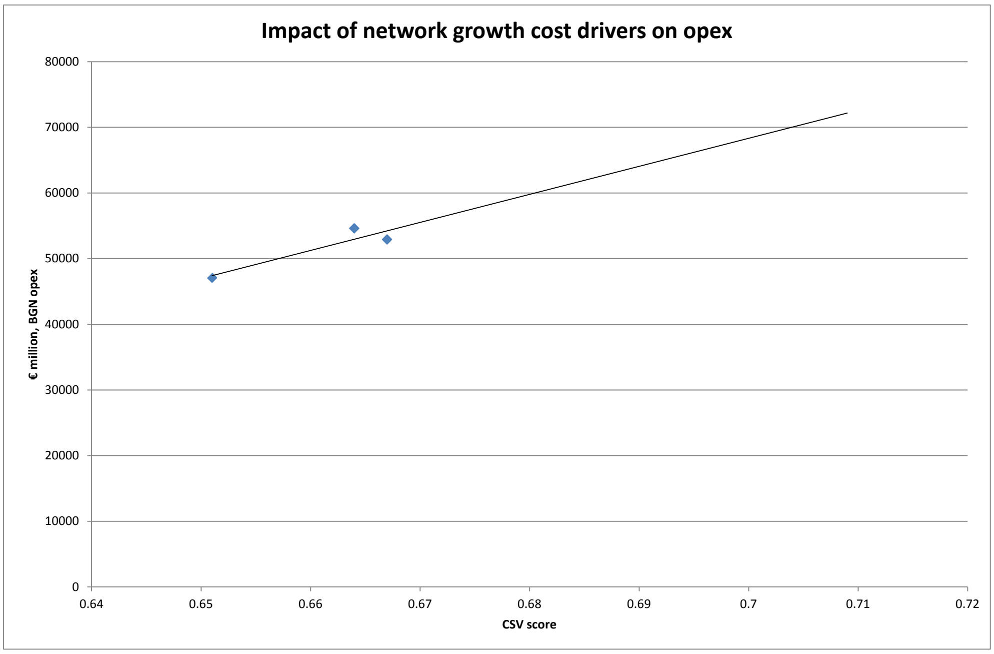


Figure 4 - BGN Impact of Network Growth cost drivers on Opex

The analysis above highlights a clear and significant error in CEPA's bottom up approach to benchmarking – they do not consider the impact of network growth (a key cost driver) on the opex BGN will require to operate the network over PC3.

It also provides substantial illustration of the impact of the efficiencies that BGN is challenging itself to deliver over the PC3 period.

[3] Note this excludes ITO costs and innovation as these are 'new' activities compared to 2007-2010

CEPA have misunderstood the 2nd and 3rd Directive projects

With respect to the ISO and ITO project, CEPA conclude that:

"our conclusion is that BGN has not been able to justify the substantial increase in operating costs resulting from the two major programme undertaken in PC2".

CEPA also argue in relation to the ITO that:

"We feel that BGN has missed the opportunity to take a more pragmatic approach that focuses on key areas allowing time for process improvement and transformation while adopting a minimalist approach to those less critical areas".

We believe this demonstrates a clear misunderstanding of the project. Conceptually, the ITO model could only ever lead to an increase in costs (albeit a smaller increase than that associated with the alternative compliance options). This is because European regulations were requiring BGN to cease achieving the benefits associated with shared support and IT functions and operate on a stand-alone basis.

We also believe that the benchmarks suggested by CEPA for 'similar' projects are inappropriate. This was not a de-merger or an outsourcing project this was a regulatory compliance project where the key driver of activity and cost was the need to comply in full with the detailed and proscriptive arrangements set out in the Directive. In consequence, there were very few less critical areas where a 'minimalist' approach could be adopted.

Moreover, the project had to be delivered under severe time pressures. The certification deadline is set in stone, and failure to meet it would expose possibly the State and BGN to substantial fines. Moreover, given the current challenges facing the wider economy and the intervention of the troika, it would be unthinkable that a publicly owned body would fail to meet key European Directives for market reform.

In consequence, the clear focus of BGE was to achieve compliance with the Directive. Moreover, BGE shared this approach and objective with the CER and the other regulators, and CER supported BGE's proposed approach. BGN is therefore very disappointed with the approach suggested with respect to the ITO project.

No objective or independent analysis

It has been suggested that the CERs consultant consortium have carried out detailed bottom up analysis of BGN's costs. However, we cannot find evidence to support this assertion:

- The Consortium have not included any evidence of bottom up benchmarking, where BGN's costs are compared against those of other operators controlling for key cost drivers
- The consortium have not relied upon any obvious form of reference modelling to identify 'optimal' costs

It is important to contrast this with the approach taken by Ofgem, where the bottom up analysis they rely on is based on objective, independently verifiable benchmarks. In particular, for direct opex, Ofgem relies on benchmarking of activity costs across the operators, and for shared services etc it relies on detail cross-sectoral benchmarking.

In contrast, CEPA's approach is subjective and opinion based. In some cases they provide no explanation for their proposed cuts, and in others their explanations are entirely assumption based. Examples include:

- **IT:** CEPA proposed a "further efficiency adjustment of €500k to arrive at a starting position for PC3" – no evidence is provided to justify the additional efficiency adjustment
- **Group recharge:** CEPA cut BGN's proposed allowance on the grounds that *"we estimate that this represents approximately 1.5% of turnover compared with 0.75% to 1.7% for other network operators".* CEPA provide no evidence to support this claim, or references to independent benchmarks. Nor do they demonstrate that the other network operators they have in mind are appropriate comparators.
- **Response times:** the allowance for response activities was cut on the basis of "*assuming that BGN is able to take steps to reduce the impact of nugatory calls"*. CEPA provided no evidence of the steps BGN could take, their likely impact or the extent to which they could be associated with a cost reduction.
- **Call-centre:** CEPA reduced the allowance on the basis that *"we have assumed that the re-tendering will result in a further reduction regardless of volumes."* It is bizarre to assume a cost reduction can be achieved regardless of what happens to volumes. CEPA also provided no evidence to suggest that the current call centre contract was inefficient.
- **General management:** CEPA reduced the proposed allowance on the basis that *"we have assumed there is scope for rationalisation with regulatory and compliance following the ITO re-organisation'*. Again, CEPA provide no analysis or objective justification for this assumption.

The examples above illustrate BGN's concern that the consortium have relied upon a largely qualitative assessment of BGN's costs, to arrive at their 'normalised' view of costs. There is no evidence that these normalised costs have been informed by independent benchmarks, or any benchmarking of BGN activities against other operators – it is largely the consortium's view. In consequence, the only significant quantitative assessment of BGN's costs is the top-down benchmarking analysis, against which we have identified significant concern (see below).

<u>CEPA have accepted the scope of works required but not provided the necessary allowances</u>
In a number of significant cases CEPA appear to have accepted the scope of works BGN has indicated as being necessary in PC3, but have not provided the necessary funding. In a number of areas these relate to critical inspection and maintenance activities that will have a material impact on the safe operation of the network. This was pointed out by BGN in its response to CEPA's proposals, but BGN have received no detail response to the points raised with CEPA and the CER.

Key examples include:

- Transmission onshore activities: BGN proposed the following increased scope of work for PC3, at an estimated additional cost of €12 million. CEPA allowed just €3 million of this, despite accepting that the scope of work was required, and providing no justification for its arbitrary cuts. Key elements of work that will be under-funded include:
    - The extensive online inspection programme proposed for PC3

- A capital programme to roll out pipeline markers across the transmission system. These markers will require on ongoing care and maintenance programme.

- Increase in scope of activities in Safety & Quality including increased reporting & system requirements to continually develop safety case controls, increase audit requirements, roll out of an Environmental Management System ("EMS"), and increasing compliance with various applicable statutory & licensing requirements.
- Compressor overhauls: CEPA's comments under the tariff heading Interconnector Compressors category was that "we consider that the PC3 forecasts are reasonable" having reviewed the overhaul schedule. Given this view BGN do not understand why the full allowance was not accepted by CEPA.
- Net cost leaks: Full costs were not allowed in this category, despite accepting that the work was necessary. The work needed in this category relates primarily to activities to investigate and rectify Mains Exceptions Reports (MERs) and incomplete data on the GIS. Activities in this area are primarily trial holes to locate mains in areas where site reports (i.e. MERs) indicate the main is in a different location as that indicated on the GIS. In addition, there exist approximately 55,000 premises indicated on GIS as being gas consumers but lack associated as-laid mains data. To rectify this trial holes or ground penetrating radar surveys to locate theses mains are required as mandated by the obligation to produce and maintain maps under the Gas acts.
- System operations: Additional scope of activities related to revised maintenance approach for DRIs. This was agreed with the CER through the safety audit process. However, the full cost allowance has not been provided for.
- Market development: CEPA suggest that market development activities are inconsistent with BGN's role as an ITO. However, BGN fails to understand the logic in this regard. Activities undertaken by BGN to develop the market are focused on increasing the total usage of the gas infrastructure, and the work undertaken by BGN in this regard does not particularly benefit any individual shipper. The best way to reduce tariffs and minimise customer costs is to ensure that the maximum possible number of people use the gas network (and enjoy the substantial savings associated with gas compared to other fuels). This has previously been recognised by the CER. To cut market development activities is a very short-sighted move that will result in the under-utilisation of the network relative to the optimum. Moreover, it is particularly short-sighted to cut market development funding at a time when network growth is most likely to come from conversions rather than new growth.

No evidence has been provided to confirm that the CERs consultants carried out an appropriate bottom up analysis of the BGN revenue requirement submissions.

Concerns with Benchmarking

BGN is deeply concerned at the approach adopted by CEPA, and accepted by CER, with respect to the benchmarking of BGN:

- CER appear to have rejected the benchmarking analysis put forward by BGN which demonstrates that BGN was efficient in PC2 and that the proposals for PC3 are also efficient

– this is particularly surprising given that BGN carried out the analysis on the same basis as all previous benchmarking analyses carried out by CER, and using the CEPA's assumptions and data;

- CEPA continue to place weight on a benchmarking analysis that is plainly wrong. CEPA's analysis is not statistically valid – it fails the key statistical tests, and so its results will be biased. CEPA have tried to remedy these flaws, however their revised analysis is also flawed – correcting for the flaws in CEPA's analysis results in benchmark results that are the same as those identified by BGN using the cross-sectional analysis approach;
- CEPA's bottom up benchmarking is not based on any objectively justifiable external benchmarks or evidence – rather it is merely the view of the consultants.
- CEPA and CER's approach to additional efficiencies is flawed and arbitrary

<u>BGN's PC3 proposals are efficient</u>

BGN submitted benchmarking analysis to the CER, which showed that BGN is efficient in both PC2 and PC3. The benchmarking analysis undertaken by Frontier Economics on behalf of BGN was based on the standard approach to benchmarking that the CER has relied upon at every previous price control for both BGN and other regulated network utilities.

<u>CEPA's top down analysis is flawed</u>

We believe that the top down benchmarking undertaken by CEPA has had a significant influence on CEPA's assessment of BGN's proposals and on the recommendations made to the CER. We believe that this is supported by a number of statements included both in the published paper and in CEPA's paper to BGN dated March 28th 2012:

> *"Benchmarking of BGN relative to similar gas ITOs has an important role to play in setting that baseline"*
>
> *"we continue to believe that BGN's direct distribution opex request is unjustified given the level of network replacement undertaken and the investment the company has made in NTP to establish a HPUM. Our conclusions are supported by our benchmarking analysis which shows BGN to be relatively inefficient."*
>
> *"We remain of the view that an efficient level of spend for an ITO business is less than what BGN has requested. We again believe this conclusion is supported by our top-down benchmarking of BGN compared to the GB GDNs".*

As set out in their published paper, CEPA adopted a different approach to BGN, seeking to use a panel data analysis incorporating data for four years. On the basis of this analysis CEPA report that

> *"Our panel analysis shows that up to 2009/10 that BGN was an average performer compared to the GB DNs but with BGN and the DNs expenditure for the 2010/11 financial year included in the regression, BGN moves to being a relatively poor performer compared to the GDNs".*

BGN is disappointed that CEPA have continued to rely on this analysis, as we set out clearly to the Commission during the process that the CEPA analysis was flawed. We understand that CEPA have carried out further analysis using their panel specification, which they claim supports their original findings. However, BGN asked Frontier Economics to review this additional work, and that review identified a number of serious issues with CEPA's new analysis.

Frontier have found that CEPA should have revised the specification of their panel regression so that it included variables that estimate how the impact of network scale on opex changes over time, thereby helping to remove this source of bias in the basic four-year panel data regression. In light of this, BGN asked Frontier Economics to re-run CEPA's balanced four-year panel data regression analysis, and to introduce variables into the model to remove the bias resulting from changes in the relationship between network scale and opex over time. The result of this regression shows BGN to be efficient in 2010/11 (around 2% below the regression line).

To check the robustness of these findings, Frontier also replicated CEPA's new analysis, again including year-scale interaction variables in each case. Again, once these interaction terms are included, these regression results for both of these model specifications show BGN to be efficient in 2010/11 (around 2% below the regression line). Frontier's assessment of CEPA's analysis is contained in the annexe to this paper.

In conclusion, therefore, BGN suggests that:

- Frontier's original benchmarking analysis, based on the CER's standard cross-sectional analysis, found that BGN was relatively efficient in each year of PC2 and PC3.
- The CER and CEPA has never disputed the finding of this analysis. Moreover, the updated cross-sectional benchmarking presented by CEPA in its published report confirms this finding.
- Frontier's analysis demonstrates that the panel analysis carried out by CEPA is flawed, and that the results cannot be relied upon.
- When the panel analysis is re-run with appropriate controls it shows BGN to be efficient.

In benchmarking, CEPA, in their paper suggest that *"the results of a four year panel should be considered with caution".* BGN believe that they should be rejected in their entirety, as they are based on a mis-specified and invalid analysis and cannot be relied upon.

Concerns with arbitrary additional efficiencies

The CERs consultants CEPA, have proposed that BGN be subject to an additional efficiency incentive of 1%, based on other regulators' recent price control decisions. They suggest this should be applied to controllable distribution opex.

BGN are surprised by this approach as we have indicated to CEPA and the CER that our proposals already include an ongoing efficiency incentive. As set out in our responses to CER over the course of the review, BGN have included an explicit efficiency factor in its proposals of 0.5% in year 1, 0.75% in year 2, 1.0% in year 3, 1.25% in year 4 and 1.5% in year 5. This is applied to all costs aside from pass through costs and labour costs. We did not apply it to labour costs, as our specifically targeted cost reduction programme with respect to labour costs had already reduces costs by more than the efficiency factor.

It is important to highlight that the approach BGN have taken to identifying and implementing this efficiency factor is entirely in line with the approach taken by utilities in other sectors, and in line with the approach CEPA allude to in their analysis.

Moreover, as the CER has previously recognised, the use of HICP inflation rather than CPI means that BGN is subject to an additional efficiency incentive. The CER recognised this explicitly in BGN's last price control. In section 8.4 of the PC2 price control review, dealing with efficiency and benchmarking:

"The inflation allowed in BGN's revenue calculations is Irish HICP which is less than the inflation on operating costs which are driven by the Consumer Price index (CPI). This incentivises BGN to make efficiencies in its operating costs as revenues are inflated at a lower rate than operating cost."

To demonstrate this point, the Figure 5 below shows an index of HICP and CPI since 2006. As can be seen CPI is significantly above HICP for almost all of the period. Over the last 2 years, the difference between the two indices amounts to 1.1% per year. This choice of inflation index results in an in-built efficiency target of 1%.

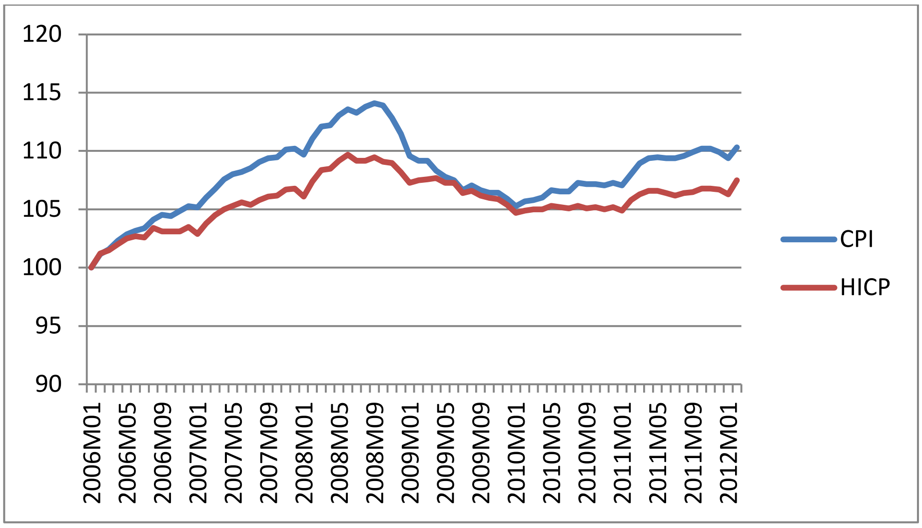


Figure 5 - Comparison of CPI Vs HICP over PC2 period

We therefore find it difficult to understand how CEPA justify a further 1% efficiency requirement, when we have included an efficiency factor in our proposals and when we are subject to a further factor as a result of the CER's choice of inflation factor.

Finally, in addition to CEPA's 1% efficiency, CER is proposing a further adjustment of €1 million over the period. CER appear to justify this on the basis that:

> *"CER notes that the choice of ITO was made in the light of the expected ongoing operating costs being lower under the ITO structure than under the alternative ISO structure. The CER takes the*

view that it is appropriate to reduce this increased cost by €2 million over the period (€1 million in distribution)."

BGN cannot understand the logic behind CER's position. The 3rd Directive required change for BGN to be compliant. Of all the potential options to achieve compliance the ITO is the cheapest and the approach approved by the Commission. BGN is therefore implementing the lowest cost option to achieve Directive compliance, and so we find it difficult to understand why CER believes that this provides justification for an additional cut in our opex.

In addition to the efficiency imposed by the HICP inflationary index, BGN has provided an additional ongoing efficiency challenge within our revenue requirement. The CER and its consultants are applying a further efficiency factor and arbitrary efficiency cuts, without any context or explanation.

Concerns over CERs approach to Capital Infrastructure Projects

SWSOS Proposal

BGN welcome the CER and its consultants conclusions that there is a compelling case for the twinning of the SWSOS pipeline in the longer term as Corrib supplies begin to decline and, that there are clearly technical shortcomings in the current operation of the SWSOS Interconnector System. This confirms BGN's view that twinning the pipeline is technically the right thing to do.

However, BGN disagree with the CERs conclusion; that they do not believe that there is a need to construct the pipeline in the short term to overcome a 'potential' 2013/14 winter constraint. Considering the range of risks/uncertainties associated with the potential capacity constraint at Moffat and the alternatives to twinning the pipeline proposed by the CER and its consultants, BGN consider twinning the SWSOS 50km single section of pipeline as the only practical solution that can be implemented in a timely manner.

BGN are unchanged in their view that reinforcing the 50 km single section of the SWSOS transmission system guarantees the supply capacity and security to meet the ROI's future demand requirements in the short, medium and long term, provides certainty to the market and is the only practical solution that can be implemented in a timely manner.

However we acknowledge that the CER as the authority responsible for security of supply are fully empowered to decide that the deferral of the pipeline is appropriate. If this is the considered position of the CER we are strongly of the view that robust alternatives be put in place on a transparent basis with industry as soon as possible.

Onshore Transmission Reinforcement Proposals

BGN also welcomes the CERs consultants analysis during the review that "there is a bona-fide case for reinforcing the 37km section of pipeline between Goat Island and Curraleigh West" and BGN concur that in order to maximise "the potential operational effectiveness" of significantly expanded gas storage facilities at Inch this pipeline should be reinforced.

BGN submitted a proposal to reinforce the Goat Island to Curraleigh West pipeline in PC3 in response to analysis which indicated that the pipeline has insufficient capacity in the event of a breach to the Cork to Dublin pipeline if Inch supplies were unavailable. Should such an event occur during a significant portion of the year this pipeline would be unable to transport all of the gas to meet the gas demand in the Cork and Waterford areas. The need to reinforce this pipeline has been considered as part of the long term network development plan since its inclusion in the "Gas 2025" study published by BGÉ in 1999.

Cost of Capital

BGN notes and broadly welcomes the proposals in the Consultation Paper in relation to the Cost of Capital over the period[4]. The proposals recognise the significant refinancing requirements of BGN over the period , the dramatically increased cost of raising capital due to the financial crisis and the difficulty in accessing the debt capital markets. The mechanism while affording protection to customers and a quicker pass through of savings to tariffs if bond yields fall over the period also acknowledges the need to maintain secure and reliable supplies of both gas and electricity which can only be achieved by BGN being capable of financing the efficient operation of the network.

However BGN does not agree with the CER's proposal with respect to the treatment of embedded debt. This represents a complete departure from established regulatory precedent by the CER. It is also at odds with regulatory precedent in each of the other regulatory sectors in Ireland and with the majority of regulatory practice in the UK. Under established regulatory precedent, the cost of debt has been based on a forward looking assessment of the appropriate cost of debt allowance, and has not given any regard to the levels of embedded debt or the prevailing rate on that date. This approach is widely recognised as providing the proper incentives to operators to finance their activities as efficiently as possible. This incentive is largely removed under the CER's revised proposals. In effect, debt becomes a pass through item.

This change in principle and the use of BGN's embedded debt cannot be characterised as a temporary change in regulatory approach due to the financial crisis. Indeed, it is essential if the CER is determined to retain this principle that it signal clearly to the market that the same principle will be adopted at PC4.

We note that Oxera identified a small number of examples from the UK of regulators moving towards the use of embedded debt. It is important to note that in each case, it was clearly indicated that the proposed use of embedded debt should be a permanent and symmetrical change, and that the regulator could not pick and choose, depending on whether the prevailing rates were above or below those of the embedded debt. All other regulators that have used embedded debt have been

[4] provided that the fundamental structures of the proposals in terms of the WACC level and the risk reward mechanism are implemented as designed and outlined in the proposals.

fair in their application of the principle. For example, the GB water industry has applied embedded debt adjustments that resulted in a higher WACC (in 1999) and a lower WACC (in 2009).

At a time of uncertainty and volatility, with constrained access to markets, regulatory certainty is vital. We would urge the CER to reconsider its position on the treatment of embedded debt. If CER moves to the use of embedded debt, it must signal clearly that the significant policy shift, will be permanent and symmetrical.

5.0 Impact of the proposed changes

The previous section of our response outlined the deep concerns BGN has regarding the evidence and analysis relied upon by the CER in reaching its proposed revenue allowances. BGN has also given to considerations the changes it would need to implement in order to live within the allowances proposed by the CER.

Unfortunately, we believe that the only way BGN could operate within the proposed allowances is to reduce substantially the scope of activities we undertake in PC3. This is because, as we have already set out in this response, we are an efficient operator and we have built substantial savings into our PC3 proposals, in the form of payroll savings, procurement savings, operational savings and a stretching overall efficiency target.

We believe it is important to set out clearly the scope of activities we undertake, and the potential implications in terms of the quality and reliability of the network. If CER wish to reduce our allowances in line with their current proposals, we believe it will be critical for there to be a transparent and agreed understanding of what BGN will be in a position to deliver over the course of PC3. In each of the main operational categories below we set out how BGN would propose to live within the CER's allowance, the key outputs that would be impacted and the implications for the quality and reliability of the network and services provided by BGN.

Total cuts (T&D) against revenue request - Impact on Asset Management (cut 14%) and Service Delivery (cut 13%)

The most significant of the CER's proposed reductions is in the area of service delivery, where the cumulative effect of the CER's proposals is a reduction of over €35 million. This level of opex reduction can only be achieved by reducing the scope of activity and/or quality of service that BGN delivers. This will require a major review by BGN of what may be considered an acceptable trade off in terms of increased risk and reduced service levels. While BGN has begun this process, it is not yet complete, and so below we provide a high-level outline of the types of service that will be impacted by the CER's proposal. What is clear is that the CER's proposals will impact most significantly on maintenance of the network. However, they will also affect the service levels we can provide to customers (for example site works, and no gas response) and to the charges customers will bear for services.

The list below details some of the possible consequences of reduced inputs to the maintenance programme:

- BGN has proposed to complete an **OLI programme** in accordance with the IS328 Standard which requires pipelines to be verified as fit for purpose at least once every 10 years. While the regulator agrees with the schedule, the funding allowance to complete the programmes is not being given. BGN is reluctant to curtailing online inspections given recent international incidents (e.g. San Bruno pipeline explosion in the United states). *However BGN will have to tailor the OLI programme in light of the allowance, but there will be a trade off between cost and risk.*

- As part of our PC3 submission BGN submitted a schedule for **compressor overhauls**. While the regulator is in agreement with the methodology of the scheduling, the allowance being proposed is not reflective of the schedule. In light of the proposed allowance, BGN will now have to review the proposed schedule and replacement policy. This will have an impact on compressor station performance associated with potential increased downtime on units. ***This cost saving will be balanced by increasing the risk on the already capacity constrained Interconnector system.***

- BGN has proposed an operational maintenance regime for the **AGIs Asset** in compliance with the strict legislative requirements of IS 328 (section 18). This standard is prescriptive on the intervals for site and diagnostic checks, functional checks and overhaul frequencies etc. In light of the proposed allowance, BGN will not be in a position to comply with the relevant standards and will look at targeted deferral of certain functional checks and overhauls. ***This cost saving from reduced maintenance will be achieved with an increased risk to reliability of the system***

- Reduce or eliminate **calibrations** of telemetry devices and metering systems. This would result in higher risk of metering errors and inaccuracies. The uncertainty limits of the metering systems, as stipulated in gas custody contracts and Code of Operations, will be compromised by the reduction in calibration frequency. The reduction or elimination of routine calibrations that check the integrity of loops for SCADA and control purposes would increase risk of equipment failure or miss-measurement. ***This cost saving will impact directly on the resilience of the network and services to shippers.***

- Reduce the scope and extent of **SCADA visibility**. Reduced SCADA services will lead to less visibility of the pipeline network. ***There will be increased risk of loss of service to large sections of pipelines with the reduced scope.***

- Less frequent **surveillance of the CP systems** will increase the risk of undetected faults that could eventually result in loss of containment from high pressure pipelines, some of which are located in urban areas. ***The BGN policy and CER regulations stipulate defined frequencies which may be compromised in order for opex savings to be achieved***.

- **Installation activities** are largely driven by customer requirements for Networks services. The Regulator is proposing cutting the proposed allowance. BGN will have to review the customer charter service levels in light of the proposed allowance as ***current service levels cannot be maintained***. Site works charges will also have to be reviewed/realigned to ensure that they are cost reflective. Currently some activities are provided without charge to customer and other activities are heavily subsidised. ***BGN will have to seek full recovery of these costs from its customers***.

- The Regulator is proposing cutting the proposed **Leak Repair Allowance**. BGN's allowance request was based on current repair practices continuing and on some improved performance in relation to Class 2 leaks. These will now have to be reassessed in light of CER's proposed allowance. BGN was proposing reducing the lead time for Class 2 leak repairs from 12 months to 6 month to reduce the associated risk. This initiative will now have to be stopped to reduce cost. Also, it was BGNs practice to repair class 3 leaks as soon as possible. This will also have to be curtailed due to lack of funding. Under this allowance BGN also requested a provision of €5m for verifying and creating GIS mapping details. The CER proposed allowance does not give the incremental allowance to proceed with this programme of work. ***While short term opex savings may be achieved by reducing the GIS mapping rectification scope this is balanced by a significant resilience and safety implication associated with this decision***. It is also a legislative requirement under the Gas acts to maintain accurate mapping.

- The regulator is proposing reducing BGN proposed **Response allowance**. BGN proposal was based around delivering a high level of service which will now have to be reviewed in light of the CER proposed allowance.
  - For PRE responses BGN will have to review the response time to find cost efficiencies (currently 1 hour max).
  - For No gas calls, BGN will have to review call scripting to identify calls which are not associated with low pressure areas and prompting customers to call their own installers as cause is likely to be downstream of the meter.
  - Also BGN will also look at pushing out the lead time for responding to No gas calls from 24 hours to 48 hours to facilitate more efficient scheduling & dispatch.
- In light of the proposed cut to the **System Operational allowance** , BGN will have to look the possibility to moving to a ***run to fail type policy*** for the non-critical installations for PC3 which will have ***an impact to network performance and service level with increased risk of interruption to local supply***.

Impact on Health Safety Quality and Environment - Total cuts (T&D) against revenue request (cut 26%)

The CER have proposed budget cuts in this area by €6.9 million, which equates to a 26% reduction compared to BGN's proposals. A reduction of this magnitude will have an impact across the range of activities undertaken in this area. Key impacts are set out below in relation to:

- Safety team
- Safety case support
- Training and accreditation
- Environment management and
- Management systems

Safety team

The largest direct impact of the PC3 cuts will be on the provision of safety support and advice to the business. With the reductions required elsewhere in the business by PC3 there will, arguably, be a greater requirement for professional safety advice, support and performance measurement in order to ensure that the reductions imposed by PC3 are implemented safely.

The cutting of the non-labour spend will inhibit BGN from carrying out independent safety audits and inspections of its own and its contractors' activities, thus restricting the ability of the business to measure and improve its performance. A reduction in safety promotion and safety communication activities will reduce the ability of the business to influence the behaviours and attitudes of those working directly and indirectly on its behalf.

It will not be possible for HSQE to attend the range of meetings and risk assessments that are currently attended, inevitably resulting in a reduction in opportunities to identify and improve situations which have the potential to cause harm. Visits and inspections performed by the Safety Team will also be negatively affected which will have a similar impact.

These reductions will ultimately result in the less effective management of safety in BGN and a potential for an increase in accidents and incidents, both occupational and gas-related.

Statutory and regulatory compliance will be inevitably be impacted as the activities and projects required to ensure compliance will be inadequately resourced (the provision of adequate resources, is, itself, a requirement under the Safety, Health and Welfare at Work Act, 2005).

Safety case report

Increasing demand has been made by the CER in relation to enhancements to the BGN Safety Cases currently operated by BGN. It is likely the resources to implement many of these changes will not be available to BGN. (The CER will undertake a major review of the existing Safety Cases in Q3 2012).

The CER also continue to expand its reporting, inspection and auditing requirements. At the same time no provision has been made in the PC3 allowance to support these expectations.

Impact on Training & Accreditation

A key direct impact of the proposed PC3 cuts will be on the provision of specialist technical training to the business. With the reductions required elsewhere in the business by PC3 there will, arguably, be a greater requirement for multi-skilled personnel who are able to perform a wider variety of tasks in a competent and safe manner. In turn this will require an increased output from the Technical Training School, not a reduction.

PAS 55 (International best practice in Asset Management). BGN is at the initial stages of obtaining the PAS 55 standard. It was proposed to roll-out this process over the period of the next price control requiring additional systems, training and consultancy support. This process may not be implemented with a reduction in Management Systems resources.

Impact on Environmental Management

The provision of greater recourses in the environmental area for PC3 is critical for the business to ensure compliance. New regulations such as the Habitats Regulation and the new Battery Directive place considerable additional costs on BGN operations.

Implementation on Energy Management, Carbon Management and Water Management initiatives needs the support of Environmental Team and an Environmental Management System (EMS) to ensure the business can remain compliant with the relevant regulation over the price control period.

It is anticipated that there will be a direct impact on BGNs ability to meet these requirements as a consequence of the significant cut in opex.

Impact on Management Systems

Within Management Systems there are requirements to develop the system, to the benefit of BGN in terms of improved efficiency, performance, safety. These extra demands can only proceed where adequately resourced.

At present Management Systems perform approximately 20+ quality system audits per annum. A reduction in resource allocation will negatively impact on the current audit programme and will prohibit a level of auditing appropriate to the size and scope of BGN.

Document control is currently resourced at a low level for the size of the organisation when compared within equivalent size industries. It was envisioned that the document control function would be expanded in order to standardise the change process within BGN. This will not be possible without being adequately resourced.

The CER also continue to expand its reporting, inspection and auditing requirements. At the same time no provision has been made in the PC3 allowance to support these expectations.

Impact across other areas – Total cuts (T&D) against revenue request in Workflow (cut 10%), R&C (Cut 10%), Finance (Cut 19%)

Office Infrastructure, Reliability / Operational Issues

Program for the buildings 'SFG20 – Building/Asset Maintenance Standard' will need to be curtailed with maintenance strategies in some cases being changed to 'run to failure', this will lead to all or portions of our properties being non operational from time to time. In addition a reduction on the number of hours where security is present on our sites will have to be assessed; this could lead to an increase in theft and vandalism across our network.

Customer Facing Services and Service Levels

Opex cost savings will lead to a direct reduction in Shipper Key account and GPRO service levels. In addition BGN will be constrained in supporting CER and the Market. It is anticipated that the Customer Charter will need to be reviewed and standards lowered, leading to increased Call Centre Handling Times. As our opex allowances have been reduced it is anticipated that both service and cost will have to be looked at in every area. This will lead to an increase in times for Site Visits, Site works, and Reinstatements and of necessity Site works charges will need to be fully cost recovered . This will increase complaints from both Shippers and Customers to the CER.

Impact on Finance, Regulatory and Standards

Shared Service and Finance are core functions of the business and are required to support the business in terms of proper governance, proper management, supporting competency and system capability. Cuts in our request allowance in this area will directly impact our ability to support the business and overall maintenance capabilities. In Regulatory, BGNs ability to participate in ENSTOG will be severely curtailed. In addition with the resource opex cut BGN will not be able to support the frequency of Code Modification and GMARG Fora. This will have a direct impact on the level of modification implementation that can be accommodated. Maximum Operating Pressure reviews will have to move from 4 years to 6 outside of IS328. BGNs
Ability to meet the CER requirements for Smart Metering, Meter Replacement programmes and Pre-Payment Meter program will be compromised. In addition BGN have no resource available to support new CER initiatives identified such as the Tariff working group or Innovation. BGNs ability to support CAG, Joint Development Statement, Republic of Ireland Risk Assessment (RA) and the Preventative Action Plan (PAP) will also be severely impacted.

Appendices

Appendix 1 – Legal Advice – McCann Fitzgerald

Appendix 2 – Frontier Economics – Analysis of CEPA Panel Benchmarking