Response Paper to Consultation on GNI Revenue for PC4

Response Paper

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Regulating Water, Energy and Energy Safety in the Public Interest

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Executive Summary

On 16 June 2017, the Commission for Energy Regulation (CER) published two consultation papers covering Gas Network Ireland’s (GNI) transmission and distribution revenue for the period 01 October 2017 to 30 September 2022. This paper provides a summary of the responses to those consultation documents as well as the CER’s response to the main points and comments raised. Please note that all responses have been published alongside this paper and should be read in conjunction with the CER’s decision documents also published alongside this paper (CER/17/259 and CER/17/260).
Public Impact Statement

GNI owns and operates the gas network which supplies all gas customers in Ireland. GNI charges gas customers an amount towards the cost of safely operating and maintaining the gas network through gas customers’ bills.

One of the CER’s roles is to protect gas customers by ensuring that GNI spends customers’ money appropriately and efficiently to deliver necessary services. The CER does this through what is called a Price Control which is carried out every 5-years, the next 5-year period starts on the 01 October 2017 (PC4).

- A Price Control is an important process because the CER must carefully consider the level of money GNI needs to safely operate, maintain and invest in the gas network for the next 5 years.

The CER will continue to monitor GNI’s performance and will challenge GNI to become more efficient over PC4. The benefits to gas customers will be:

- A gas network that is operated to the highest safety standards, ensuring safe supply of gas to customers;
- A reliable and secure supply of gas to homes and businesses;
- The efficient management of the gas network resulting in stable tariffs; and
- A high standard of customer service at all times with timely resolution to complaints.

As a result of the PC4 transmission and distribution decision documents, the average annual residential customer’s bill\(^1\) will rise by €2.89. The estimated percentage effect is an increase of less than half a percent.

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\(^1\) As per CER/17/042 the average domestic consumption for gas is c.11,000kWh. Based on these figures the average annual gas bill is approx. €760 for a standard plan.
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# Glossary of Terms and Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation or Term</th>
<th>Definition or Meaning</th>
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</thead>
<tbody>
<tr>
<td>BGE</td>
<td>Bord Gáis Energy</td>
</tr>
<tr>
<td>BPQ</td>
<td>Business Planning Questionnaire</td>
</tr>
<tr>
<td>CAPEX</td>
<td>Capital Expenditure (Capex) is the initial expenditure on investment in network infrastructure, such as underground cables.</td>
</tr>
<tr>
<td>CER</td>
<td>Commission for Energy Regulation</td>
</tr>
<tr>
<td>CNG</td>
<td>Compressed Natural Gas</td>
</tr>
<tr>
<td>GB</td>
<td>Great Britain</td>
</tr>
<tr>
<td>GNI</td>
<td>Gas Networks Ireland</td>
</tr>
<tr>
<td>LDZ</td>
<td>Local Distribution Zone</td>
</tr>
<tr>
<td>OPEX</td>
<td>Operating Expenditure (Opex) is expenditure on operating and maintaining the network infrastructure, e.g. maintenance, inspection and IT.</td>
</tr>
<tr>
<td>PC</td>
<td>Price Control</td>
</tr>
<tr>
<td>SCADA</td>
<td>Supervisory Control and Data Acquisition</td>
</tr>
<tr>
<td>SEPA</td>
<td>Scottish Environment Protection Agency</td>
</tr>
<tr>
<td>SWOS</td>
<td>South West Scotland Onshore System</td>
</tr>
<tr>
<td>UAG</td>
<td>Unaccounted for Gas</td>
</tr>
<tr>
<td>WACC</td>
<td>Weighted Average Cost of Capital is the amount that GNI can earn on the RAB to fund the capital requirements of the business.</td>
</tr>
</tbody>
</table>
1 Introduction

1.1 Commission for Energy Regulation

The Commission for Energy Regulation (CER) is Ireland’s independent energy and water regulator. The CER was established in 1999 and now has a wide range of economic, customer protection and safety responsibilities in energy. The CER is also the regulator of Ireland’s public water and wastewater system.

Our mission is to regulate water, energy and energy safety in the public interest. The CER regulates the revenues that Gas Networks Ireland (GNI) receives from gas tariffs. The CER ensures that revenues provide for the safe, efficient operation and maintenance of the gas networks. This is done on a 5-yearly basis, with the next 5-year control period due to start on 01 October 2017.

As part of its regulatory role the CER, every 5 years, carries out a review of the revenues that GNI are allowed to recover through gas tariffs for the ongoing operation and maintenance of the gas network. In reaching its decision, the CER has reviewed expenditure by GNI over the previous price control (PC3) to ensure that revenue was spent efficiently, and has reviewed forecast revenue required by GNI over next Price Control (PC4).

1.2 Background information

On 16 June 2017, the CER published a consultation paper which set out the CER’s proposals for the allowed revenue that GNI can recover for PC4 from 01 October 2017 to 30 September 2022. The paper invited public comment by 28 July 2017 on a wide range of matters relating to GNI’s proposed revenues to operate and maintain the transmission and distribution gas network. The purpose of this response paper is to provide a summary of the submissions received to the consultation along with the CER’s response. The CER’s full decision (CER/17/259 and CER/17/260) in relation to PC4 accompanies this response paper.
1.3 Structure of this paper

This response paper is structured as follows:

- **Chapter 1**: provides a brief introduction and background;
- **Chapter 2**: outlines the comments received and the CER response to each; and
- **Chapter 3**: conclusion.

1.4 Related documents

- [CER/17/127](#) CER Consultation Paper October 2017 to September 2022 Distribution Revenues for GNI
- [CER/17/130](#) CEPA PC4 Review of GNI Distribution Revenues
- [CER/17/129](#) CER Gas Distribution Revenue Model
- [CER/17/132](#) FTI Consulting Report on Cost of Capital
2 Comments Received

2.1 Introduction

On 16 June 2017, the CER published two consultation papers covering GNI’s transmission and distribution revenue for the period 01 October 2017 to 30 September 2022. This section provides a list of the consultation responses received and a summary of the main issues raised by respondents. In addition, the CER’s response to those comments is provided.

2.2 List of Respondents

In total there were seven responses to the consultation documents, these are listed below:

- Bord Gáis Energy
- Gas Innovation Group
- Gas Networks Ireland
- Irish Offshore Operators’ Association
- Paul Hunt
- Scottish Environment Protection Agency
- Vermillion

Please note that the full version of all seven responses have been published alongside this paper.

2.3 Comments Received

This section compiles comments received which for ease of reference are grouped by topic.

2.4 Opex

2.4.1 GNI Comment

In their consultation response, GNI expressed concern over the proposals for Opex which in their view remain heavily informed by PC3 costs and run rates and lower projected customer numbers. GNI stated that if necessary additional operational outputs are required that cannot be achieved within the overall allowances, the CER should be willing to reassess the proposed allowances during PC4.
2.4.2 CER Response

During PC4 it will be the responsibility of the networks business to determine: which projects are to be progressed, in light of changing circumstances, what additional work, not included in their initial submission, is necessary and efficient, and which projects will be deferred subject to the overall revenue cap. The outturn will be reviewed by the CER and only expenditure that is demonstrated as necessary and efficient by the GNI and approved by CER will allowed. However, as was the case in PC3, there is a procedure in place through which GNI can apply for necessary additional Opex funding/revenue allowances for specific items. 3.

2.4.3 BGE Comment

Bord Gáis Energy (BGE) expressed concern that the amount of information provided in the PC4 consultation papers makes it difficult to understand why certain costs are significantly increasing between PC3 and PC4. BGE do not consider GNI’s ‘growing trend’ as an appropriate justification for all revenue increases.

a) Operations

BGE is of the view that the CER should provide a full cost breakdown of how GNI Operations Opex costs are incurred, including details of the deliverables and outputs expected along with identifiable targets (noting that Operations Opex costs are increasing by 10% and 19% in the Transmission and Distribution businesses respectively).

b) IT Opex

BGE raised concern regarding the significant increase in IT Opex, noting that in both consultations IT Opex is presented as combined revenue between the Transmission and Distribution businesses, making it difficult for BGE to analyse the costs. BGE believe that the costs should be presented on a split basis.

c) Pass-through Opex Items

BGE believe that certain pass-through items in Opex could be explained better to improve stakeholders’ understandings of why costs are changing between PC3 and PC4. BGE pointed out that in the Distribution business, shrinkage costs are increasing from €23.6m in PC3 to €51.1m in PC4. BGE are of the view that it would be useful if the shrinkage cost rationale was accompanied by methods and plans to reduce shrinkage issues. BGE noted that Opex for Revenue Protection is increasing from €2m in PC3 to €11.6m in PC4 without any reason. BGE also stated that rates
in the Transmission business are increasing by 37% (€23m) compared to PC3, while rates in the Distribution business are decreasing by 89% (€52.8m).

d) Commercial Opex
While BGE supports the expansion of the network, they stated that it is difficult to comment on the level of revenue allowed as there is no supporting evidence to explain the commercial programme nor the target outputs expected from incurring these costs.

Further to the above, BGE highlighted an apparent misalignment between the increase in allowed revenues between Commercial Opex (over 200%) supporting connection growth and the increase in allowed Capex revenue for Connections (16%).

2.4.4 CER Response

Operations Opex
There is a level of difficulty in equating Opex costs to individual outputs/deliverables as Opex allowances are intended to support investment programmes and cover the day-to-day running of the networks business rather than tied to individual projects.

However, the CER agrees that it is important GNI provide clear milestones and deliverables in relation to proposed projects allowed under PC4. With this in mind the CER has decided to require GNI to provide regular reports to the CER outlining its record of performance and delivery against the programmes and initiatives that constituted its PC4 business plan. This will also form a key part of GNI’s submission and the CER’s review for PC5. The information provided in the GNI reports will include detailed analysis of how output volumes of work and delivered programmes specifically compare to the business plan GNI submitted for the PC4 review and how GNI considers is had met its proposed “commitments” during PC4 and improved the performance of its network.

IT Opex
The CER note that in their response BGE referenced distribution costs only for PC3 but referenced transmission and distribution costs for PC4. For convenience, table 2.1 below details the breakdown in figures across transmission and distribution, when comparing PC3 outturn figures to the PC4 allowance there is a c.32% increase in transmission and c.23% increase in distribution. This increase is linked to. SCADA Technology & Market Systems costs and incremental Opex
driven by Capex and cyber security requirements. The CER carried out benchmarking of GNI against its industry peers and is satisfied that the increase in IT Opex is appropriate.

Table 2.1: IT allowances and outturn

<table>
<thead>
<tr>
<th>€000s</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
<th>Yr 4</th>
<th>Yr 5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>D – PC3 outturn</td>
<td>5,423</td>
<td>4,852</td>
<td>5,208</td>
<td>6,305</td>
<td>6,502</td>
<td>28,291</td>
</tr>
<tr>
<td>D – PC4 allowed</td>
<td>6,799</td>
<td>6,962</td>
<td>6,984</td>
<td>7,033</td>
<td>6,910</td>
<td>34,688</td>
</tr>
<tr>
<td>T – PC3 outturn</td>
<td>5,427</td>
<td>4,748</td>
<td>5,209</td>
<td>6,241</td>
<td>6,643</td>
<td>28,268</td>
</tr>
<tr>
<td>T – PC4 allowed</td>
<td>7,339</td>
<td>7,470</td>
<td>7,470</td>
<td>7,503</td>
<td>7,414</td>
<td>37,196</td>
</tr>
</tbody>
</table>

Pass-through Opex Items

With regard to BGE’s queries on pass-through Opex costs, the CER would like to clarify that there is a typographical error in Table 5.10 PC4 Recommendations – Pass-through Opex in the Distribution Consultation paper\(^2\). Which has led to higher numbers in certain areas. This typographical error has been amended in the final decision document. Therefore, Shrinkage costs are not increasing (either based on PC3 outturn or based on PC3 allowances).

For ease of reference, the table below shows outturn for PC3 and the allowance for PC4 (the shrinkage incentive is only applied in distribution). The target is set on an assumed volume and cost with an incentive applied around differences in volume. The CER expects GNI to improve performance with respect to the volumes of UAG over PC4 and has set targets in this regard.

Table 2.2: Shrinkage allowances and outturn

<table>
<thead>
<tr>
<th>€000s</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
<th>Yr 4</th>
<th>Yr 5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>D – PC3 outturn</td>
<td>3,789</td>
<td>4,227</td>
<td>4,306</td>
<td>6,804</td>
<td>4,455</td>
<td>23,581</td>
</tr>
<tr>
<td>D – PC4 allowed</td>
<td>3,628</td>
<td>3,608</td>
<td>3,547</td>
<td>3,470</td>
<td>3,385</td>
<td>17,639</td>
</tr>
</tbody>
</table>

As stated above, there was a typographical error in the CER consultation distribution paper. The allowances for Revenue Protection are broadly in line with the Revenue Protection spend for the

\(^2\) CER17127 PC4 Distribution Consultation Paper
final year of PC3. Given the increased workload in this area, the CER is of the view that allowances are reasonable. This cost is deemed as a pass-through, with the CER reviewing this annually.

Table 2.3: Revenue protection allowances and outturn

<table>
<thead>
<tr>
<th>€000s</th>
<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
<th>Yr 4</th>
<th>Yr 5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>D – PC3 outturn</td>
<td>271</td>
<td>644</td>
<td>244</td>
<td>273</td>
<td>610</td>
<td>2,042</td>
</tr>
<tr>
<td>D – PC4 allowed</td>
<td>611</td>
<td>613</td>
<td>616</td>
<td>618</td>
<td>621</td>
<td>3,079</td>
</tr>
</tbody>
</table>

On commercial rates, the categorisation has been set out by GNI as being reflective of the allocation of costs to the transmission and distribution businesses, and has been reviewed by the CER. As such the CER has decided not to change this.

Commercial Opex and growth incentives

The CER recognises the benefit of increased utilisation of the existing gas network for gas customers and welcomes GNI’s proposals in this regard. The CER rejected a proportion of the incremental growth Capex request over PC4 on the basis that it viewed GNI’s proposals as overly ambitious. However the commercial department has increased in size over PC3 and has absorbed staff (and costs) from other areas. The costs at the end of PC3 for commercial Opex is more aligned with what the CER would expect for PC4, with incremental Opex required to support any new growth initiatives. As stated above the CER rejected part of the requested increase for the commercial function taking into account the expected Capex programme for PC4.

2.5 Opex Incentives

2.5.1 GNI Comment

In their response, GNI broadly welcome the proposals regarding incentives set out in the consultation document. However, expressed concern around particular incentives, such as the incentive on Unaccounted for Gas (UAG).

GNI state that the proposed UAG factors for PC4 are out of line with the UAG outturn in PC3. In their view, the starting point that the CER has proposed for PC4 of 0.75% is also out of line with current estimates of UAG and precedent in Great Britain (GB). GNI stated that the CER has provided no evidence or analysis to support its proposed targets. GNI are concerned with the starting target of 0.75 % and propose that the UAG factor for the Gas Year 2017/18 is set at 1.15%.
2.5.2 CER Response

The CER note that GNI in their consultation response revised their proposed UAG targets. In their response they state that an appropriate starting factor for PC4 would be 1.15% [GNI evidence relies on the comparability of GB evidence and outturn performance by GNI over PC3] down from the starting point of 1.3% in their original PC4 submission. The CER’s is of the view, that GB evidence is not directly comparable to Ireland due to differences in network characteristics. It is also unclear why performance in PC3 was significantly worse than that in PC2 for GNI, especially given that the trend in GB is an improving one.

- **Comparability of GB evidence**

In principle, (Local Distribution Zone) LDZ shrinkage and unidentified gas should be broadly equivalent to UAG. However it is reasonable to expect that the GNI shrinkage element should be less than that of GB because of the proportion of iron mains remaining and unidentified gas. Also some of the uncertainties associated with Shipper and Independent Gas Transporter (IGT) behaviour under the GB Network Code are greater than those that might influence GNI’s UAG.

- **Improvement in performance from GB evidence**

In evidence provided by GNI from GB, there has been reduction of 7.0% between 2013/14 and 2015/16, the last year of data. A further reduction of 11.3% is forecast from 2015/16 to 2020/21. The shrinkage element for GB Gas Distribution Networks (GDN) is forecast to be between 0.50% and 0.47% on average across the PC4 period, if unidentified gas is not included. The CER expect that the trend of improving performance would be also witnessed in Ireland if the regimes are comparable.

- **GNI’s own performance**

GNI has invested in initiatives intended to reduce UAG. Little evidence has been provided as to why PC4 should have a higher UAG volume than for PC3. In their business plan, GNI noted that the 2014/15 figure was an outlier and is not representative of general performance, with an investigation initiated into why this occurred.

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3 Unidentified gas was suggested by GNI to be equivalent to 1.08% in 2013/14, 0.85% in 2014/15 and 1.18% in 2015/16.
The CER PC3 decision noted that UAG levels had fallen from 0.85% to 0.42% between 2007/08 and 2010/11. With this level of performance in the past, the rationale behind the significant deterioration in UAG performance over PC3 relative to PC2 is unclear, especially given the aforementioned investment by GNI. The figure below highlights that GNI has clearly not improved performance to the extent expected at the PC3 decision (and has faced a financial penalty for the deterioration in performance witnessed).

Figure 2.4 GNI distribution network UAG outturn performance

![Graph showing GNI distribution network UAG outturn performance](image)

*Source: GNI*

The CER originally proposed a UAG of 0.75% dropping to 0.55% over the course of PC4. However, the CER has carefully considered GNI’s response and has decided on a UAG factor starting at 0.95% decreasing over the course of PC4 to 0.75% in the final year of PC4. This sets the starting point slightly above the reported UAG value of the last full outturn year (2015/16) and then glides to the same endpoint target as PC3.

These targets strike a balance between challenging GNI to improve their UAG performance from their current PC3 outturn values, whilst providing an achievable target. In addition, the target is a slightly more challenging one compared to the one place in for PC3. The CER is of the view that GNI’s performance over PC3 should not result in a stagnation of goals.
GNI stated that initiatives were being undertaken in PC3 to improve performance and over the course of PC4. If the PC4 review does not indicate an improvement towards PC2 outturn values, the CER will consider conducting a review of the initiatives being taken by GNI to reduce UAG.

<table>
<thead>
<tr>
<th>UAG</th>
<th>GNI initial proposal</th>
<th>CER Initial proposal</th>
<th>CER Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017/18</td>
<td>1.30%</td>
<td>0.75%</td>
<td>0.95%</td>
</tr>
<tr>
<td>2018/19</td>
<td>1.20%</td>
<td>0.70%</td>
<td>0.90%</td>
</tr>
<tr>
<td>2019/20</td>
<td>1.10%</td>
<td>0.65%</td>
<td>0.85%</td>
</tr>
<tr>
<td>2020/21</td>
<td>1.00%</td>
<td>0.60%</td>
<td>0.80%</td>
</tr>
<tr>
<td>2021/22</td>
<td>0.90%</td>
<td>0.55%</td>
<td>0.75%</td>
</tr>
<tr>
<td><strong>Total Cost €</strong></td>
<td><strong>21,342,414</strong></td>
<td><strong>12,627,612</strong></td>
<td><strong>17,638,625</strong></td>
</tr>
</tbody>
</table>

### 2.5.3 BGE Comment

**Opex Incentives**

BGE support the introduction of strong incentive mechanisms, however they believe that improvements could be made to deliver better efficiencies.

BGE stated that the effect of the proposed Opex incentive may encourage GNI to perform less efficiently, noting that without reference to outputs it is difficult to hold GNI accountable for their deliveries. BGE believe a more suitable approach would be to assess the outputs delivered against Opex savings to determine whether savings were made efficiently.

BGE is of the view that the Opex incentive is asymmetrically weighted to benefit GNI over customers. They noted that GNI is allowed to retain all savings made on any Opex under-sPENDs, while GNI can challenge the need to have made over-sPENDs which may ultimately be passed onto customers. To improve this asymmetry, BGE believe a 50% sharing factor should be made between GNI and consumers on any Opex under-sPENDs.
**Site Work Opex Costs**
To improve site work costs, BGE believe that a single one-off charge per site should be payable to GNI on those Siteworks categories commonly involving multiple sites visits.

**2.5.4 CER Response**

**Opex Incentives**
As previously mentioned in this paper there is a level of difficulty in equating Opex costs to individual outputs/deliverables as Opex allowances are intended to support investment programmes and cover the day-to-day running costs of the company, rather than being tied to individual projects.

The categorisation of the Opex incentive as being asymmetric is not entirely accurate. While Opex allowances may be revised for uncontrollable costs or additional activities, the CER does not permit overspends by GNI in Opex to be funded by the gas customer. A 50% sharing factor would represent a significant change in the approach by the CER and in the CER’s view lead to a weakening of the incentive whereby GNI are required to perform in line with the allowance.

**Site Work Opex Costs**
The CER recognises that given the nature of GNI’s business, a number of processes require site visits. Whilst the CER acknowledges that the efficiency of this process is of high importance to customers, given the nature of gas and the risks associated with it, the CER do not consider it appropriate to set a cap on the number of site visits. There may be valid reasons as to why a number of site visits have occurred such as inability to access a property. The CER is of the view that where GNI incurs a cost in attempting to access a site, GNI should be able to recoup the cost associated with such an attempt. A single one-off charge per site could potentially result in GNI and/or the wider customer base incurring costs through repeated site visit attempts.

**2.6 Capex**

**2.6.1 GNI Comment**
GNI expressed concern that significant reductions are proposed for Capex, especially for distribution refurbishment and connections. GNI stated that given the scale of reductions to the refurbishment allowance proposed, it is likely that there will be insufficient funding available within the overall allowance cap to accommodate any significant level of unplanned interventions or scope increases even through the reprioritisation of works.
In relation to Capex, GNI made a submission to the CER during the PC3 period to extend the network to Listowel, Co. Kerry and Foynes, Co. Limerick based on an estimate of costs. Since that time, the procurement process has been completed for the construction element of the distribution network. GNI stated that the projected final cost for the distribution element is now €17.4m, although construction risk remains and the final costs could still be higher. The CER proposed allowance for this project is €15.9m. GNI is strongly of the view that the allowance for this project, being based on actual market tested prices, should be provided in full.

2.6.2 CER Response

The Capex allowance set out by the CER reflects certain assumptions such as load growth and new connection numbers. Ultimately, it is the networks business’ responsibility to plan and develop the distribution system efficiently.

During PC4 it will be the responsibility of the networks business to determine which projects are to be progressed, what additional work in light of changing circumstances, not included in their initial submission, is necessary and efficient, and which projects will be deferred subject to the overall revenue cap. The outturn will be reviewed by the CER and only efficient and necessary capital expenditure will be added to the asset base. Notwithstanding this, as was the case in PC3, the CER has a procedure in place with GNI through which it may apply for necessary additional funding/revenue allowances for specific items.

Regarding the Listowel/Foynes requested allowance, GNI provided further information which assisted the CER in further understanding the nature of the cost breakdown and atypical costs associated with this project. The CER has decided to allow the full project costs of €17.39m to be included within the overall allowance. The PC4 portion of the Listowel/Foynes allowance now equals €11.59m compared to the original recommendation of €10.13m. The CER notes that although the allowance has been increased, the outturn will be reviewed as part of the normal Capex review process, which will take place during the PC5 determination, to ensure that the allowance has been spent efficiently.
2.7 Capex Incentives

2.7.1 GNI Comment

Unfinanced Overspend
GNI consider that there are two main issues in relation to the Capex incentive framework, which leads to asymmetric risks for GNI. GNI state that the CER proposal to finance over-spends for 5 years, regardless of when the overspend occurred, rather than from when the overspend actually occurred until the end of the price control period, doubles the penalty for unfinanced overspends which will inevitably impact the decision making process. GNI will be more reluctant to overspend an allowance and is likely to require interim decisions/rulings from the CER in order to have greater certainty on the subsequent regulatory treatment.

Clawback
GNI is of the view that ‘claw-backs’ associated with capital underspends, which the CER deem are not ‘efficiently’ deferred, should be calculated using Euribor plus 2% instead of the CER’s proposal of using GNI’s WACC as the interest rate.

GNI stated that in general terms the Capex incentive provides that where GNI is able to achieve savings compared to its projected investment allowances, it is allowed to earn the rate of return plus a depreciation payment of the expenditure saved. However, they stated that the methodology in the revenue model does not apply the incentive as described in the price control consultation papers, and weakens the incentive. GNI is of the view that the revenue model underestimates the incentive as the model first calculates a clawback of revenue arising from all underspend, with an interest charge applied, and then adds back the revenue earned on the underspend without adjusting for the interest charge contained within the clawback.

2.7.2 CER Response

Unfinanced Overspend
In the Consultation paper, the CER proposed to use a five year period because it creates symmetry with the efficiency incentive on underspends. As well as strengthening the efficiency incentives on GNI, a five year assumption creates a more symmetric risk share between GNI and customers.
Unfinanced Overspends occur in circumstances where GNI has gone over the budget on a project and, in the CER’s view although the work was necessary there is no justification for the allowed unit rate being exceeded. GNI is required to finance the revenue associated with this overspend.

The CER has reviewed the effects on revenue of the different Capex Incentives (i.e. Efficiency Savings, Efficient Deferrals and Unfinanced Overspend). Following this review, the CER has decided to keep the Unfinanced Overspend category as it was in PC3 (i.e. GNI will be required to finance the overspend from when it actually occurred until the end of the price control period which is on average two and a half years).

The aim of this incentive is to improve project budgeting and avoid overspends. The CER is of the view that the revenue at risk under the current methodology provides an appropriate weighting. Changing the incentive could create unintended consequences as highlighted by GNI. Due to the lack of evidence that the current methodology is deficient the CER has decided to keep the Unfinanced Overspend incentive as it was in PC3.

Clawback
From a technical perspective, the question around the correct discounting rate depends on how the money is used. If GNI is aware of the non-spend and have additional funds to use, the CER is of the view that it is reasonable to assume that this money will be used in place of other financing until it is repaid. This would indicate that the cost of capital is the correct term to discount back by.

CER note that in the event that GNI wish to avoid the application of the WACC discounting rate then it can return the unspent revenue during the price control. In addition GNI have the option to spend this revenue later in the price control period. Therefore the CER have decided that the cost of capital will continue to be used in the clawback methodology.

GNI’s view that the WACC discounting rate should also be applied to the efficiency incentives\(^1\) stems from their view of the clawback of total Capex underspend as a penalty. As stated the CER disagree and believe that this is the appropriate mechanism. However, in order to insure no

\(^1\) GNI mentioned only those related to underspend (i.e. Efficient Deferrals and Efficient Savings, not Unfinanced Overspend).
pervasive incentives were put in place from the perspective of GNI the CER carried out an analysis with the clawback of Capex underspends viewed as a negative revenue adjustment.

GNI states that the incentives are currently underweighted as the model first calculates a clawback of revenue arising from all underspend, with a WACC discounting rate, and then adds back the revenue earned on the underspend without adjusting for the WACC discounting rate contained within the clawback calculation.

The first point to raise is that the underspend resulting in a clawback and the underspends relating to efficiency incentives are not mutually exclusive. Unspent Capex allowances are clawed back at a total price control level, however efficiency savings are calculated on a project by project basis.

Secondly, the CER’s analysis indicates that even if the clawback is viewed as a negative adjustment and the efficiency incentive as positive adjustment, their combination tends to result in an overall positive adjustment for GNI the vast majority of the time[2]. Therefore the suggestion that GNI could be incentivised to incur Capex in order to avoid the clawback from a wholly revenue based perspective seems unlikely. This is compounded by the fact that any Capex incurred is reviewed as part of the price control process.

2.7.3 BGE Comment

Capex/Opex Incentive Misbalance

BGE believe that the manner in which the incentives are structured means that the benefits of making Opex savings greatly outweighs the benefits of making Capex savings. They noted that GNI is allowed to retain all Opex savings but they can only retain a percentage of Capex savings (and only for a period of five years). BGE is concerned that this asymmetry may encourage GNI to report Capex costs as Opex costs, which hampers transparency and creates inefficiencies in the Price Control process.

[2] There were some instances early in a price control period where an underspend that was also an efficient deferral resulted in an overall negative revenue adjustment when the deferred spend had a lengthy asset life. In the rare case that this occurs, as stated earlier, there is no reason why GNI cannot return any non-spend over the course of the price control and as a result avoid the full WACC discount rate being applied.
BGE noted that similar to Opex incentives, there exists an asymmetric reward/penalty for Capex which ultimately benefits GNI over consumers. They stated that if GNI overspend in any Capex projects, they are given the opportunity to justify this spend and may be compensated, which will be paid for by the consumer. BGE believe a 50/50 sharing factor would be a fairer approach to managing under or over-sPENDs.

**Capex Monitoring Programme**

BGE agrees with the CER that a Capex Monitoring Programme report should be developed for GNI which would detail all capital-related projects, their expected expenditure and timelines. BGE suggested that to aid transparency, this report should be open to industry for review.

**2.7.4 CER Response**

**Capex/Opex Incentive Misbalance**

The categorisation of Capex as an asymmetric incentive is not entirely accurate. Opex overspends are not funded by consumers unless an allowance is made for uncontrollable costs or additional activities. A 50% sharing factor would represent a significant change in approach from the CER and would weaken the incentive for GNI to perform in line with the budget.

**Capex Monitoring Programme**

The CER note BGE's agreement that a Capex Monitoring Programme report should be developed. The CER will consider the option of developing a Capex Monitoring Programme. As stated in earlier in this paper, the CER has decided that GNI will be required to provide a report as a key part of its submission for the PC5 review that details its record of performance and delivery against the programmes and initiatives that constituted its PC4 business plan. This should include a detailed analysis of how outturn volumes of work and delivered programmes specifically compare to the business plan that GNI submitted for the PC4 review and how GNI considers it has met the proposed commitments during PC4 and improved the performance of its network.
2.8 Corrib Capex

2.8.1 GNI Comment

For the PC4 period GNI requested an allowance for the installation of gas quality monitoring equipment associated with the Corrib Linkline. The two initiatives are to install moisture (measuring high dew point) detection on the Corrib Linkline and gas quality (measuring Calorific Value (CV) and Specific Gravity (SG) monitoring stations in strategic locations.

GNI pointed out that during commissioning there were several recordings of off-specification gas (high dew point) in the Corrib Linkline. The current moisture detection system in the Corrib terminal is not being fed back to GNI Supervisory Control and Data Acquisition (SCADA) and therefore is not visible to GNI. The installation of an online chilled mirror device on the Corrib Linkline (at Moneynierin) would provide continuous monitoring of the gas supply, enabling GNI to protect the network from contamination. The estimated cost of the initiative is €500k.

In addition, GNI stated that there is a difference in the CV (energy per m³) between Corrib and Moffat gas. There are two different tiers of metering systems utilised on the network. For larger users the volume is multiplied by the CV as measured on site by specific local analysers. For smaller users (the majority) the volume consumed is multiplied by an estimated CV based on the region or zone of the network. Following the introduction of Corrib gas to the gas network, and in particular to accommodate the variation of CV, GNI increased the number of measurement zones to 15. At locations on the network where the gases mix and it is not possible to accurately determine the source of gas at these locations with the current level of measurement. GNI outline that due to the difference of the gas CV at these locations, the risk of errors in metering is increased. With the introduction of the SG and CV analysers at these key locations, an accurate determination of the gas quality (CV) can be made. GNI estimate the cost of the initiative to be €500k.

2.8.2 CER Response

With regard to the dew point detector, the CER is of the view that there is a clear benefit for GNI to be aware immediately of hydrocarbon dew point excursions but rather than the installation of additional equipment it would seem more efficient if the current detection system in the Corrib
terminal is fed back to GNI via their SCADA system, which is currently not the case. In the interest of controlling costs for gas customers and for the wider gas industry, the CER encourages GNI to seek such online data from the Corrib operator. The CER has decided not to allow expenditure for the online chilled mirror device at this time until the outcome of any discussions with the Corrib operator are finalised.

GNI originally requested an allowance for gas quality monitoring on the Corrib Linkline. There was no description or rationale provided for this item and therefore the CER granted no allowance in the consultation document. GNI has since provided further information on this work. The CER is of the view that due to the different CVs of gas from Corrib and Moffatt and a variable interface depending on the flows from these sources, it is reasonable to expect a benefit to accrue from more accurate energy flow metering at appropriate locations. The CER has decided to allow GNI €500k for this initiative. However, the CER has decided that this spend should be added to the RAB of the transmission system rather than being included in the Linkline operational costs as it provides a benefit to the gas consumer. The CER will review this cost for efficiency as part of the PC5 lookback.

2.9 Output Incentives

2.9.1 GNI Comment

GNI questioned the design of the connections incentive which is based upon meter fits rather than new connection units. They stated that the incentive targets the housing sector rather than the broader domestic sector which would include apartments. GNI requested that the CER also review the incentive floor which appears to be calculated incorrectly as €27,290 when it should be €36,290.

2.9.2 CER Response

The CER agrees that having the incentive based on meter fits would not provide an incentive to connect a multi-occupancy building. The CER has revised the connections incentive to include an
incentive to connect multi-occupancy building. However, the CER expects that such a building would be cheaper on a unit cost basis than single occupancy housing.\(^4\)

Therefore, the CER has separated the domestic connections into two separate categories for the proposed incentive. The operation of the I&C connection incentive remains unchanged. The CER has kept the same revenue at risk for GNI i.e. €4.1m as the maximum potential reward and €4.1m as the maximum potential penalty.

**Figure 2.5: Incentives around connections**

<table>
<thead>
<tr>
<th></th>
<th>I&amp;C</th>
<th>New Housing</th>
<th>New Apartments</th>
</tr>
</thead>
<tbody>
<tr>
<td>PC4 BAU Target</td>
<td>3,475</td>
<td>62,264</td>
<td>59</td>
</tr>
<tr>
<td>Cap</td>
<td>7,000</td>
<td>90,000</td>
<td>76</td>
</tr>
<tr>
<td>Floor</td>
<td>0</td>
<td>34,529</td>
<td>41</td>
</tr>
<tr>
<td>Incentive rate/ connection</td>
<td>€160</td>
<td>€125</td>
<td>€425</td>
</tr>
<tr>
<td>Maximum reward/ penalty</td>
<td>€0.60m</td>
<td>€3.47m</td>
<td>€0.01m</td>
</tr>
</tbody>
</table>

The CER would like to clarify that there was an error in the original calculation for the incentive for domestic connections and the incentive floor of €36,290 is correct. This has been amended in the final decision document.

**2.9.3 BGE Comment**

**Growth Incentives**

As a supplier, BGE encourages expansion of the network in the interests of reducing costs on a per customer basis, however they believe that the incentive mechanism could be improved by sharing the reward with customers in a way that would encourage further customer growth. BGE is of the view that the incentive payment to GNI’s total revenue should go towards a dedicated fund within GNI that contributes to the cost of connecting gas customers.

**Customer Service Incentive**

BGE disagrees with the proposals to apply a 3-year ‘shadow incentive’ to customer service performance as it is an unnecessarily long duration and encourages GNI to hold back on improving

\(^4\) Refer to Section 7.1.1 and 8.2 of the PC4 Distribution Decision paper for further detail.
their customer service experience. At most, BGE suggested that GNI should be tested on 12 months (i.e. until April 2018) with financial incentives applying thereafter.

**2.9.4 Comment**

One respondent stated that they support the application of the incentive mechanism related to the ambitious targets for new connections and agree that GNI should not get additional revenues unless the growth in connections is achieved.

**2.9.5 CER Response**

The purpose of the ‘shadow incentive’ is to allow the CER time to test and monitor the proposed metrics and develop a baseline of GNI’s performance in the PC4 environment. The CER is minded to sense check GNI’s performance relative to GB GDN’s performance. The CER is of the view that reducing the shadow incentive to a period of 12 months would not give the CER sufficient time to reflect on comparative performance. Therefore, the CER has decided to apply the shadow incentive for a period of 24 months.

**2.10 Efficiency Targets**

**2.10.1 GNI Comment**

**Catch up efficiency**

GNI raised objection to the CER’s proposal to implement a 0.75% per annum compounding catch up efficiency target. GNI stated that they cannot accept the CER’s assertion that GNI is inefficient due to uncertainty in benchmarking results and comparability of approach and transparency. GNI commissioned Frontier Economics to benchmark its distribution business and Frontier’s analysis has consistently found GNI to be efficient.

Without access to CEPA’s data, Frontier are unable to fully test what is driving these differences. As such, GNI maintains the view that the lack of transparency in the benchmarking process increases the uncertainty of the CER’s benchmarking results.
Ongoing efficiency
GNI in their submission stated that the total factor productivity analysis carried out by the CER and its advisors appears to be based on (1) CER precedent adopted for Gas Networks Ireland at the PC3 review; and (2) evidence from Ofgem and Ofwat on productivity gains in their sectors. GNI raised concern regarding the ongoing efficiency target for GNI of 1% per annum, stating that it should be re-evaluated to take account of updated data in relation to productivity levels and increasing cost pressures in Ireland. GNI also noted that CEPA rely on Irish KLEMS data for the period 1998-2007 to determine average annual growth rates for economy wide and sectoral productivity. GNI is of the view that given the most recent KLEMS data available is 10 years old, it no longer an accurate indicator of the current Irish economy. GNI also state that CEPA’s implicit Real Price Effect (RPE) appears implausibly low.

2.10.2 CER Comment

Catch up efficiency
The CER recognise that there are differences in opinion between the economic consultants employed by GNI and the CER’s consultants. However, following further discussions between the parties, the CER is confident that, the approach taken by CEPA and the data used in the analysis is robust and appropriate. The CER has decided that an annual catch-up efficiency target of 0.75% as proposed in the consultation paper will be applied to the GNI distribution business.

The CER notes that the use of top-down benchmarking is important in light of cost reporting changes from GNI and limitations of trend analysis. This is due to the changes in the organisational structure for GNI and the Ervia Group. The purpose of the catch-up efficiency challenge is to encourage GNI to make savings beyond those included in frontier shift. The CER notes that there is scope for improvement in the GNI distribution business with the initiatives conducted over PC3 and expected in PC4. There are also a number of initiatives for GNI to pursue efficiency savings for the business.

As outlined in the Distribution Consultation Paper, the CER and its advisors have adopted a conservative approach to the benchmarking, as outlined by some of the following factors:

- **use of average efficiency benchmark** – if the upper quartile (as per Ofgem and Ofwat) rather than average efficiency benchmark had been used, the efficiency gap would have been 14%; the impact of this would have been to triple the catch-up efficiency factor used;
• **inclusion of GNI in the sample** – exclusion of GNI from the sample would have significantly increased the size of the efficiency gap, as reflected in one of our sensitivities;

• **use of most conservative model specification** – the most conservative model out of the original three models was utilised for our baseline results; and

• **use of annual catch-up factor** – this acts as something of a glide path as GNI are not required to have allowances equivalent to the assumed efficient company immediately.

In addition, the CER and its advisors have conducted a number of sensitivities to ensure that the results are robust. Information on the assumptions taken on the benchmarking approach are considered in Section 4.3.2 of the Distribution Decision Paper and it is clear that the approach taken includes a degree of caution.

**Ongoing efficiency**

The arguments and evidence presented by GNI and Frontier Economics do not change the CER’s view that a 1.0% ongoing efficiency factor, which takes into account expected cost pressures (e.g. labour and business services such as insurance) faced by GNI during the forthcoming price control, is an appropriate assumption for PC4.

Evidence quoted as regulatory precedent in the CER and its advisors’ analysis drew from recent price control decisions in the Ireland (including GNI PC3) and the UK.

The EU KLEMS data set was used to develop historical evidence of productivity growth within individual sectors of the Irish economy. The KLEMS data set measures the contributions of capital (K), labour (L), energy (E), material inputs (M) and services (S) to gross output growth. The CER and its advisors use KLEMS as this represents a reputable source used in regulatory precedent in both Ireland and the UK. The absence of data post-2007 is an issue if there has been a structural break leading to a lower level of productivity. There has not been a clear case presented of a structural break.

When estimating a productivity growth benchmark using historical information, a key decision is the time period of data that is used. Productivity is a highly cyclical variable, which will show marked variation over the economic cycle as well as differences across economic cycles. It is
standard practice to consider TFP growth over complete economic cycles.\textsuperscript{5} The CER and its advisors consider it appropriate to use a full economic cycle to capture performance in upturns and in downturns. As the last full economic cycle ended in 2007, this is where our data concludes. This provides predictability and transparency from a regulatory perspective if a longer term time horizon is considered, rather than placing more weight on more recent years.

The CER and its advisors original analysis included both partial productivity measures as well as total factor productivity analysis. Value added and gross output measures were also considered to present a range of evidence. The Frontier Economics approach centres on one data series which indicates that an ongoing efficiency factor of at least 0.5% should be applied.

The CER and its advisors analysis did find that a GNI-specific weighting of inputs, based on GNI’s BPQ submission, would lead to higher productivity growth assumptions than the economy on the whole.

\textbf{Table 2.1: Average annual growth rates for productivity measures from EU KLEMS (1988 - 2007)}

<table>
<thead>
<tr>
<th></th>
<th>TFP (VA)</th>
<th>TFP (GO)</th>
<th>LP (VA), constant capital</th>
<th>L&amp;IIP (GO), constant capital</th>
<th>L&amp;IIP (GO), variable capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>All industries</td>
<td>1.1%</td>
<td>0.5%</td>
<td>2.1%</td>
<td>0.6%</td>
<td>0.5%</td>
</tr>
<tr>
<td>GNI-specific weighting\textsuperscript{6}</td>
<td>2.0%</td>
<td>0.8%</td>
<td>3.6%</td>
<td>1.0%</td>
<td>0.6%</td>
</tr>
</tbody>
</table>

The CER is setting an ongoing efficiency assumption for GNI. With an allowance provided for initiatives such as the introduction and ongoing rollout of new asset management systems (HPUM\textsuperscript{7}) and proposed increases in IT investment during PC4. Continued productivity improvements might be expected over time from GNI’s operating cost base, to ensure that gas customers benefit from funding this investment. Arguably the company structure following the merger with Irish Water should also permit further efficiencies to be achieved. The point to note, is that without delving too deeply into GNI’s business model and operations that are practical


\textsuperscript{7} High Performance Utility Model
reasons to believe that opportunities for further ongoing efficiency gains should be achievable through new technologies and work processes over PC4.

In their Business Planning Questionnaire (BPQ) submission, GNI did not include an explicit Real Price Effect (RPE), instead choosing to incorporate this into their cost estimates (with an ongoing efficiency assumption modelled separately). The bottom up approach used by the CER and its advisors considered the overall GNI costs and so cost increases above Harmonised Index of Consumer Prices (HICP) inflation would have been in the data being assessed. If the CER was to add an RPE on top of the proposed allowances, there would be a risk of double counting.

2.10.3  **Comment**

Two respondents were of the view that the 0.75% ‘catch-up’ efficiency applied to the Distribution business should also be applied to the Transmission business.

2.10.4  **CER Comment**

The CER and its consultants have considered whether to apply the catch-up efficiency to the transmission business; however we have not been able to benchmark transmission and do not consider it appropriate to do so for PC4.

2.11 **Weighted Average Cost of Capital (WACC)**

2.11.1  **GNI Comment**

GNI welcomes the CER’s approach to the WACC in being mindful of regulatory precedent and stability, it nevertheless has a number of concerns about the CER’s proposals. GNI stated that the CER’s proposed cost of debt is significantly below the long-term cost of debt. Frontier’s cross-check suggests a long-term average cost of debt of c.2.9%, which is in line with their point estimate, and significantly higher than the 2.5% proposed by the CER.

GNI stated that the CER’s proposed Cost of Equity is below GNI’s estimate, resulting from a lower asset beta. GNI disagree with FTI’s approach, which excludes SSE from the basket of comparator utilities used to benchmark GNI’s asset beta.

GNI noted the CER’s failure to include an aiming up allowance, despite providing such an allowance for Irish Water and ESB Networks. In addition, GNI stated that the CER has not made
any provision to take account of the risks that may arise from Brexit or other significant macro events. GNI is concerned that such events could lead to significant increases in sovereign risk, with consequent impacts on GNI’s financing position. They stated that if Brexit (or any other market shock) were to have significant impacts, these would need to be addressed through a re-opening of the price control settlement.

2.11.2 BGE Comment

BGE is of the view that the aiming up allowance should not be included in the WACC calculation. BGE believe this is an inefficient process which adds costs to consumers. They noted that if the CER’s initial WACC calculations become inaccurate during the PC4 process, a review of the figures could be made after Year 3.

2.11.3 CER Response

In relation to the cost of debt, GNI advances no new arguments in this regard. CER’s financial consultants (FTI) included a discussion of the Frontier “cross-check” of the long term cost of debt in paragraphs 4.31 to 4.40 of their report (CER/17/132). This section of the report explains why the CER and its advisors do not agree with Frontier Economic’s cross-check of the long-term cost of debt. Essentially the period over which Frontier Economics calculates the average cost of debt encompasses the Eurozone financial crisis which has the effect of adding a “crisis premium” to the estimated historical cost of debt. In addition Figure 4-9 in the FTI report highlights that Ofgem’s index for the cost of debt, which is based on a long run average, is below 2.9%.

Regarding the equity beta, GNI again advances no new arguments. FTI explained in paragraphs 5.39 to 5.42 of their report (CER/17/132) that SSE are not considered a good comparator. This is due to the business having significant unregulated activities which expose it to greater market risk and in turn a larger asset beta.

GNI also does not raise any new points in relation to “aiming up”. In fact GNI seems to adopt a slightly different position to previous submissions. As noted in paragraph 7.7 of the FTI report, Frontier Economics on behalf of GNI stated (emphasis added):

“[T]he CER should either implement a specific aiming up allowance, or use point estimates towards the high end of the range for the various WACC parameters.”
The CER has decided to adopt a point estimate toward the higher end of its range. In addition BGE are in agreement with the CER that an explicit aiming-up allowance should not be included in the WACC calculation.

For the reasons set out in paragraphs 7.29 to 7.38 of the FTI report, CER do not agree that the risks (Brexit or other significant macro events) described qualitatively by GNI provide a strong justification for a higher cost of capital. As stated in paragraph 7.37, it is unclear ex ante what the scale and impact of any possible future exceptional market conditions might be, so it is not possible to determine an appropriate adjustment ex ante.

The CER note both GNI’s and BGE’s comments regarding a re-opening of the WACC. Only in the most exceptional circumstances would a re-examination of the WACC be considered.

2.11.4 Comment

A respondent expressed concern over what he states as the generation of inflated estimates of the cost of capital. The respondent stated that under the current proposals for the WACC, it is assumed that the debt beta is zero, which generates an overestimate of the equity beta and an excessively high cost of equity. He stated that the result is an estimate of the cost of capital of 4.63% when the actual cost is likely to be closer to 4%.

2.11.5 CER Response

With regard to the respondent’s implicit calculation of the impact of the debt beta (as described further below), the CER considers that:

- i) the impact appears to be in the wrong direction; and
- ii) the impact appears to be too large.

In respect of (i): the logic is that, if you assume that the required return on debt includes a degree of systematic risk, then the asset beta (which measures the systematic risk of the underlying business) is the sum of the debt and equity betas, weighted according to gearing (i.e. the shares of debt and equity in the capital structure). Therefore if the CER were to assume a positive (as opposed to zero) debt beta the result would imply a higher cost of equity, all else being equal.

With regard to (ii), as an example, the Competition Commission in GB examined the impact of the debt beta in its 2014 final determination on the Northern Ireland Electricity appeal and adopted a
debt beta of 0.1 on the basis that it had little impact. In footnote 5 to its final determination it concluded:

“We have assumed a level of 0.1, but results do not tend to be sensitive to the level of debt beta. In light of this, we did not carry out work to assess the level of NIE’s debt beta.”

It is important to appreciate that debt beta cannot be measured directly in the same way as the equity beta. The Sudarsanam et al. survey of international regulatory practice cited in the FTI report considers that this may be why it is common regulatory practice to assume the debt beta is zero. In a footnote, Sudarsanam et al. explain that:

“While the estimation of equity beta using time series regression models is now standard and estimation of debt beta can be based on a similar methodology, in practice, absence of traded debt often makes regression-based estimation unsatisfactory.”

They note that assuming a zero debt beta:

“…perhaps has more to do with the difficulties in reliably estimating debt beta than with the inherent validity of the view that debt has no systematic risk. Here regulators may balance the lack of realism of this assumption against the reliability of debt beta estimates.”

The CER is of the view that the approach outlined in the consultation paper is appropriate.
2.12 Innovation Funding

2.12.1 **GNI Comment**

In their response, GNI outlined that the lack of Capex allowances for renewable gas injection facilities seems contrary to the objective of the proposed renewable gas connection policy, which they are currently working on with the CER. GNI believes a Capex allowance aligned to the proposed renewable gas connection policy is essential in PC4. GNI is concerned that this sends a negative message to customers looking for renewable gas and to potential renewable gas producers. Therefore, GNI is requesting €8.5m for five installations.

GNI welcomes the innovation fund of €17.5m for the PC4 period. However, they stated that the majority of this fund (€12.83m) is dedicated to the Causeway Study on the impact of CNG on the natural gas network. They outline that only €3.17m of this fund can be allocated to strategic projects. GNI believes that this falls short of amount necessary to undertake demonstration or pilot projects in the following areas which have significant potential in the medium term. GNI welcomes the €1m for research but believes this is insufficient. GNI state that gas research plays a vital role in advancing development of current and new technologies. Moreover, in the context of meeting a least cost transition to a low carbon future, gas research provides a critical input into energy policy. GNI asked that the CER reconsider the allowance provided for innovation funding.

2.12.2 **Comment**

The Gas Innovation Group expressed their support for the inclusion of innovation funding for the price control period, stating that to date the innovation fund has supported a wide range of activities. However, the respondent pointed out that given PC4 proposed funding is largely allocated to CNG, they would welcome an increased level of innovation funding to enable the greater roll out of new innovative technologies.

2.12.3 **CER Response**

Taking into account GNI’s response and recognising that continued utilisation of the gas network is essential to help contain tariffs for gas customers, the CER has decided to allow GNI an
innovation fund of up to €20.0m for PC4. The CER also notes the White Paper,\(^8\) and is of the view that an innovation fund of up to €20.0m is appropriate as Ireland moves to decarbonise the economy. The CER is initially awarding GNI €17.5m for innovation, with a further €2.5m potentially available to GNI. The CER will make a final decision on the allocation of the additional €2.5m at a later date in PC4. The decision to release/or not release the additional €2.5m will be informed by the outcomes and outputs of GNI and the Gas Innovation Group throughout PC4. These outputs and outcomes will be monitored via innovation reports which are detailed below. The €20.0m is inclusive of the €12.83m awarded as part of the Causeway Study decision.

The CER is of the view that it is important for GNI to continue to explore other types of technologies through the operation of the Gas Innovation Group which was established during PC3. The CER will seek regular reports from GNI over the course of PC4 on the outputs from the various studies and the benefits to gas customers.

GNI also submitted separate Capex requests for both CNG and biomethane. Regarding biomethane, the CER disagrees with GNI’s view that a lack of Capex funding is contrary to the objective of the proposed biomethane connections policy. The CER note that the biomethane connections policy has not yet been consulted upon and hence the CER disagrees with GNI’s view as no objective has been established as of yet.

GNI also sought additional funding for the roll out of CNG stations in the period following the conclusion of the Causeway Study. Unless GNI is able to provide exceptional rationale for additional CNG infrastructure, the CER will wait until the conclusion of the Causeway Study to determine the effects of CNG on the natural gas grid prior to making any decision on additional CNG infrastructure.

An innovation allowance of up to €20.0m will provide GNI with the ability to examine alternative uses for the natural gas grid as Ireland moves to a decarbonised economy by 2050. The CER has advised GNI that the use of the innovation allowance is to leverage, rather than fully fund, innovation projects and that GNI should be more proactive in securing funding from other sources.

It will be the responsibility of both GNI and the Gas Innovation Group to determine the best possible use of the innovation funding. Applications for funding submitted to the Gas Innovation Group will demonstrate the potential to achieve the following:

- Will deliver significant carbon savings;
- Increase throughput through the gas system;
- Assists in the transition to a low carbon economy; and
- Provide measurable value to all gas customers.

Decisions for funding approved by the Gas Innovation Group shall state measurable outputs and outcomes for the projects. This outputs and expected outcomes will be detailed in an “Innovation Awarding Report” which will be prepared by the Gas Innovation Group following the awarding of funding for an innovation project. These awarding reports will be circulated to the CER for information purposes. The awarding reports will assist the CER in assessing the performance of innovation projects throughout PC4 and will assist the CER when deciding whether that additional funding of €2.5m represents a good investment for all gas customers.

The CER will ensure that GNI report bi-annually on the outputs and outcomes of the innovation funding. These reports will include a mid-year report submitted to the CER by 30 June of each year and an end of year annual report submitted to the CER by 30 November each year. The Gas Innovation Group will present to the CER on both of these reports. The CER will review these reports to ensure that the aims stated by the Gas Innovation Group in their decision to award funding are being met. The annual reports will be published on GNI’s website. In addition, where the Gas Innovation Group awards funding for research purposes the results of such research will also be published GNI’s website. These should be reported on in the subsequent innovation reports with the outputs and outcomes informing any further innovation funds in later price controls.
2.13 Independent Transmission Operator (ITO) Costs

2.13.1 **GNI Comment**

GNI is of the view that the disallowance by the CER of the ITO costs would be wholly unfair and unreasonable. GNI outlined that the CER previously assessed the necessity and efficiency of the ITO related costs with full knowledge that the sale of BGE was intended and determined that the ITO costs would be added to the Regulated Asset Base (RAB). The decision to sell BGE was taken in February 2012 and despite this knowledge the CER required Ervia to continue to incur ITO setup costs, notwithstanding the CER was aware that the ongoing sale process would achieve compliance with the unbundling requirements of the Directive.17.

In addition GNI also outlined that the CER wrote to Ervia and confirmed it would “certify BGE as an ITO, subject to the completion of all outstanding ITO work items identified within the specified timeline” (emphasis added). The outstanding ITO work detailed in this letter was the following:

- “full separation of IT and telephony systems;
- identifying separate auditors for BGE and BGE ITO;
- defining a rebranding process from July 2013 to December 2013, which is to be implemented in January to March 2014; and
- incorporating BGE ITO, appointment of a management and supervisory board and implementation of transfer plans, which are to be achieved in February and March 2014”.

There was no suggestion in this letter that costs associated with these work items would not be recoverable, or that there was any change in the basis of the allowance provided in the PC3 Decision Papers. GNI is strongly of the view that it is inappropriate that this expenditure now be written off. The CER wished the ITO model to be in place as a back-up in the event that the sales process was not finalised or was significantly delayed. It is therefore unreasonable for the CER to then require GNI to face the cost burden of such a backup arrangement.

GNI understand that the intent of the retrospective write off of ITO costs is not to ‘strand’ these assets per se. GNI understands the CER believes that Ervia/GNI has recovered the value of these costs already and so the intent would be to avoid a double recovery. However, for this to be the case, it would necessitate that the costs of separation were indeed recovered by the sale process.
2.13.2 CER Response

The unbundling of the supply and networks activities of Ervia (then called Bord Gáis Éireann) was necessary at the time in order to ensure compliance with the requirements of Directive 2009/73/EC. To this end, an initial decision was taken by the then Minister for Communications Energy and Natural Resources to opt for the creation of an ITO business, which required the separation of a number of functions within BGE, as described above in GNI’s response. A further decision was taken by the Irish Government to sell the supply business arm of BGE and in doing so obviated the need for the ITO business to be created. Nevertheless, although the ITO business was never fully established, the CER is of the view that the separation of the functions as described above to create the ITO business facilitated the sale of BGE (the supply business).

Put simply, the buyer of the seller of BGE would have been required to carry out this separation costs. It is therefore reasonable to assume that the work carried out to separate the network functions had a value which would have been realised in the sale price of BGE.

The CER is of the view that the money to create the ITO business, which was placed on the RAB, has been the subject of a disposal and therefore should be treated as such. The CER will allow GNI to recover the revenues up to the year of sale of BGE (2014) and will not allow GNI to recover the costs beyond that date.

2.14 Supplier of Last Resort

2.14.1 BGE Comment

BGE noted that there has been no reference made to Supplier of Last Resort (SOLR) under any of the recovery headings. Understanding that monies are needed to fund this service provision, BGE requested that the CER include them within the overall revenue allowances when finalising PC4.

2.14.2 CER Response

If the CER allow an annual cost for SOLR, the CER will allow GNI to treat this cost as a 100 per cent pass-through cost, which will recoverd through the annual tariff setting process. If costs arise
in a SOLR event which are to be recovered through Transmission and Distribution this will be treated as a pass-through. If these costs are large enough to cause financing costs/cashflow issues for GNI then an appropriate response will be made for example mid-year tariff review.
2.15 South West Scotland Onshore System (SWSOS)

2.15.1 Comment

The Scottish Environment Protection Agency (SEPA) welcomed the proposed increase in the Capex programme in PC4 in order to address issues associated with an ageing asset base and environmental/compliance requirements and requested clarification of the following issues:

- An indication of the individual initiatives / improvement works (relating to environmental considerations) to be progressed as part of the proposed capital expenditure allowance for the two compressor stations in the SWSOS; and
- An indication of the initiatives or upgrade programmes related to environmental considerations disallowed by the CER that have led to the shortfall in the requested Capex funding of €2.1million.

2.15.2 CER Response

The CER request that GNI engage with SEPA with the aim of providing them with the requested detail. In addition the CER note that the reduction in Capex funding referred to by SEPA does not affect any environmental related expenditure.

The CER welcome the response from SEPA. The CER note the importance of GNI updating other agencies as to their plans for GB infrastructure. The CER is of the view that the allowance is appropriate.

2.16 Network Tariffs

One respondent raised comments regarding the CER’s review of the tariff methodology and compliance under Regulation 2017/460.

Irish Offshore Operators Association (IOOA) noted that in previous years the annual tariffs and assumptions used to determine the tariffs were published on a draft basis to allow industry to comment. The respondent requested that the CER revisit this approach again to ensure that GNI do not make incorrect assumptions in determining the tariffs.
IOOA noted that due to the twinning project transmission tariffs are higher than they should be.

### 2.16.1 CER Response

The CER notes the comments above, however as the comments relate to the annual tariff setting process which is outside the scope of this paper. The CER will engage directly with IOOA on the matters raised.

### 2.17 Asset Depreciation

#### 2.17.1 Comment

One respondent noted that straight line depreciation is used to depreciate an asset and if that asset continues to operate after it is fully depreciated that GNI receive no return on that asset. The respondent expressed concern that this may create a perverse incentive in which GNI will always replace assets (e.g. equipment with a depreciation period of five years) in the year after the asset is fully depreciated even though the asset may still be fit for purpose and continued operation after the depreciation period.

#### 2.17.2 CER Response

This is present in all determinations. The technical ex-ante review at the time of the price control acts against any such incentive (if one exists) through scrutiny of the business plan and needs case. In simple terms, the CER would not envisage approving the replacement of functioning equipment just because it has been fully depreciated.

#### 2.17.3 Comment

Vermillion support the IOOA response and requested a simple calculation example regarding the potential double return for GNI on Capex.

Vermillion also queried the increased costs (from €1.7m to circa €3m) associated with the operation of the Corrib Linkline.

#### 2.17.4 CER Response

The CER note that this issue was raised by IOOA directly with the CER during the consultation process and before the closing date for all responses to the consultation. In response the CER
provided a worked example to IOOA and are happy to assist with any further queries. The CER is satisfied that the model and decision paper clearly sets out how revenue on Capex is earned by GNI.

The initial figure for the operational costs associated with the CorribLinke was an estimate, the actual outturn figures have been evaluated and reviewed by the CER and its advisors and have been deemed as necessary expenditure. The CER has updated future forecast expenditure to reflect the actual outturn figures.

3 Conclusion

The CER received a total of seven responses to the PC4 consultation. Having reviewed all the responses received, and having considered the issues raised, the CER has today published its final decision on GNI's allowed revenue for both transmission and distribution over the course of PC4. The Decision Paper will provide clarity on many of the issues raised in the consultation process and in addition this document has attempted to address directly the main issues raised in the consultation responses received.