Ms. Sarah Mac Cauley and Mr. Daniel Ward,
Commission for Energy Regulation,
The Exchange,
Belgard Square North,
Tallaght,
Dublin 24

28th July 2017

Dear Sarah, Daniel,

Re: Consultation on October 2017 to September 2022 Distribution Revenue for Gas Networks Ireland (CER/17/127) and Consultation on October 2017 to September 2022 Transmission Revenue for Gas Networks Ireland (CER/17/128)

Bord Gáis Energy (BGE) welcomes this opportunity to respond to the Commission for Energy Regulation’s (CER’s) Consultation on the fourth Price Control (PC4) review of Gas Network Ireland’s (GNI’s) Transmission and Distribution revenues for the period October 2017 to September 2022. We remain committed to engaging in the PC4 process to ensure our customers receive value for money. This response is a collective of our views to both the Transmission and Distribution PC4 revenue consultations.

Network costs are a significant component of a customer’s gas bill and as a supplier in the market who ultimately takes accountability for the charges faced by customers, we are concerned that the amount of information provided in the PC4 Consultation papers makes it difficult to understand the rationale for the significant increase in certain costs between PC3 and PC4. While some increases are understandably being driven by GNI’s ‘growing trend’, we do not consider this an appropriate justification for all revenue increases. Going forward, we believe that more detailed information and rationale around planned expenditures (both operational expenditure (Opex) and capital expenditure (Capex)), in the 5-year price control review processes and also in the annual reports for setting annual Transmission and Distribution tariffs should be provided. This greater transparency will enable interested stakeholders to be more constructively involved in the governance process and should ultimately improve the efficiency of costs incurred by the network operators.

We appreciate that as part of an expanding business, it is not unusual to expect that GNI will incur higher Opex and Capex costs. However, to ensure that these higher costs are managed effectively, we support the identification and introduction of strong incentive mechanisms to ensure costs are incurred as efficiently as possible and that the balance between higher consumer costs and network expansion is optimised. Whilst BGE is supportive of the introduction of the incentive mechanisms proposed for PC4, we believe they could be further improved to deliver better efficiencies. We are concerned that some of the incentives proposed are either too broad, asymmetric, or in some instances may even encourage inefficient operation. For example, we believe the customer service incentive should be restructured, further detail of which we include below.

We are also concerned that some of the proposed Opex incentives are designed to reward GNI purely on savings made rather than a combination of savings and outputs delivered. BGE suggests that a more suitable approach would be to assess the outputs delivered against the Opex savings to determine whether or not they were made efficiently.

In terms of incentivising GNI to increase their growth rate, BGE is supportive of this. However, we believe this incentive mechanism could be improved by structuring it so that the reward is shared with customers which would in turn encourage further customer growth and we have included some suggestions in this regard below.
In summary, BGE’s main concerns relate to some of the proposed incentives and to the level of transparency provided in respect of Opex costs which has made it difficult to assess the reasonableness or otherwise of the related increases. While we understand a growing business will incur higher operating costs, we believe that more detailed information/ rationale should be provided to justify such increased costs.

Recognising how important it is that GNI is appropriately, but not over-rewarded and that customers do not over-pay, we believe that the design of the incentive mechanisms could be improved to encourage better performance from GNI and ultimately prevent consumer costs from increasing inefficiently. We discuss these issues and provide further comment in the main body of our response overleaf.

If you have any queries on anything provided in this response, please do not hesitate to contact at any time.

Sincere regards,

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Brian Larkin
Regulatory Affairs - Commercial
Bord Gáis Energy

(By e-mail)
1. **Opex costs**

As previously mentioned, network costs are a significant component of a customer’s gas bill and as a supplier in the market who ultimately takes accountability for the charges faced by customers, we are concerned 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. While increases are understandably being driven by GNI’s ‘growing trend’, we do not consider this an appropriate justification for all revenue increases.

Looking at the cost analysis provided in PC4, we believe that greater transparency and provision of much more detailed information is necessary in the future to enable interested stakeholders to fully understand the rationale for cost levels. There are numerous examples in Opex costs where large revenue increases are being provided with little justification as detailed below:

1.1. **Operations Opex**

According to the Consultation papers, Operations Opex costs are increasing by 10% and 19% in the Transmission and Distribution businesses respectively (equivalent to €38.7m total) with ‘growing trends’ being the primary message to justify the need for these increases. It is difficult to assess whether or not these increases are reasonable based on the information provided. At a minimum, we believe the CER should require a full cost breakdown as to how these costs are incurred, including details of the deliveries and outputs expected. This would also provide identifiable targets which could then be used at the end of each year to assess how efficiently these costs were incurred.

1.2. **IT Opex**

IT Opex costs are seeing a much more significant increase than Operations Opex – from €28.3m in PC3 to €71.9m in PC4 (a 154%\(^1\) increase). In the Consultation papers, while the CER recognise that very little justification has been provided by GNI for requiring higher IT costs, there is still an extremely large allowance being granted to GNI, despite the analysis showing that GNI spend more on Opex than their peers (i.e. UK Gas Networks, etc.). Again, on the basis of the information provided, it is difficult to assess whether this increase is reasonable.

We note that in both Consultations, IT Opex is presented as combined revenue between the Transmission and Distribution businesses, which makes it difficult to interpret, especially when analysing costs of each business. In order to improve transparency for revenue analysis, we believe that IT costs should be presented in the Consultation papers on a split basis between the Transmission and Distribution businesses.

1.3. **Pass-through Opex items**

While pass-through costs are typically known to be uncontrollable costs by GNI, we 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. We detail these one by one below:

i. **Shrinkage costs:**

In the Distribution business, shrinkage costs are increasing from €23.6m in PC3 to €51.1m in PC4 (a 117% or €27m increase). While it is a reasonable assumption that an expanding gas network and increasing throughput would lead to higher shrinkage costs, there is no supporting evidence or rationale to explain why shrinkage costs are more than doubling.

\(^{1}\) Note that this is substantially higher than the stated 35% increase in the Consultation papers.
In addition to the above, we believe it would be useful if shrinkage cost rationale was accompanied by methods and plans to reduce shrinkage issues. As we understand, shrinkage costs are made up between volumes of leaked gas and volumes of stolen gas. As a way of improving transparency, we believe that these costs items should be presented separately, which in turn would improve awareness and potentially act as a mechanism for reducing shrinkage costs.

ii. Revenue Protection

Opex for Revenue Protection is increasing from €2m in PC3 to €11.6m in PC4 (a 467% increase) without any reasons provided in the Consultation. While the absolute revenue is not as significant as other Opex line items, the percentage change from PC3 to PC4 is the highest. In the interests of transparency, we believe the rationale for this increase should be provided.

iii. Rates

We note that there is an apparent contradiction in the direction of cost movements when comparing Rates between the Transmission and Distribution businesses. 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).

1.4. Commercial Opex

While BGE supports the expansion of the gas network, it is difficult to comment on the level of revenue allowed as there is no supporting evidence to explain the commercial programme nor the targets/outputs expected from incurring these costs. To improve transparency, we believe that GNI should be required to provide this.

Further to the above, there seems to be a misalignment with the increase in allowed revenues between Commercial Opex (over 200%) supporting connection growth and the increase in allowed Capex revenues for Connections (16%). Understanding that a large portion of GNI’s requested revenues have not been allowed by the CER for their ambitious growth campaign, it would seem that their Commercial Opex allowance is increasing disproportionately to the rest of the ‘growth’ allowances.

2. Incentive mechanisms

As part of an expanding business, we appreciate that it is not unusual to expect higher Opex and Capex costs. However, to ensure that these higher costs are managed effectively, we support the identification and introduction of strong incentive mechanisms to ensure costs are incurred as efficiently as possible and that the balance between higher consumer costs and network expansion is optimised. BGE believes that the incentive mechanisms proposed for PC4 however, could be further improved to deliver better efficiencies as we are concerned that some of the incentives proposed are either too broad, asymmetric, or in some instances may even encourage inefficient operation. We detail our concerns below:

2.1. Opex Incentives

*Poor definition of outputs*

We believe that the effect of the proposed Opex incentive may encourage GNI to perform less efficiently. By assessing performance purely based on the level of underspend in Opex, it encourages inefficient cost cutting to be made that may not at all benefit the consumer or the network system. Without reference to outputs, it makes it difficult to hold GNI accountable for their deliveries. Therefore,
we believe a more suitable approach would be to assess the outputs delivered against the Opex savings to determine whether the savings were made efficiently.

**Asymmetric reward/penalty**
We also believe that the Opex incentive is asymmetrically weighted to benefit GNI over customers. For example, GNI are allowed to retain all savings made on any Opex under-spends, while they can challenge the need to have made over-spends which may ultimately be passed onto customers. To improve this asymmetry, we believe a 50% sharing factor should be made between GNI and consumers on any Opex under-spends.

**Efficiency targets**
The CER are proposing a 1% efficiency savings target for both Transmission and Distribution businesses and an additional 0.75% ‘catch-up’ efficiency for the Distribution business only. Since both businesses are part of the same group, we believe this 0.75% additional ‘catch-up’ efficiency should be also applied to the Transmission business also.

**Site Work Opex costs**
Finally, to improve site work costs, we believe a single one-off charge per site visit should be payable to GNI on those Siteworks categories commonly involving multiple site visits. This would incentivise GNI to minimise the amount of site calls they make and to optimise the times of the day for making site visits.

### 2.2. Capex Incentives

**Capex/Opex incentive misbalance**
We 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. For example, 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). We are 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.

**Asymmetric reward/penalty**
Similar to Opex incentives, there exists an asymmetric reward/penalty for Capex which ultimately benefits GNI over consumers. 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. We believe a 50/50% sharing factor would be a fairer approach to managing under- or over-spends.

**Capex Monitoring Programme**
Finally, 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. We suggest that to aid transparency, this report should be open to industry for review.

### 2.3. Growth Incentives

As a Supplier, BGE encourages the expansion and growth of the network in the interests of reducing costs on a per customer basis and we therefore agree that GNI should be encouraged to increase their growth rate via incentives. However, we believe this incentive mechanism could be improved by sharing the reward with customers in a way that would encourage further customer growth. Rather than adding this incentive payment to GNI’s total revenue, we believe it should go towards a dedicated fund within GNI that contributes to the costs of connecting gas customers. Historically a key barrier to gas customer growth has been the costs of connecting gas customers. Such a fund combined with socialising the rest of the customer connection costs across the network would help mitigate this major barrier, which would ultimately benefit all parties involved and encourage customer connections.
2.4. **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 their customer service experience.

While we understand that GNI need time to update their systems to align with the definition of a complaint, the Decision for them to accept and implement it was published in April 2017. By October 2017 (i.e. the start date for PC4), GNI will have 6 months of data to analyse any new metrics that have been introduced since the Decision. We believe the need for 3 years to test and monitor GNI’s metrics is both inappropriate and inefficient. At most, we suggest they should be tested on 12 months (i.e. until April 2018) with financial incentives applying thereafter.

3. **Cost of Capital**

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

4. **Other issues**

4.1. **Supplier of Last Resort**

We note 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, we request that the CER include them within the overall revenue allowances when finalising PC4.