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Jenny Pyper
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26 July 2016

Dear Ms Pyper

Peer review of the Utility Regulator's estimate of the cost of capital for GD17

I write on behalf of the UKRN Cost of Capital Working Group (the working group) to report the conclusions of our peer review of the Utility Regulator's (UR) estimate of the cost of capital for its GD17 price control review for Northern Ireland's gas distribution networks.

The GD17 review covers the price control period of six calendar years, 2017 to 2022, for three companies: Phoenix Natural Gas Limited (PNGL), firmus energy (FE) and SGN Natural Gas Limited (SGN). The UR considered the cost of capital only for PNGL and FE as the relevant SGN inputs were specified by the outcome of the competition for its licence.

We have carried out the review in accordance with the terms of reference we agreed with the Utility Regulator on 24 April 2016 and which I attach to this letter. Your staff kindly provided us with copies of published documents including the 16 March 2016 draft determination, a 15 January 2016 report from First Economics on the cost of capital and the 17 April 2015 approach document. They also provided us with copies of relevant submissions from PNGL and FE including business plan commentaries and associated submissions¹ on the cost of capital. We have not reviewed responses to the draft determination from the companies or their advisers.

The members of the working group met on 18 May, 1 June (by phone) and 15 June to consider the issues relevant to UR's cost of capital estimates, and reviewed drafts of this letter in the last of those three meetings and on 13 July 2016.

¹ These comprised an FE letter to Alan Craig dated 19 February 2016, a 19 February 2016 note on the tax adjustment for the pre-tax cost of capital estimate prepared by Oxera on behalf of FE and a February 2016 report on the cost of capital prepared by economic consultants Frontier Economics and NERA Economic Consulting on behalf of PNGL.

The UR's cost of capital estimates in its draft determination can be summarised as:

- a real (RPI-indexed) pre-tax cost of equity of 6.6% for both companies at a gearing ratio of 55%;
- real cost of debt assumptions for each company informed by their current debt interest costs and an RPI inflation assumption of 3.1%; and
- a mechanism to reflect the outcomes of refinancing expected for both companies during the price control period

I note that the pre-tax cost of equity of 6.6% broadly corresponds to a post-tax estimate of 5.3% at a prevailing tax rate of 20%². Table 178 of the UR's draft determination indicates that this would be equivalent to a post-tax cost of equity of 6.3% on a re-gearred basis to 65%, slightly higher than the most recent equivalent estimates in Ofgem's RIIO-ED1 and Ofwat's PR14 reviews.

We understand that the UR's draft determinations were informed by advice from First Economics set out in its 15 January 2016 report. The report makes reference to recent decisions by other regulators and, in general, the estimates in that report for each component of the cost of capital estimate lie within ranges that are consistent with decisions made by other UKRN regulators. We would expect the UR to review these components in light of market developments before reaching its decision.

Notwithstanding these relatively conventional component-level estimates, the working group recognised that the two companies represent outliers in some respects relative to other regulated businesses, in particular relative to their nearest comparators, the gas distribution networks (GDNs) in Great Britain (GB) regulated by Ofgem. The working group decided to focus its attention on whether there are any potentially material risk issues arising from these outlying characteristics.

We identified four factors that we considered could have a material bearing on the risk for investors in PNGL and FE relative to risk in other regulated companies. These factors are

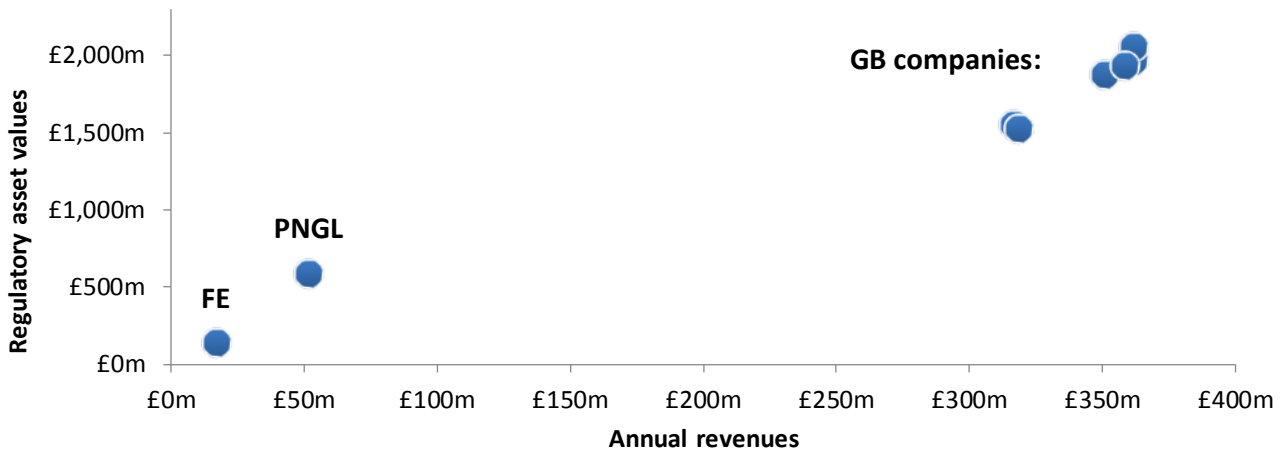
- relatively small sizes of the businesses;
- relative maturity of the regulatory regime;
- longer term uncertainty in gas distribution; and
- relatively low operating gearing.

Size of the businesses

The two businesses are significantly smaller, both in terms of their current levels of annual revenues and regulatory asset values (the aggregate of the total regulatory value and profile adjustment for PNGL and FE), relative to the GB GDNs, as shown in the following chart.

² The last budget announced corporation tax rates reducing to 17% by 2020, but the draft determinations indicate a mechanism to take account of changes in tax rates.

Figure 1: Relative size of the companies



Source: UR and Ofgem analysis. Values and revenues expressed in December 2014 price terms

We considered that the relatively small size of PNGL and FE could have an effect on their debt costs. However, the UR’s cost of debt estimates are informed by the companies’ actual debt costs and the UR’s proposal to adjust cost of debt allowances in light of the outcome of the re-financings means any size effect should be fairly taken into account.

We recognised that other UKRN regulators have periodically considered whether small company uplifts are appropriate for the cost of equity. After considering recent decisions, notably in Ofwat’s PR14, we concluded that the size of these businesses should not have a material bearing on what returns equity investors might reasonably require.

Maturity of the regime

The working group noted comments made by Moody’s in its 3 December 2015 and 13 May 2016 credit opinions on PNGL’s financing subsidiary that, relative to GB, regulation is “less established in Northern Ireland with a shorter track record of transparent decision making”. This is a factor that Moody’s takes into account when considering credit ratings of regulated businesses, although we noted that the Utility Regulator and its predecessors have been regulating energy networks since the privatisation of NIE in June 1993. The working group considered whether this factor could have a material effect on the cost of equity for PNGL and FE.

The UR representative highlighted that the UR had, when considering this issue, given weight to the Competition Commission’s 26 March 2014 price determination for Northern Ireland Electricity Limited³. In paragraph 13.113 of its determination, the Competition Commission expressed its view that the cost of equity should be calculated with no adjustment for a Northern Ireland premium. We concluded it would be reasonable for the UR to translate this conclusion to its GD17 decision.

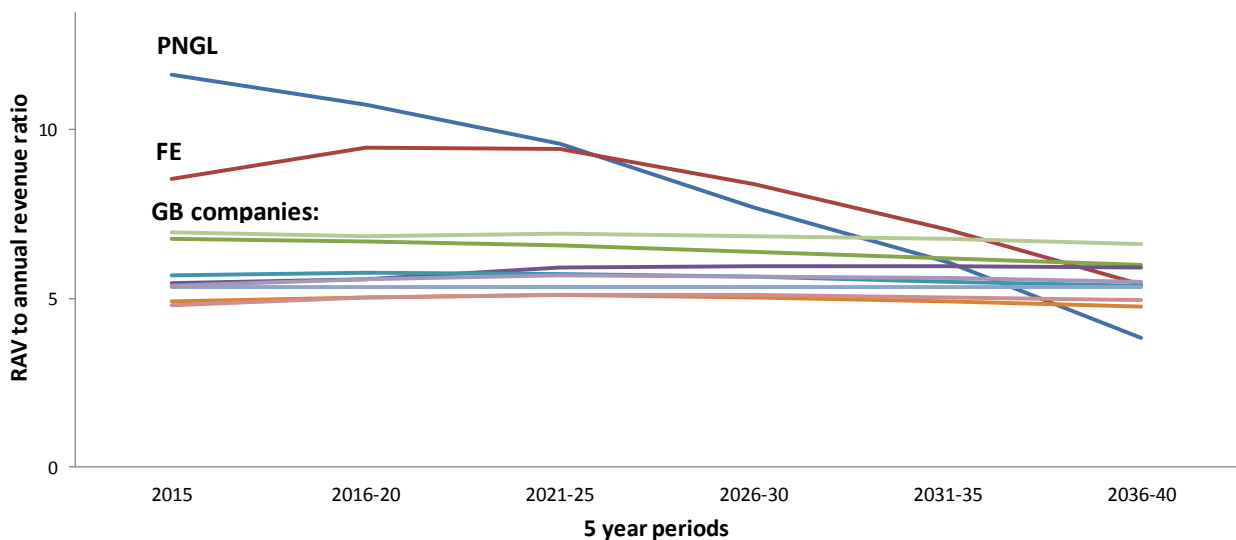
³ Published by the Competition and Markets Authority in April 2014

Longer term uncertainty in gas distribution

Informed by a PNGL submission relating to long-term stranding risk⁴ and statements made by Ofgem for its last price control review for gas distribution,⁵ the working group identified that potential uncertainty surrounding the longer term role of gas distribution in the transition towards a low carbon energy sector may be relevant to the cost of capital estimate. We noted that Ofgem has adopted a frontloaded depreciation profile for gas distribution assets “to ensure the value of investment that is still to be recovered from future revenues does not get so high that recoverability becomes unduly exposed to potential government decisions or other developments in the market towards decarbonisation of the energy sector”.⁶

In light of this, we considered the relationship between investment values and revenues would give some useful insights into exposure to government decisions and market developments. We arranged analysis to create the following chart, which illustrates this relationship for PNGL and FE and the GB GDNs.

Figure 2: Relationship between regulatory asset values and revenues



Source: UR and Ofgem projections

The relatively high regulatory asset values (relative to revenues) for PNGL and FE reflect the build-up of the profile adjustment under the long-term revenue deferral model adopted in Northern Ireland for greenfield gas network developments. We concur with the Utility Regulator’s conclusion in paragraph 10.32 of its draft determination that this should not increase beta risk (our discussion on operating gearing below indicates it should have the opposite effect).

However, it means that the value at risk to any recoverability issue is relatively high, at least in the medium term.

⁴ Section 2.2 of a February 2016 paper by Frontier Economics and NERA Economic Consulting on behalf of PNGL

⁵ For example paragraphs 8.7 to 8.9 of Ofgem’s 31 March 2011 ‘Decision on strategy for the next gas distribution price control - RIIO-GDI’ (RIIO-GDI strategy decision)

⁶ Paragraph 8.7 of the RIIO-GDI strategy decision



The chart indicates that PNGL and FE are expected to have significantly higher value at risk (relative to revenues) compared with the GB GDNs for the next ten years, while the value at risk should return to GB levels over the subsequent 10 years.

Since the asset/revenue relationship for the Northern Ireland networks is projected to normalise to GB norms in the medium term, recoverability issues might only arise in the event of a particularly rapid pace of progress towards a decarbonised economy. We understand that the Northern Irish government has an explicit policy of promoting the use of gas and the UR is best placed to evaluate the longer term policy environment in Northern Ireland. This means that investors' exposure to stranding risk may therefore be contained, but it may not be negligible.

We believe it is helpful to consider this risk issue alongside the question of the companies' operating gearing.

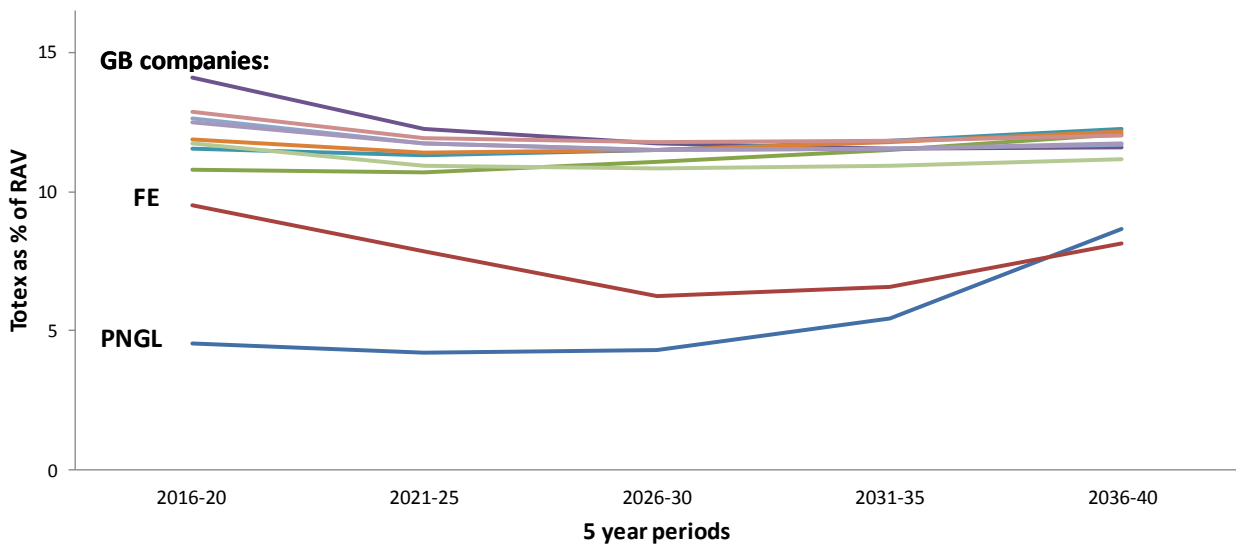
Operating gearing

Another consequence of the long-term revenue deferral model adopted in Northern Ireland is that activity levels are relatively small relative to the companies' regulatory asset values. This means we would expect the uncertainties arising from those activities would also be relatively small.

In common with the regulated companies in the GB energy networks, PNGL and FE will be regulated on a revenue cap basis (instead of a price cap), which gives companies some assurance that they will be able to recover their allowed revenues. This should have the effect of limiting exposure of companies to demand risk. This means a more important source of financial uncertainty will be the companies' cost programmes⁷.

The following chart illustrates the levels of those cost programmes relative to their regulatory asset values, for both NI and GB companies.

Figure 3: Relationship between expenditure and asset values



Source: UR and Ofgem projections

⁷ We also considered relative exposures to defined benefit pension scheme liabilities (FE and PNGL do not have the large legacy schemes that the GB GDNs have) and financial markets (the UR's approach to the cost of refinanced debt should help protect investors from market risks).



Although we cannot be clear how uncertainties in a company's cost programmes translate into systematic or beta risk (conventionally, the type of risk we are primarily concerned about when we estimate the cost of equity), the small scale of PNGL's and FE's cost programmes, relative to their asset levels, indicate a lower exposure to systematic risk from these programmes than would be the case in the GB GDNs.

Considering the risk issues together

The UR may wish to consider how longer term uncertainty in gas distribution on the one hand, and systematic risk from PNGL's and FE's cost programmes on the other, combine to inform its judgement around the companies' cost of equity. While these two factors might influence UR's estimate of the cost of equity in two opposite directions, we believe the tension between these issues bear more careful thought and analysis before it reaches a conclusion. They arise from features of the two companies that are markedly different from their GB peers. Because these differences are so marked, we recommend the UR should give further consideration to the possibility of non-negligible net effects.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian Rowson'.

Ian Rowson, Project Lead

On behalf of the UKRN Cost of Capital Working Group

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The UKRN Cost of Capital Working Group includes the following members:

Martyn Andrews, Ofwat
Gordon Cole, ORR
Alan Craig, UREGNI
Ben Johnson, SSRO
Maggie Kwok, CAA
Elinor Mathieson, Ofwat
PJ McCloskey, CAA
Alan McNaboe, Ofcom
Matthew Rees, SSRO
Ian Rowson, Ofgem

Terms of Reference

UKRN peer review of the GD17 cost of capital

1. Background

- 1.1. The UK's economic regulators have joined together in the UK Regulators Network (UKRN) to ensure effective cooperation between sectors.
- 1.2. Without cutting across the independence or specific goals of each regulator, UKRN will strengthen work across sectors. It will explain and take account of the differences between sectors, while maximising coherence and shared approaches in the interests of consumers and the economy.
- 1.3. Working groups have been formed to carry out the project work of the UKRN. The cost of capital working group has agreed terms of reference⁸ and a set of principles⁹. Participating regulators have also identified a number of ways that they can work together¹⁰ to support and further the cost of capital principles including supporting one another during decision periods through peer reviews.
- 1.4. GD17 is the first draft determination to be published since this agreement and the UR has agreed with Ofgem they would lead a review under the remit of UKRN cost of capital working group.

2. Information to be provided

- 2.1. GD17 Approach¹¹
- 2.2. GD17 Draft Determination document and annexes.¹²
- 2.3. GDN submissions to the UR on cost of capital.
- 2.4. Other information as deemed relevant to the review following initial engagement and discussion on the documents above.

3. Purpose

- 3.1. The cost of capital working group believes there is merit in engaging other regulators on the development of relevant cost of capital decisions. This will lead to better informed decisions, facilitate cross sector comparisons and allow opportunities for future cross sector work to be identified.
- 3.2. The specific purpose of the review is to ensure the UR's decision is informed by the experience and insights of the regulators represented on the working group.
- 3.3. Particular focus should be made to sense check the methodology and analysis presented as part of GD17 draft determination.

⁸ http://www.ukrn.org.uk/?page_id=575

⁹ http://www.ukrn.org.uk/?page_id=983

¹⁰ http://www.ukrn.org.uk/?page_id=429

¹¹ http://www.uregni.gov.uk/publications/gd17_approach_document.l

¹² http://www.uregni.gov.uk/publications/gd17_draft_determination

4. Deliverables and Timing

- 4.1. A report addressed to the UR that summarises the key findings of the review and outlines how the lead reviewer has engaged with other members of the working group to reach those findings.
- 4.2. The report should be available by 30 June (to be discussed) to ensure it can be considered sufficiently prior to the final determination.