

Ivan Bell  
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30 September 2009

Dear Ivan

**Re: PNGL Extensions to Saintfield and Whitehead**

Thank you for your licence extension applications to the above mentioned towns. We are supportive of PNGL's desire to expand the gas network to more parts of Northern Ireland. We have a principle objective in relation to gas to promote the development and maintenance of an economic, efficient and coordinated gas industry. Accordingly we welcome all proposals to rollout the network beyond its current boundaries, and have on previous occasions granted licence extensions which we considered to be consistent with this objective.

We have kept this objective in mind as we considered your applications.

***Licence extensions***

We are minded to grant the licence extensions subject to public consultation.

However we would like to reiterate our reservations regarding the extension to Saintfield progressing in the absence of a wider Down area gas development strategy. We would like to see more analysis as to whether, if a connection was to be made to Downpatrick, that there might be a better, cheaper way to bring gas to Saintfield; and indeed, whether the connection to Saintfield via Carryduff (as currently proposed) would in any way worsen the economics of a connection to Downpatrick. We note PNGL's view that the current proposed connection route to Saintfield would not make future connections to towns in the Down area any less economic and we would welcome the opportunity to consider the analysis that has informed this opinion.

***Allowed revenue***

Modifying the licence to grant these extensions would also require us to reopen the current price control review (PC03), to allow additional costs into your regulatory asset base and to set additional allowed revenue for you to recover.

In this regard, it might be useful to recap on the history behind these applications. PNGL first submitted the applications in late July, accompanied by two financial models showing a NPV positive outcome for each extension project. However, on detailed inspection of your models, we uncovered a number of issues that we consider needed to be amended (namely a discounting error, and assumptions relating to volumes forecasts and Traffic Management Act (TMA) costs). PNGL subsequently submitted revised financial models in early September. On this latest view, both projects now show substantially negative NPV outcomes (circa £350k each, or about 12 per cent of total capex costs).

Of course, any changes we make to PC03 would be guided by our principle objective to ensure industry development is economic. To date, our interpretation of this objective has meant granting approval to projects that are expected to break even or better. Whilst there may be a case for considering extensions to areas that are marginally uneconomic, a detailed policy setting out how this could be achieved needs careful consideration on a NI-wide basis. This is an issue that DETI is actively reviewing and until such work is further advanced we feel we should stay with the current approach of only allowing economic projects.

We are therefore minded to take the approaches described below in setting allowed revenue, which we believe to be appropriate in current market conditions.

### **1. Lower the rate of return and find capex efficiencies**

PNGL has assumed a rate of return of 7.5 per cent to 2016, and 5.87 per cent thereafter. This is consistent with rates of return set in PC03, which covers your existing licence area. As you aware, the origins of your current rate of return dates back to 1996, when PNGL was granted a rate of 8.5 per cent to develop the market in the Greater Belfast area (later amended to 7.5 per cent in the 2006 agreement). This rate was set to be commensurate with the risk PNGL was taking on (that is, in developing a completely new and untested market), and also to reflect market conditions at the time.

For these particular extensions, we do not believe the level of risk is comparable with that faced by PNGL when you first started developing the Belfast market. Your business model is now tried and tested and the appetite for gas in Northern Ireland well established. Furthermore, wider economic conditions have changed significantly. For these reasons we believe that PNGL would be suitably compensated at a lower rate of return, and would suggest the rate currently offered by Ofgem to GB gas distribution companies in the most recent price control as an appropriate starting point for consideration.

As well as adjusting the rate of return, we believe there may be engineering efficiencies to found in your capital programme. We therefore invite you to reconsider your capex proposals. If you can find efficiencies, and combine this with a lower rate of return, this would clearly improve the economics of the extensions.

### **2. PNGL take on more risk**

We also consider it would be appropriate for PNGL to bear more risk in terms of gas volumes sold and/ or TMA costs. By this we mean:

- You could retain your original volumes assumption but with a claw back mechanism in your licence that would result in PNGL bearing the loss in the event forecast gas volumes are not achieved; and/ or
- You could exclude TMA costs from your model altogether, significantly reducing capex costs. Doing this would incentivise PNGL to undertake the capital works as quickly as possible, with a view to complete construction before TMA comes into force. Note however that we would not allow *ex-post* recovery of TMA costs in the event TMA does come into force during the construction period.

This proposal is clearly linked to the rate of return proposal. If PNGL takes more risk on volumes or TMA, we can see a case that a somewhat higher rate of return would also be required.

We hope you will welcome our initial position to approve these extensions, and look forward to discussing with you at the earliest opportunity how we meet the challenge of rolling out the gas network on an economic basis.

Yours sincerely

A handwritten signature in black ink, appearing to be 'B. McHugh', written in a cursive style.

Brian McHugh  
Director of Gas