

Brian McHugh
Gas Directorate
Queens House
14 Queen Street
Belfast BT1 6ED

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Dear Brian,

The views of Fitch Ratings regarding the open consultation paper “Phoenix Natural Gas Limited Price Control Draft Proposals 2012-2013” are outlined below.

Section 7.25 - 7.36 “Outperformance - our proposal”

- PNG’s licence was last updated on 26 June 2009. The respective document does not include a mechanism that provides for clawback of outperformance.
- The magnitude of outperformance included in the total regulatory value (“TRV”; GBP52.8m of outperformance compared to GBP312.8m of opening TRV value, all in 2006 prices) and the intention to clawback respective amounts for the benefit of customers have not previously been made public by the Utility Regulator (“UReg”).
- After Fitch assessed the regulatory regime as part of the rating review process for PNG, the agency commented:

“It is envisaged that prior to the next five-year price control period, a modification will be made to the licence such that capex under-spend will be removed from the depreciated asset value on a five-year rolling basis, meaning the company retains the benefit of capital expenditure efficiencies for five years after which the benefit will be passed to customers. Capex over-spend will be treated symmetrically with under-spend, where PNG can demonstrate to UReg that the over-spend has been incurred efficiently. Discussions on the detailed mechanisms and methodology for achieving this are still ongoing.”

- In line with Fitch’s perception of good regulatory practice, the agency expected any potential licence modifications to be consulted on with all relevant stakeholders:
 - The UReg consultation paper does not elaborate on the reasons for the large TRV adjustment. Has any stakeholder voiced concern about previous decisions made by the regulator? Viewing the consultation paper as a whole one may reasonably get the impression that consumer interests are very much emphasised in these draft proposals at the expense of investor interests.
 - A licence modification requires consent from the licensee.
- In line with Fitch’s perception of good regulatory practice, the agency expected any potential licence modifications would be introduced on a forward-looking basis, ie.

grandfathering of investment up until the point in time of introduction of the revised incentive arrangements:

- The outperformance that UReg proposes to clawback relates to expenditure from the period 1996 - 2006;
 - Ofwat and Ofgem both recently changed incentive mechanisms applicable to the respective regulatory regimes, which relate to the introduction of the Capital Incentive Scheme and the Information Quality Incentive (the latter now applied to total expenditure). Those changes became effective as part of the price control processes and apply to future investment.
- Fitch's prevailing assessment of regulation for gas distribution networks in Northern Ireland assumes a reasonable level of predictability and transparency. The limited communication regarding UReg's intention to pursue a substantial TRV adjustment at a later date and the circumstance that this relates to expenditure dating back up to 15 years, does not particularly support this view.

Section 9 - Financeability

- In section 9.6, rating thresholds from the Ofgem consultation for the RIIO T1 and GD1 price controls are detailed. Fitch would like to point out that its view on Ofgem regulation differs from the one on gas distribution in Northern Ireland.
- Ratio guidelines for the existing 'BBB' Long-term Issuer Default Rating of PNG are maximum gearing of 70% net debt / TRV and minimum interest cover of 1.5x post-maintenance and post-tax interest cover. Besides, Fitch employs cash flow analysis to assess whether a company has sufficient financial flexibility to stay within ratio guidelines, even in case of reasonable downside scenarios.
- Generally, following each price control Fitch reviews whether the risk/return profile embedded into a tariff settlement or other meaningful aspects of a regulatory regime have changed, before updating the rating of an issuer. If there are any material changes, then Fitch may decide to revise applicable ratio guidelines.
- Diagram 1 on page 56 gives an overview of Interest Cover Ratios - *Before assuming dividends*. Fitch would like to note that any regulated entity that does not pay dividends will report substantially improving interest cover over time. However, there are not many regulated utilities in the UK that do not pay any dividends. Hence, the assumption to use a scenario with no dividends as a starting point for a financeability test does not seem reasonable.

Sincerely,



Fitch Ratings
Erwin van Lümich
Managing Director
Energy, Utilities & Regulation



Oliver Schuh
Director
Energy, Utilities & Regulation