CONFIDENTIAL RESPONSE

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We welcome the opportunity to respond on the Phoenix price control. We have limited our response to two areas, (1) the mechanism for allowing costs to follow connections and (2) the financeability of the business.

(1) Mechanism for allowing costs to follow connections

The mechanism appears to align the business to increasing owner occupied connections, an important incentive for the wider gas industry. It does however allow the business to "ignore" other market sectors, such as new build, to concentrate solely on this sector. We would suggest that if the other targets such as new build targets were not met, the shortfall in these targets should be deducted from the owner occupied target before calculating the allowed revenue.

(2) Business Financeability

We agree that the financeability of PNGL's business going forward is of primary importance to consumers. It is essential that a regulated utility business should be able to sustain a solid investment grade profile in order to ensure its ongoing ability to finance itself at a reasonable cost in the market and on commercially reasonable terms. Your analysis suggests that there will be some adverse pressure on ratios in the first year or two, which is to be expected given both the proposed reduction in the TRV in 2012 and a rigorous approach to PNGL's allowed revenues in 2012-13.

The very sensible and necessary correction of the position of PNG being allowed return on cash it hasn't even invested, should not materially affect the financeability of the business. The business remains readily financeable. While the reasons for the proposed reduction are well understood and appear consistent with the regulatory treatment, particularly of capex outperformance, by other UK regulators, this is nonetheless a significant one-time reduction. If PNGL's gearing is held at well below 80%, we do not believe that a spike above 70% would be unduly detrimental to the ratings analysis, given the reasons for its occurrence, provided it can be shown that gearing will fall below 70% again in subsequent years.

Similarly, any significant reduction in PNL's opex allowance in 2012 and 2013 would impact interest coverage ratios in the short term. However, while the opex allowance you have proposed in Section 5 is significantly (c. 15%) lower than what PNGL has sought, the 2012 figure is c.12% higher than the 2009 (last available) audited figure. We assume the corresponding outturn for 2010 and 2011 will be broadly comparable, given the low growth and relatively low

inflation pertaining for most of that period. We therefore do not anticipate any significant impact on interest cover ratios. The underlying high return allowed to PNG, of 7.5% plus inflation, in other words close to 13% p.a., makes it a highly lucrative business. The correction would be expected to have a small effect the price of future debt, but debt is readily available. Currently PNG has a £275m bond providing the bulk of its debt. The £275m of the asset base that is being supported by this debt is returning a financing profit of some £20m in a single year. There is therefore a very large amount of scope for the business to absorb any small increase in its debt price. The Fitch agency recently offered the opinion that the correction would lead it to downgrade PNG by one notch to BBB-, still investment grade. This fact that the business remains investment grade demonstrates the business is inherently financeable. In regard to the price impact on the debt, research in 2009[i] valued a movement of one notch by Fitch at only 0.45%.

The NIAUR consultation suggests a number of metrics and benchmarks for assessing financeability. It is instructive to note that the metrics applied by the actual financing of the business, in the form of the current £275m bond issuance, sets targets for the amount of debt in the business not to exceed 77.5% (Net debt / TRV) and for earnings to exceed interest by a ratio of 1.4: 1 ("PMICR of 1.4:1"). Both these tests should be easily passable based on the forecasts provided. Moreover these tests achieve a debt rate of some 5.6%.Undoubtedly these could be adjusted downward if required at the expense of a small increase in rate or if more cash introduced by the shareholders.

Yours faithfully

Gerard McIlroy

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[i] Bongaerts,Cramer,Goetzmann 2009, based on a movement of Fitch ratings one notch also crossing from speculative grade to investment grade