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20th September 2012

Dear Graham

BGE (NI) Ltd Price Control 2012-2017 Cost of Debt Consultation

We refer to the BGE (NI) Ltd Price Control 2012-2017 Cost of Debt consultation paper issued by the Utility Regulator (UR) on the 24th August 2012.

UR has estimated the real cost of debt for BGE(NI) to be 3.2% on the basis of two components:

- The real risk-free rate (rf) of 2%; and
- An uplift to reflect the market debt premium (MRDP) for BGE(NI) of 0.82%.

PNGL welcomes UR's conclusion that yields on government-issued index-linked gilts *"from recent years may not be an entirely reliable proxy for the risk-free rate"*. As part of its ongoing Competition Commission Inquiry, PNGL has stressed the need for regulators to take a long-term view when assessing the cost of capital, particularly in the context of the prolonged financial crisis which has caused significant uncertainty. Market interventions, sovereign risk concerns and government financing requirements have all distorted the market for government securities, making measuring the risk-free rate on this basis alone problematic.

However, while PNGL considers that the figure of 2% is an appropriate value for the real risk-free rate where revenues are indexed to RPI[1], this is not an appropriate figure if revenues are indexed to CPI. PNGL understands that the evidence presented in Table 2 of the consultation paper is predominantly based on RPI-indexed price controls. An upward adjustment would

[1] This is also supported by Ofgem's initial proposals for the RIIO-GD1 review, which suggest a 2% real risk-free rate for the RPI-linked price controls. See RIIO-GD1: Initial Proposals – Overview, 27 July 2012, Para 6.10

therefore need to be made to these figures to reach an appropriate real risk-free rate for a CPI-indexed control.

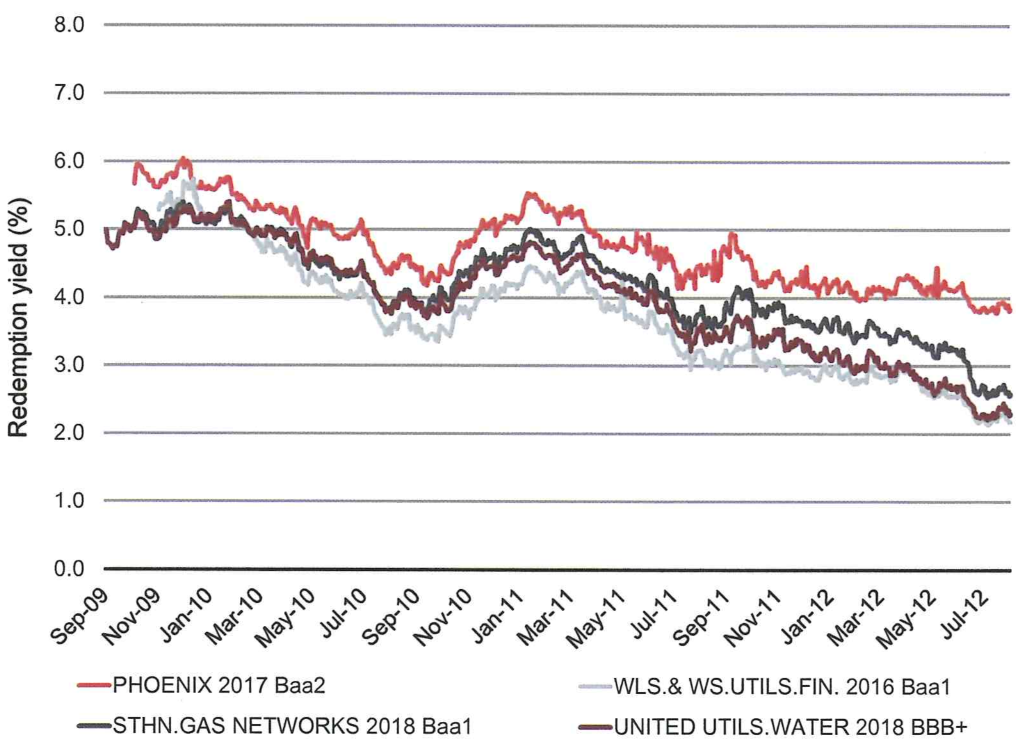
PNGL's main concern with the proposals, however, is that UR has underestimated the MRDP for BGE(NI). The most significant omission from UR's analysis is that it ignores market evidence of a risk-premium associated with investing in Northern Ireland utilities relative to Great Britain (GB). In addition, PNGL believes UR's analysis is based on an inappropriate starting point, as a result of a flawed comparator analysis. These concerns are discussed in turn below.

Northern Ireland risk premium

PNGL considers that there is strong market evidence of a risk-premium associated with investing in Northern Ireland utilities relative to GB.

PNGL's current bond was issued in 2009. Figure 1 below compares the yield on PNGL's traded bond with that of comparator bonds issued by GB gas and water companies. The comparator bonds are in the same credit rating bracket as PNGL's bond, and have similar maturities. Figure 1 shows a persistent premium on PNGL's bond relative to the GB comparators.

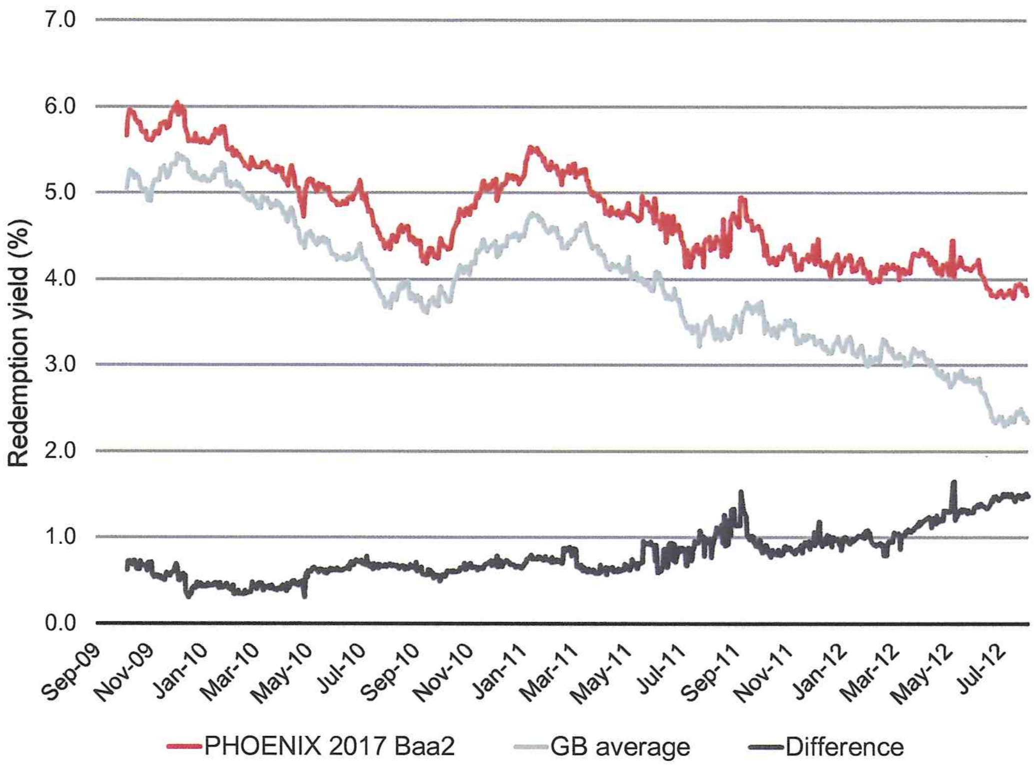
Figure 1: Cost of PNGL debt relative to GB comparators



Source: Thomson Datastream

Figure 2 shows PNGL's debt premium over the average cost of GB comparators in the period September 2009 to August 2012.

Figure 2: PNGL Cost of Debt relative to GB comparator average



Source: Thomson Datastream

Figure 2 shows that a premium relative to GB comparators has been observed since the issuance of PNGL's bond, and has tended to grow since then. Over the six months to August 2012, PNGL's bond traded at an average yield premium relative to GB comparator utilities of 124bps. The average premium over the three months to August 2012 was 140bps.

Market data for NIE's bond is also illustrative of the risk premium attached to Northern Ireland investments relative to GB. As far as PNGL is aware, NIE bonds are currently the only listed debt issued by a Northern Ireland utility other than PNGL's. Figure 3 below compares the yield on NIE's most recently issued publicly traded bond[2] (which is due to mature in 2026) relative to the average yield on six GB comparators[3].

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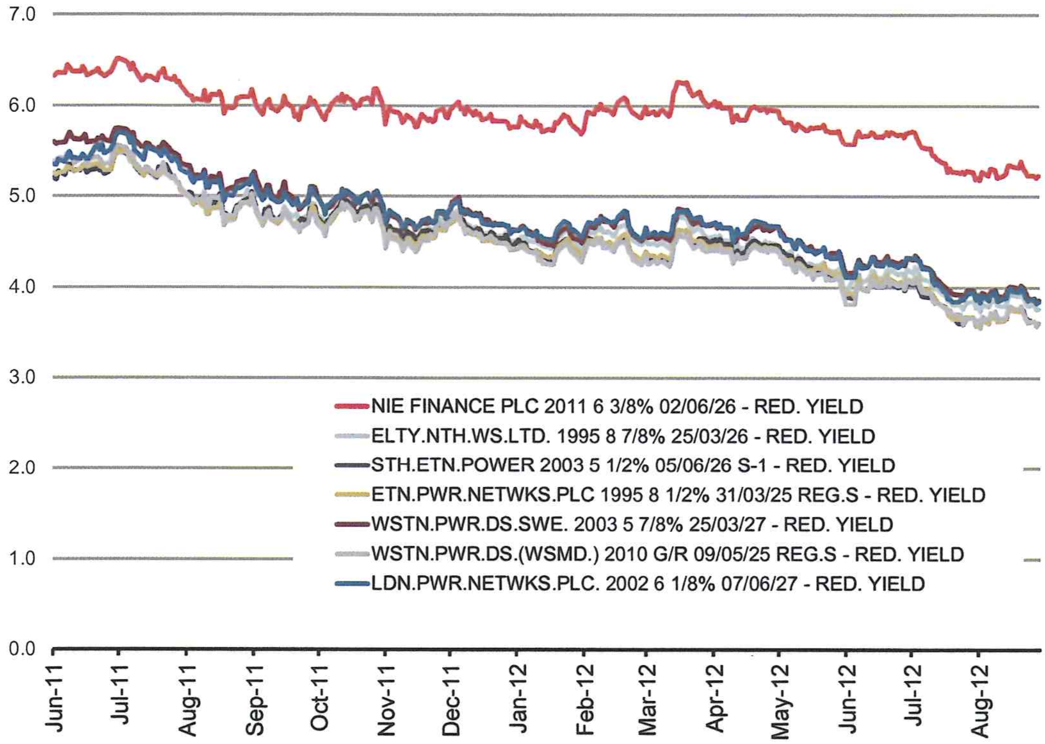
[2] NIE has another outstanding bond which matures in 2018 but is traded thinly

[3] The GB comparator bonds are in the same credit rating bracket as NIE's bond, and have similar maturities

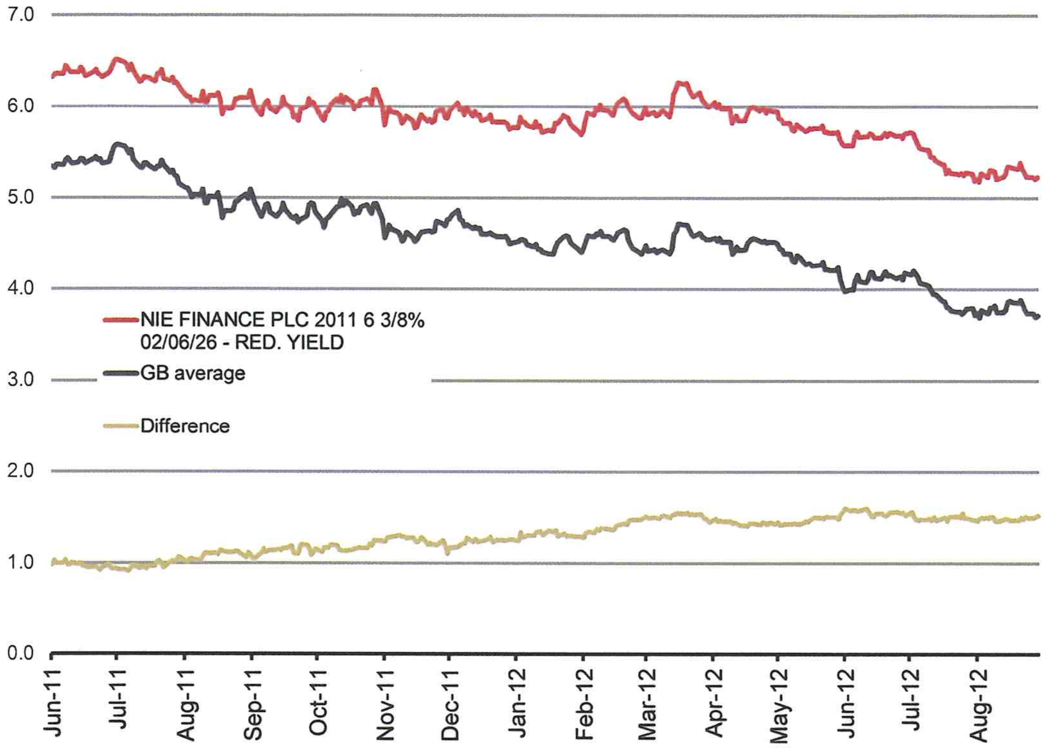
Figure 3: Cost of NIE debt relative to GB comparators



Source: Thomson Datastream

Figure 3 shows a persistent premium on NIE's bond relative to the GB comparators since it was issued in May 2011. The premium relative to the GB comparator average is shown in Figure 4 below.

Figure 4: NIE Cost of Debt relative to GB comparator average



Source: Thomson Datastream

Since NIE's bond was issued in May 2011, it has traded at an average yield premium to GB comparators with a similar credit rating of 129bps.

PNGL does not believe that this evidence can be rejected on the basis that it *"was considered extensively during RP5 and the RP5 proposals do not assign a Northern Ireland specific risk premium to the cost of debt"*[4]. To the extent that any cost of capital proposal for regulated NI utilities ignores this market evidence, PNGL believes that proposal will under-estimate the cost of capital.

In its Provisional Determination on the PNGL inquiry, the Competition Commission has also recognised the existence of a risk premium in Northern Ireland. On the basis of its own independent comparator analysis for PNGL, the Commission concluded that: *"over the whole period since PNGL's debt issuance, the yield has been about 70 bp higher than the comparator*

[4] Consultation paper, paragraph 4.1

bonds. The differential in yields averaged about 60 bp before August 2011 and about 90 bp after August 2011. This suggests that the yields have widened by about 30 bp since August 2011."[5]

PNGL believes that, irrespective of its causes, the fact that such a premium exists means that it must be taken into account in the cost of capital calculation, in line with UR's statutory duty to ensure companies remain financeable.

UR's comparator analysis

UR states that the figures presented in Table 5 reflect a *"range of possible debt premium figures"*[6], implying that any of these figures might be a reasonable starting point for setting the cost of debt for BGE(NI)'s 2012-2017 price control. However, PNGL considers that UR has not identified a comparable or coherent "range" of evidence, and that most of the data points would not represent appropriate starting points for UR's analysis. For example:

- UR proposes to calculate a debt premium *"inclusive of the 0.38% gearing effect by examining the yield on bond issues by other UK utilities with a credit rating below that of a transmission standard of 'A'"*[7] and that as a result *"the Utility Regulator should only consider data for the 'BBB' rated utilities."*[8] As presented in Table 5, the Iboxx index figure which includes A-rated utilites is inconsistent with this approach.
- The interest rate on the NIE bond issued in May 2011 is a "snapshot" view of the cost of debt for NIE at a specific point in time, and would therefore be an inappropriate starting point for determining BGE(NI)'s cost of debt for the forthcoming period. This type of approach would require a regulatory commitment that if the actual cost of debt went up during the price control, this would be reflected in an uplift to the allowed cost of debt.
- UR is currently consulting on its NIE RP5 proposals. Both Fitch[9] and PNGL[10] have stated concerns that UR's proposal for NIE's RP5 cost of capital is too low.
- The allowed cost of debt for the BGE(UK) Price Control 2007 – 2012 was calculated five years ago, and therefore does not take into account any new information since then, or reflect updated expectations about the forthcoming period.

Given the inconsistency across the types of data described above, PNGL considers that presenting this evidence as a "range" is misleading. PNGL considers that the Iboxx index ('BBB'

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[5] Competition Commission: Phoenix Natural Gas Limited Price Determination, Provisional Determination, 6th August 2012, paragraph 8.89
[6] Consultation paper, paragraph 5.10
[7] Consultation paper, paragraph 5.6
[8] Consultation paper, paragraph 5.9
[9] See Fitch Ratings statement, 18 May 2012: "Utility Regulator in Northern Ireland Sets Out Challenging Financing Assumptions"
[10] PNGL response to the NIE RP5 consultation

only) debt premium of 1.29% is the only evidence presented by UR in Table 5 that would be a reasonable starting point for determining BGE(NI)'s MRDP for 2012-2017. Under UR's approach, this figure would be reduced by 0.38% to account for the gearing effect, meaning the MRDP for BGE(NI) would be 0.91%.

Summary

Overall, PNGL believes that, excluding the CPI effect, UR's proposal of 3.2% underestimates the cost of debt for BGE(NI) by c.140bps. PNGL considers that, for an RPI-linked control:

- the MRDP is 0.91% based on the appropriate Iboxx index comparator;
- for BGE(NI) this must be adjusted for the gearing effect (+0.38%) and the current Northern Ireland risk premium (+1.2% to 1.4%) giving a total debt premium of 2.49% to 2.69%;
- with a 2% real risk free rate, the total cost of debt is 4.49% - 4.69%.

PNGL believes this estimate is in line with Ofgem's approach to setting the cost of debt, adjusted to reflect the observed Northern Ireland premium.

Yours sincerely

Ivan Bell
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Phoenix Natural Gas Ltd.