

PNGL response to UR discussion document
“Price Control for Northern Ireland’s Gas Distribution Networks
GD17 – Discussion Document on our Overall Approach”

Phoenix Natural Gas Limited (“**PNGL**”) welcomes the opportunity to respond to the Utility Regulator’s (“**UR**”) discussion document on its overall approach to the GD17 process.

PNGL understands it will have the opportunity to fully engage with UR on an ongoing basis as part of the GD17 review. Timely engagement on all aspects of the control is imperative, particularly in areas which have yet to be determined as part of previous price control reviews e.g. determining the rate of return to be applied post 2016. While we have not sought to undertake a full review of the areas that UR has indicated it may consider as part of its GD17 price control review, there are some aspects of the approach outlined by UR that warrant further comment at this stage:

- *Business plan submission for GD17*
 - *Timing of business plan submission for GD17*

Condition 1.3.7 of PNGL’s Licence requires that PNGL’s Regulatory Accounts submission for 2014 is made by the end of quarter 2 of 2015, three-months before PNGL is required to file its 2014 Statutory Accounts with Companies House. Condition 2.3.13 of PNGL’s Licence requires that PNGL’s GD17 business plan submission is made by the end of quarter 3 of 2015. This three-month period is (i) logical, in that it follows actualisation of data for 2014 and would therefore be reflected in PNGL’s GD17 business plan submission; and (ii) more efficient, as it enables more effective management of internal resources to each element of the process. Aligning submission of the 2014 Regulatory Accounts and the GD17 business plan would defeat this purpose and place significant strain on PNGL’s short-term resourcing requirements.

Furthermore a number of key work streams will, for the first time, be subject to detailed scrutiny during the GD17 price control review e.g. establishing a rate of return using a standard regulatory approach and stakeholder engagement. Preparation of PNGL’s GD17 business plan submission will therefore prove more resource intensive than previous price control submissions.

- *Format of business plan submission for GD17*

This strain on resources would be exacerbated still further by (i) UR’s intention to publish its final approach document and template for GD17 on 31 March 2015, just three-months

before it proposes PNGL makes a complete GD17 submission; and (ii) UR's requirement that PNGL make its GD17 business plan submission in the template provided by UR.

On the former, PNGL submitted to UR its completed cost reporting template for 2013 in September 2014. PNGL identified, in its response that UR must engage with NI GDNs on completion of the template to ensure that the two NI GDNs use the same categorisations when reporting opex and capex ensuring a consistent core dataset. Furthermore, PNGL advised UR that until it can be established that the information as presented in the template provided by UR is consistent between the two NI GDNs and between NI and GB, analysis of data must be limited. To date, this engagement has not taken place. The three-month window which UR proposes between issue and submission is therefore wholly inadequate.

On the latter, the template provided by UR in which PNGL is to make its GD17 business plan submission is not the basis upon which PNGL records its actual costs. Preparation of PNGL's GD17 business plan submission, based on our experience of populating one year of cost reporting data for 2013, will therefore prove more resource intensive than previous price control submissions while PNGL ensures that the information is presented in the format required by UR.

Given the challenges and number of key work streams of the GD17 price control review, PNGL is willing to discuss aspects of the control which are independent of submission of the GD17 business plan template and which may therefore be submitted by 30 June 2015. This would enable UR to progress these areas in advance of the complete GD17 business plan submission by 30 September 2015.

- *Optimum duration*

PNGL believes that the timely completion of PNGL's GD14 review has helped the development of the natural gas network in Northern Ireland and the move to a period of longer term regulatory stability. UR has confirmed that it is considering a duration for GD17 of six years. PNGL agrees with any move to a longer price control period and welcomes the opportunity a six year control would afford to embed the outcome of UR's GD17 determination in its operations. However UR must ensure that the GD17 determination is reflective of a longer duration e.g. by determining the appropriate basis for reopeners, changes brought forward under EU legislation etc.

- *TRV*

We do not recognise nor agree with the composition of the PNGL TRV in paragraph 4.134, since it is not consistent with our licence or with the Competition Commission's conclusions at the Inquiry of PNGL12. The 'building blocks' of TRV are set out in PNGL's licence under condition

2.3.18, which states that $TRV = DAV + Q + CC + PA$. Since our previous submissions to the Competition Commission and to UR provide full justification for PNGL's view, we do not comment further on it here.

Further we do not agree with the proposal for setting of a dual rate of return for certain components of the TRV in paragraph 4.134. Although UR has not clearly stated its intention in relation to a dual rate of return, UR's proposal appears to be similar to that which was raised in its GD14 Consultation Paper (July 2013). As noted in our response to that paper (see extract in appendix), any such approach would be:

- **conceptually flawed and practically difficult to implement** – since, as noted by PwC and Professor Ian Cooper, splitting the TRV into component parts will only affect the risk profile of the business (and therefore the cost of capital) if a genuinely different level of guarantee or risk profile can be attached to each part, which is clearly not the case for PNGL;
- **out of line with regulatory precedent** – since the vast body of relevant regulatory precedent has not adopted this approach, and regulators which have seriously considered adopting it (i.e. the CAA) have decided to reject it. More recently Ofgem has clearly stated that the WACC is the appropriate discount rate for rolling up revenue deferral over time.¹; and
- **inconsistent with the findings of the Competition Commission** – since the Commission clearly stated in its Final Determination for PNGL12 that earning a return at the WACC on capitalised outperformance does not over-compensate PNGL, and an alternative (lower) return would distort incentives since it would result in changing the value of the capitalized outperformance.

UR has not provided any reason that it would choose to ignore the substantial body of other regulatory decisions made over the last two decades which have all adopted a single WACC approach, and which are all more analogous to PNGL. UR's proposed departure from GB norms, without apparent justification or foundation in theory or precedent, only serves to highlight differences in the regulatory approach between Northern Ireland and GB, and is only likely to increase the perception of regulatory risk in Northern Ireland. Proposals such as these support the view of the debt ratings agencies that regulation in Northern Ireland is less mature than GB, which adds to the risk profile of the company.

Overall, we do not consider there is any merit in a split cost of capital approach and do not consider it would be appropriate for UR to consider applying such an approach at the GD17 review.

¹ See: https://www.ofgem.gov.uk/sites/default/files/docs/decisions/ed1_revenuechange_decision.pdf

- *Benchmarking*

UR makes a number of statements about its intentions to use benchmarks as part of the GD17 review, however its methodology is unclear. If done properly, such comparisons may be useful: PNGL believes it runs a lean and efficient business in line with industry-leading standards. Consideration must however be given to relevant specific factors, both for comparing PNGL to firmus, and when comparing the NI GDNs to those in GB or other “relevant” regimes.

Furthermore PNGL does not have sight of the dataset used in benchmarking GB GDNs. For example, the synthetic unit rates proposed by UR as part of its RIGS modelling during the GD14 price control review (which UR intends to adopt again at this review) resulted in an allocation of costs across the individual capex cost lines which were not comparable to PNGL’s cost lines.

This lack of transparency places PNGL at a significant disadvantage. PNGL has no ability to test or verify the analysis undertaken by UR without access to the GB data, nor does it have any ability to demonstrate proactively its own efficiency level relative to the GB DNOs. As UR has recognised, transparency is an essential part of good regulation, in particular for ensuring due process has been followed and enhancing predictability and accountability. While this must be balanced with the need to ensure data protection and confidentiality, there are likely to be options available to meet both requirements: for example, by anonymising data; aggregating confidential information; or using confidentiality rings or data rooms².

Given these challenges, PNGL will welcome the opportunity to engage with UR on its benchmarking proposals so as to ensure that meaningful comparisons can be made.

- *Innovations*

PNGL welcomes UR’s indication in paragraph 4.124 that it will encourage any plan of the GDNs to provide innovations as part of their GD17 business plan submissions. PNGL believes it runs a lean and efficient business in line with industry-leading standards but is always considering ways that may make our business more efficient or offer enhanced service to consumers. PNGL considers there would be a variety of options where further innovation and testing could deliver improved outcomes for consumers. One example is in the area of smart metering, where it is likely to be beneficial for PNGL to conduct a trial during the GD17 price control period. PNGL intends to review developments and innovations elsewhere and will include a case outlining the benefits of any proposed funding in its GD17 business plan submission.

² See, for example, guidance on transparency published by the CMA:
[https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/270249/CMA6 Transparency Statement.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/270249/CMA6_Transparency_Statement.pdf)

Appendix: Further detail on split cost of capital approach based on our response to UR's GD14 Consultation Paper

A split cost of capital approach involves a number of conceptual flaws and practical complexities

In principle, the rate of return must be set to ensure that PNGL remains financeable and can continue to attract funding to support its ongoing activities. An appropriate approach to the cost of capital should therefore reflect investors' expectations of the risk surrounding the recovery of PNGL's investment over time.

Investment is recovered through cash flows derived from PNGL's regulatory model. Based on the formulae defined in PNGL's Licence, the regulatory model produces a single line of expected cashflows on the basis of a number of model parameters, including the TRV as a whole. PNGL's model does not incorporate separate revenue streams associated with separate or separable levels of risk, nor can PNGL's regulated activities be meaningfully separated according to some proposed split of the TRV.

Investors' expectations do not, therefore, vary across different parts of the TRV. At the extreme, should the business fail, investors do not have different levels of guarantee that they will recover the value of different parts of the TRV. Similarly, PNGL raises both debt and equity against the value of its TRV as a whole, and investors do not face a different level of risk of under-recovery of their investment across different parts of the TRV.

We therefore do not agree with UR's contention in paragraph 4.134 that *"As identified in GD14, PNGL have a very unique build up of the TRV, which can be broadly divided into 2 areas as follows:*

- 1) Conventional RAB (Regulatory Asset Base), i.e. capex, opex, working capital, etc.*
- 2) RAB based on regulatory commitment, i.e. deferred capex and historical outperformance.*

We will consider the implications of setting either a single or dual rate of return for certain components of the TRV".

There are a number of other conceptual flaws and practical complexities associated with a split cost of capital approach, which have been recognised in both academic literature and regulatory commentary.

- A split cost of capital approach would imply the need for significant changes to the regulatory framework, so that the TRV (or any notional component of the TRV) would be subject to a genuinely different level of regulatory or political guarantee. Without this, a split cost of capital will not result in a reduction in the overall cost of capital allowed to the business to finance its regulated activities, since the underlying risk faced by the

business has not changed. Absent a change in the regulatory contract, therefore, there is no reduction in overall business risk.

- The risk exposure of the TRV itself (or any notional component of it) is not necessarily debt- like, given future risks which could impact the recovery of the TRV.
- It is unlikely to be in the interest of customers for regulators to assume that the TRV (or any notional component of it) should be entirely debt funded. Equity has a disciplining effect on the company to operate efficiently and deliver outputs, and putting the recovery of historic investment (as reflected in the TRV) at risk is a core part of the incentive regime. The Competition Commission noted this concern with a split cost of capital approach in its review of the Stansted Q5 control period³.
- Regulators in general have tended not to prescribe particular corporate financial structures, instead basing allowances and incentives on an efficient notional capital structure. However, any split cost of capital approach implies that the regulator would determine that the TRV (or a notional component of it) should be entirely debt financed. Ofgem and Ofwat noted in 2006 that allowing flexibility in capital structures has allowed for innovative financing approaches to be adopted⁴.

These concerns and others are highlighted by PwC in its April 2013 report for the CAA, which considered applying a split cost of capital at the Q6 review for UK airports⁵. PwC reviewed the relevant academic literature⁶; regulatory commentary; and evidence from potential parallels in commercial and financial structures. On the basis of this comprehensive review, PwC concluded that the CAA should not apply the split cost of capital approach.

Regulatory precedent supports a single allowed WACC for regulated business like PNGL

The overwhelming body of GB precedent is in line with the principles set out above for setting a single WACC for a single regulated activity. Ofgem, Ofwat, Ofcom and the Competition Commission have all adopted this approach, and there is little evidence that any serious consideration has been given to alternatives by most of these regulators.

³ See Competition Commission, Stansted Airport Ltd, Q5 price control, October 2008, Appendix L paragraph 10. <http://www.caa.co.uk/docs/5/ergdocs/ccstanstedl.pdf>.

⁴ See Ofgem/Ofwat "Financing Networks: A discussion paper", February 2006, paragraph 107. http://www.ofwat.gov.uk/regulating/reporting/pap_con_financingnetworks.pdf?download=Download.

⁵ PwC, Cost of capital For UK Designated Airports, Paper on the split cost of capital and skewed returns – prepared to the Civil Aviation Authority, April 2013. <http://www.caa.co.uk/docs/78/Q6PwCCofCapitalSplitSkewed.pdf>.

⁶ Notably papers by Professor Dieter Helm and Professor Ian Cooper.

The sector in which the potential for applying a split cost of capital has been considered most closely is UK airports. The CAA ultimately rejected the approach, stating (in relation to Heathrow) that *“On balance, the CAA considers that although the split cost of capital may have some academic attractions, it is not persuaded that it should employ it for HAL for Q6”*⁷. UR has previously highlighted a single example, that of Ofcom in its August 2005 determination for BT, as evidence of *“regulatory precedent for an approach which involves separating RAV into more than one pot”*⁸. However, UR failed to acknowledge that this example is not analogous to its proposal for PNGL.

- ***In 2005, Ofcom made a distinction between separate businesses within the BT Group, whereas PNGL has a single activity as a DNO.***

In 2005, the BT group was a vertically integrated company that operated across all segments of the telecoms sector, including operating the regional, national and international networks as well as the local copper access network and the provision of retail fixed line services. Each segment of the telecoms industry constitutes a different activity with a distinct cost and revenue structure, and unique risk profile. Ofcom’s objective when looking at the copper access network in isolation was to *“reflect variations in systematic risk between different activities”* within the integrated group, and to avoid competitive distortions in downstream markets associated with non-cost-reflective pricing. By contrast, PNGL operates the single activity of gas distribution and neither the company nor its risk profile are separable according to differences in underlying activity.

- ***Ofcom made its decision in the context of the upcoming structural separation of the copper access business from the rest of the BT group, which does not bear any resemblance with PNGL’s circumstances.***

In September 2004, Ofcom launched its strategic review of telecommunications. Among other conclusions, its review identified competition concerns in fixed line services. Ofcom took the view that these could be mitigated via the promotion of equality of access to the copper network, and potential deregulation in other areas. In this context, BT offered to proceed with the structural and operational separation of its copper access business from the rest of the group⁹. This proposal was being consulted on at the time

⁷ CAA, Economic regulation at Heathrow from April 2014: initial proposals, paragraph 9.18.
<http://www.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf>.

⁸ Price Control for Northern Ireland’s Gas Distribution Networks GD14, Consultation Paper, 16 July 2013, paragraph 12.21

⁹ http://stakeholders.ofcom.org.uk/consultations/statement_tsr/statement_tsr_pes.

Ofcom published its 2005 decision on the WACC, and was eventually agreed in September 2005 (thereby concluding the telecoms review). The 2005 WACC was therefore set in the context of a vertically integrated industry that was in the process of being unbundled, which necessitated providing a view of the expected cost of capital post-unbundling. This context does not apply to PNL, and the approach is therefore not analogous to the PNL situation.

UR has not provided any reason that it would choose to ignore the substantial body of other regulatory decisions made over the last two decades which have all adopted a single WACC approach, and which are all more analogous to PNL. UR's proposed departure from GB norms, without apparent justification or foundation in theory or precedent, only serves to highlight differences in the regulatory approach between Northern Ireland and GB, and is only likely to increase the perception of regulatory risk in Northern Ireland.

The Commission rejected a split cost of capital approach in its PNL12 Inquiry

During the Commission's PNL12 Inquiry, UR proposed a similar split cost of capital approach for PNL to that which it describes as part of this GD14 consultation. The Commission clearly rejected this approach, concluding that the allowed rate of return did not over-compensate PNL, and that it remained appropriate to reward outperformance at the allowed rate of return so as to maintain the power of the incentive regime and avoid distortions (footnotes and emphasis added):

*"A second key point advanced by UR is that capitalization of outperformance over-compensates PNL. **We do not agree.** While earning a return on an asset for a period of, in this case, 40 years will increase PNL's return in absolute terms, the value of the capitalized sum is equivalent in financial terms to the outperformance accrued (**always provided, of course, that an appropriate capitalization rate is used**).*

[Footnote 22]: ***We consider that the allowed rate of return is the appropriate interest rate to use in this context.*** This is because the reward of outperformance is part of the incentive regime, and to use a lower rate than the allowed rate of return would reduce the power of those incentives. This is also so that the incentive to earn outperformance is the same as the incentive to use that money to make real expenditures, ie a different interest rate on accrued outperformance would reduce the relative incentive to achieve efficiencies.] We have set out ... why we consider that the rate of return used is not inappropriate. ***We therefore do not accept that the fact that the sums under consideration here have been capitalized and a return realized over 40 years means that PNL is being over-rewarded.*** UR said that it was not intended that historic outperformance was to be rewarded at this rate. However, we have seen no indication in

the 2007 determination that it was not intended to use the same rate of return for this purpose.”¹⁰

In light of the Commission’s final determination for PNGL12, we consider it disappointing that UR continues to undo the progress made over the last two years to, as UR states, “draw a line under the past” so that UR, PNGL and its investors can move forward with clarity and confidence in the stability of the regulatory framework. Proposals such as these only support the view of the debt ratings agencies that regulation in Northern Ireland is less mature than GB, which adds to the risk profile of the company. We would not expect UR to re-open any issues the Commission has already covered and considered closed, and in line with the Commission’s conclusions we would not expect UR to impose any reduction in the value accruing to investors retrospectively via its proposals for the GD17 WACC.

¹⁰ see the Commission’s Final Determination, at paragraph 9.78.