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18th February 2011

Leigh Smyth
Electricity Directorate
Queen's House
14 Queen Street
Belfast
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Dear Leigh

Re: Assessment of Potential Financing Options for Utility Networks – Discussion Paper

Thank you for providing BGE(UK) Ltd with the opportunity to respond to the First Economics discussion paper on Potential Financing Options for Utility Networks. As a company BGE(UK) Ltd have committed to and have delivered on substantial investment in gas network infrastructure in Northern Ireland and as such, have a critical interest in this discussion.

We attach a summary response, to the possible options identified in the Consultants paper. BGE(UK) Ltd would welcome the opportunity to meet with the Authority to discuss our response in greater detail and to present to you, further information in support of our position.

We would also welcome an understanding of the Authority's expectation of the next steps in the process regarding this matter. BGE(UK) Ltd would like to ensure that the Authority have the correct contact personnel from us, in terms of communications on and any future engagements in which we will be pleased to participate. We will submit to you separately these contacts, which have already been sent to the Authority's Gas Directorate for completeness

I trust you find our comments useful and we look forward to meeting with NIAUR to discuss in greater detail.

Yours sincerely

Jack O'Connell
Head of Regulation and Commercial
Bord Gais Networks on behalf of BGE(UK)Ltd

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Response to NIAUR financing paper

The First Economics paper on network infrastructure investment raises some fundamental issues regarding the efficient financing of utilities, and suggests some radical solutions to address these issues. BGE UK welcomes the opportunity to respond to this paper.

The key proposals set out in the First Economics paper are:

- greater involvement of third parties in construction;
- the creation of a RABCo which holds the debt financed part of the RAB; and
- the implementation of some form of guarantee (from license to primary legislation) on the ability of the debtholder to recover their loans.

The First Economics paper suggests that these proposals would address 'sub-optimalities' in the financing of utilities and lead to lower overall financing costs. The First Economics proposals appear to be based on evidence which, they assert, shows that utilities are holding 'too much' equity and that the debt premium they are paying looks high.

We are concerned by the proposals contained in the First Economics paper.

First, the current regulatory model serves customers well. It has resulted in significant opex efficiencies being realised, has incentivised efficient capex investment and has provided a stable and well understood operating environment. In the current investment climate, and given the significant capital investment required in Northern Ireland, we believe that a move away from this framework, could make the funding of future investment significantly more difficult, and could be perceived to be substantially increasing the regulatory risk facing investors.

Second, the paper fails to demonstrate that current arrangements are sub-optimal. We do not believe the analysis in the paper can be relied upon as showing an "anomaly" in relation to financing structure. The conceptual arguments are not compelling, and rely on the assertion that financial markets are unable to accurately identify and price the average risk facing a business. The paper uses partial evidence to support these arguments, and fails to take into account a large number of factors which could explain the observed situation in relation to both equity and debt. It also fails to explain why incentivised management would fail to secure an efficient financing structure.

Third, the proposals for change set out in the paper are likely to result in increased costs to customers:

- *The proposed RABCo transfers risk to customers and reduces efficiency incentives and oversight.* The proposals with regard to RABCo will simply result in a

transfer of risk from bondholders to customers/tax payers. This will reduce the incentives on bondholders to properly hold management to account, and will also reduce the incentives on the management of RABCo to ensure that debt is refinanced as efficiently as possible. Even if the transfer of regulatory risk to customers and the state (e.g. through a debt guarantee in primary legislation) were considered desirable, this could be achieved without the loss of financing incentives within the current framework and without the need for restructuring and the creation of a separate RABCo; and

- *The third part construction proposals are likely to lead to higher costs and an incentive mismatch.* The models currently used for infrastructure delivery already involve a significant element of outsourcing and contestability. The specific model for third party involvement put forward in the First Economics paper involves a number of practical operational issues and transaction costs which will result in increased costs to the customer.

Finally, we note that network investment to date has been undertaken within a well established licensing regime. The regime is widely recognised to have created a positive investment climate, not least as it establishes a clear and robust process associated with licence modifications in order to protect the interests of investors. Any changes to the regime put forward by NIAUR will need to continue to respect investors' interests. Failure to do so would put at risk the renewables development policies of the government, and create the potential for legal challenge.