18th February 2011

Leigh Smyth
Electricity Directorate
Queen's House
14 Queen Street
Belfast
BT1 6ED

Dear Leigh

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

Thank you for providing firmus energy with this opportunity to respond to the above discussion paper. We understand First Economics have been commissioned by your office to assess past examples of project financing, to consider a range of project financing options and to assess the pros and cons of each option.

Having been awarded a conveyance and supply licence for the 10 towns franchise areas under a no profit, no loss arrangement, firmus energy has constructed over 550 km of distribution network since licence award, back in 2005. Although much capital investment has already been "sunk" in the 10 towns, significantly more investment is needed to meet our overall business imperative to connect a further 50,000 customers over the next 25 years. A clear and stable regulatory regime which respects existing investors' interests will be critical to securing this future investment.

firmus energy, via our parent company, BGE, continues to invest heavily in the energy infrastructure in Northern Ireland. However, we are extremely perturbed by the suggestions outlined in the discussion paper which we feel could act to dissuade new capital investment in NI.

Two considerations have been put forward. Firstly, that major expansion projects could be split out from existing licensed businesses and secondly, splitting part of the regulated companies RAB into separate companies between the day to day network maintenance and network renewals.

The discussion paper goes on to suggest that it is "sub-optimal" to combine the "operating business" with a "capital recovery" business due to a number of factors;

- that the higher risk of the operating business tarnishes the lower risk capital recovery business which in turn drives up financing costs

- that the requirement for a large balance sheet to finance projects curtails in some ways the range of companies that are able to operate a networks business

We fail to see any convincing evidence which supports the idea that current financing structures are sub-optimal and we would fervently refute this. We would also disagree with any suggestion that the average cost of capital would be lower for two distinct businesses rather than for a single business carrying out the same activities and we have seen no evidence which would suggest otherwise.

In the case of firmus energy (with less than 10,000 connected customers) we do not consider it reasonable to split an embryonic business like ours either now or in the future into an operating business and separate projects business. Indeed, it is acknowledged within the discussion paper, that, for utilities in GB, the current regulatory framework has already delivered opex efficiencies of 30%-50%.

We do not favour an approach which could potentially separate major investments from network infrastructure companies or indeed separating ownership of the RAB so that it can be financed separately from other parts of the business.

Clearly there are marked differences in the maturity of the gas industry in Northern Ireland, the maturity of the networks in Belfast and the 10 towns and the recovery periods under which they work to. Additionally, the focused nature of our licensed towns business is in marked contrast to the GB market where gas availability is almost universal and where penetration levels are greater than 90%.

We are concerned by the proposal that large investment schemes could be designed and delivered by parties other than the network operator. There is a suggestion within the document that a cut off at around £50m may is a reasonable threshold. This would inevitably rule out gas distribution projects but could in the longer term impact gas transmission operators within Northern Ireland.

Similarly, we do not believe that there is a the potential for further third party involvement in construction and it is misleading to suggest that the current models for infrastructure delivery in Northern Ireland do not already involve a significant amount of outsourcing. Within our own period contract construction, audit and maintenance activities have been outsourced to a period contractor following a formal tender process.

Within the discussion document two major benefits of third party involvement have been outlined. These include;

- tendering of schemes from design to completion would increase the scope for overall innovation and efficiencies across the areas of work
- where network operators have been unwilling to invest in major schemes the opportunity for third parties could help to bypass this reluctance

We believe the above benefits are both unfounded and unproven.

We do not believe that the proposals for the creation of a separate RABCo would reduce costs to customers as the transfer of risk in itself will not result in lower costs to customers. Indeed, it is unclear from the discussion paper who would be liable for accepting risk on project delivery. We feel this is a major omission within the discussion document.

In summary, firmus energy accepts that risk and reward incentivises investors to manage projects as well as capital and operational costs. However, we are concerned that the discussion document fails to quantify how current financing arrangements are sub-optimal. We also fail to see that the proposed RABCo model would reduce costs to customers and as well as this we feel any attempt by the Regulator to “move the goal posts” on current project financing would most certainly curtail investor appetite for future investment in NI.

Given that further infrastructure investment is required in Northern Ireland within the electricity, gas and renewables sectors we feel it would be folly to propose a change to financing structures that could thwart investor appetite in networks/capital intensive projects across Northern Ireland. There is a serious risk that the proposals, if implemented, would deter investment in Northern Ireland generally because investors would fear that they would not earn their expected returns as a result of changes to the regulatory regime over time.

I trust you find these comments useful.

Yours sincerely

Michael

Michael Scott

Head of Business Development