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Gas to the West: Northern Ireland Premium

Prepared for the Utility Regulator

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1. Introduction

The Utility Regulator has asked First Economics to review six[1] recent applications for new conveyance licences, focusing especially on the assumptions that two applicants have made about a "Northern Ireland risk premium". We have been asked to provide the following.

1. An outline of the type of submission you would expect to see in support of this assumption in order to establish that the assumption was sound, including for instance the types of evidence you would have expected to have seen presented.

2. An assessment of each applicant's submission against this model response highlighting any expected evidential sources missing or any deficiency in the quality of evidence provided.

These things are set out below.

For the avoidance of doubt, we have restricted our work to these specific terms of reference and have not sought to assess any of the other assumptions contained within the applications.

2. An outline of the type of submission you would expect to see

Claims for a Northern Ireland premium translate ultimately into a higher cost of debt and/or a higher cost of equity than investors would seek from a similar investment in Great Britain.

We would expect the Utility Regulator to be presented with empirical evidence showing that previous projects or investments have commanded such a premium.

On the cost of debt side, empirical evidence could be obtained by comparing the borrowing costs incurred by similar entities from Northern Ireland and Great Britain. These entities could be companies from the utility sector or they could be corporate borrowers in other industries. In order for the comparison to be a fair one, we would want to see that an attempt had been made to control for:

- credit rating;
- differences in the scale and tenor of companies' debts;
- trading liquidity/illiquidity; and
- any other company-specific risk factors which might make investors price up or price down a company's borrowing costs.

If lenders genuinely factor a Northern Ireland risk premium into interest costs, we would expect this premium to come through clearly in such analysis.

[1] We understand that there are a further two applications that we did not review – the unconnected versions of the BGE (UK) high pressure application and the firmus energy low pressure application. Our instructions are that there are no materials differences between these applications and the connected versions of those applications that we did review.

The cost of equity side is more complicated because it is highly unlikely that an applicant will be able to identify comparable companies in Northern Ireland and Great Britain with stock market listings. This means that the applicant will not be able to use equity pricing models like CAPM.

We would be content for an applicant to rely principally on academic/theoretical arguments to justify any assumption that is made about a Northern Ireland equity risk premium. These arguments would be strongest if they built from empirical evidence of a Northern Ireland debt risk premium and explained how the pricing of equity finance could be inferred from the observed pricing of debt.

3. Assessment of each applicants' submission

Two of the six applications make explicit assumptions about a Northern Ireland risk premium. We note that it is possible that other applicants might also have made provision for such a premium, either consciously without using these precise words or unconsciously via the method that they use to calculate the cost of debt and/or cost of equity. We nonetheless focus our comments specifically on:

- the Scotia Gas Networks (SGN) low pressure application; and
- the Phoenix Natural Gas (PNG) low pressure application.

<u>SGN</u>

The SGN application contains the more detailed supporting evidence in the form of a consultant's report from Oxera. Oxera does not itself provide the empirical evidence that we referred to in section 2, but instead refers to the Competition Commission's empirical work in the recently concluded NIE inquiry. In particular, Oxera relies on the Commission's finding that "there appears to be a premium in the yield on NIE's debt compared with comparable instruments issued by other electricity distribution companies in the UK" of up to 50 basis points.

We do not consider this to be a complete summary of the Commission's findings. Specifically, we note that the Commission did not conclude that this 50 basis points premium was evidence of a Northern Ireland risk premium. The relevant passages in the Commission's report are as follows:

> Determination on Northern Ireland premium and the cost of existing debt
>
> 13.64 We accept that there appears to be a premium in the yield on NIE's debt compared with comparable instruments issued by other electricity distribution companies in the UK.
>
> …
>
> 13.66 We did not rule out the possibility that the premium, which was at its greatest in 2011 and 2012, was in part caused by market concern about ESB, which was alleviated following ESB's successful refinancing in the latter part of the calendar year 2012.
>
> …
>
> 13.111 Importantly, the observed premium on NIE bonds has decreased significantly since January 2013 (see Figure 13.2) and does not now appear significantly higher than Frontier's highest estimate of a liquidity premium. It appears to us that the yield on NIE's bonds is no longer indicative of any additional risk perceived by bondholders compared with similar companies elsewhere in the UK.

It follows that the Commission's analysis and findings would give support to any assumptions that an applicant wished to make about a debt liquidity premium.[2] But it does not give any support to assumptions about a general Northern Ireland risk premium.

A similar interpretation error is apparent in Oxera's reading of the Commission's analysis of NIE's beta. Oxera notes that the Commission "adjusted the asset beta upwards compared to the longer-run estimates of asset betas of the GB regulated utilities" and that "multiplying this implied uplift by the ERP assumed by the CC gives the additional risk premium required to compensate equity investors in NI relative to Great Britain". The Commission's methodology was actually as follows:

> 13.183 … Our own and First Economics' estimates suggest longer-run estimates [of the asset beta for listed GB utilities] of between 0.31 and 0.4. Taking into account that our comparator set is not an exact match for NIE and its regulatory framework we have selected a range for beta towards the upper end of the range suggested by these estimates. Accordingly, we estimate a range of 0.35 to 0.4.

It can be seen from the above that (a) there was no "adjustment" and (b) the Commission's reason for going to the top-end of the GB beta range was not due to any general Northern Ireland risk premium.

We can therefore say that there are considerable deficiencies in the evidence that SGN has provided.

<u>PNG</u>

The PNG application contains a reference to PNG's view that "Northern Ireland investments are associated with incremental regulatory uncertainty". The only supporting evidence for this view is the observation that there have been two recent referrals from the Utility Regulator to the Competition Commission.

It is not clear how this demonstrates that Northern Ireland investments are more risky, particularly when (a) the first of the two referrals saw the CC step in to protect the value of PNG's RAB, and (b) the second referral concluded with a clear defeat for NIE in its attempt to obtain more revenue from customers.

We note that PNG did not provide any of the evidence that we outlined in section 2.

[2] In layman's terms, a liquidity premium is extra interest that lenders charge in exchange for holding debt that is difficult to trade with other parties. In NIE's case there was evidence of a liquidity premium because there was very thin trading in NIE's bonds.