

Graham Craig
Gas Transmission
Utility Regulator
Queens House
14 Queens Street
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20th March 2014

Consultation on Gas Network Extensions in Northern Ireland: Approach to Comparing High Pressure Licence Applications

Dear Graham

Mutual Energy Limited ("**Mutual Energy**") welcomes the opportunity to respond to this consultation. The Mutual Energy group includes two wholly owned subsidiaries (Premier Transmission Limited and Belfast Gas Transmission Limited) that hold licences to convey gas issued by the Northern Ireland Authority for Utility Regulation ("**NIAUR**"), granted pursuant to the Gas (Northern Ireland) Order 1996.

Mutual Energy's response to this consultation comprises answers to the consultation questions, included below, along with the attached report commissioned from Economic Insight, which sets out additional evidence and analysis in relation to the amount and variability of controllable operating expenditure.

Questions

Q1. Do respondents have views on the proposed approach or views on an alternative approach?

In principle, we think that the NIAUR is right to make an adjustment to WACC in order to recognise the difference in risk borne by equity holders under a revenue cap compared to a cost-pass through model. We also think that a methodology based on the Capital Asset Pricing Model (CAPM) is conceptually sound, in line with regulatory precedent and consistent with the way the WACC is calculated. The critical issue is the extent to which there is evidence to support the assumptions relating to the amount and variability of controllable operating expenditure, discussed further below.



Q2. Do respondents have views on the methodology of calculating the ‘risk adjustment factor’ from variations in equity returns?

Overall, we think that the methodology of calculating the ‘risk adjustment factor’ from variations in equity returns is sound.

However, we note that this step requires the NIAUR to make an (informed) assumption about the probability of the variability in controllable operating expenditure exceeding a particular range. The NIAUR’s methodology assumes that this chance is fixed at 10% and does not fall as the range increases (see Table 5).

This may be an appropriate assumption for small increases in variability, but perhaps less appropriate for the increases in the scenarios presented by the NIAUR. That is, it does not seem reasonable to assume that the chance of exceeding a 5% cost variability is the same as the chance of exceeding a 20% cost variability. Indeed, given the reopener trigger, the chance of the latter occurring and having a 1 for 1 effect on returns would seem to be close to zero.

With this in mind, the table below compares the low, medium and high risk factor adjustments in Table 7 of the consultation paper, with revised estimates using:

- a 10% probability of exceeding the 5% variability assumption;
- a 5% probability of exceeding the 10% variability assumption; and
- a 1% probability of exceeding the 20% variability assumption.

The table shows that making this adjustment reduces the medium scenario risk factor adjustment and substantially reduces the high scenario risk factor adjustment.

	Low	Medium	High
Table 7	0.09%	0.22%	0.53%
Revised probabilities	0.09%	0.19%	0.34%

Q3. Do respondents have any comments on the calculation of the various parameters to which the methodology has been applied?

We enclose and refer the NIAUR to a report we commissioned from Economic Insight, which sets out additional evidence and analysis in relation to the amount and variability of controllable operating expenditure. In particular, the report supplements the NIAUR’s analysis and contains additional actual market evidence, which we think helps inform and validate some of the assumptions made by the NIAUR.

The report contains evidence based on comparators, particularly from the energy and water sectors, and strongly suggests that the NIAUR should use lower figures for both the amount of controllable opex and its variability, namely:

- a figure between £1.0m and £1.4m, with a medium or central estimate of £1.2m, would be more appropriate estimates for controllable opex based on the evidence; and
- a figure between 3% and 7%, with a medium or central estimate of 6%, would be more appropriate estimates of opex variation, based on the evidence.

We agree with Economic Insight that estimates of £1.2m and 6% better represent the evidence available.

Q4. Do respondents have views on the application of the 'risk adjustment factor'?

We think that the application of the risk adjustment factor is sensible.

Q5. Do respondents consider that the proposed range of possible values for the 'risk adjustment factor' is reasonable?

Based on the Economic Insight report, we think that the range of possible values for the risk adjustment factor is too wide and too high overall. The report suggests that a range of 0.04% to 0.14%, with a medium or central estimate of 0.11% would be more appropriate.

Q6. Do respondents consider that the final risk adjustment figure should fall anywhere other than the medium point on the proposed range?

As noted above, we think that the final figure should be lower than 0.22% and a figure of 0.11% would be more appropriate. Alternatively, the NIAUR could use its 'low scenario' figure of 0.09%, which is more consistent with the evidence than its current proposed 'medium scenario' figure of 0.22%.

Conclusion

Mutual Energy believes that the NIAUR should use lower figures for both the amount of controllable opex and its variability and that estimates of £1.2m and 6% better represent the evidence available. In addition we believe the range of possible values is too wide and too high. As a result we believe the risk adjustment factor is too high and a figure of 0.11% would be more appropriate based on the evidence set out.

Should you wish to discuss any aspect of our response please do not hesitate to contact me.

Yours sincerely,



Emma Jayne Armstrong

Accountant