RESPONSE TO NIAUR'S NOTICE UNDER ARTICLE 14(2) OF THE GAS (NORTHERN IRELAND) ORDER 1996 - PROPOSED MODIFICATION TO THE GAS CONVEYANCE LICENCE HELD BY BGE (UK), CONDITION 2.2 RATE OF RETURN PROVISIONS

31 March 2016

1. INTRODUCTION & BACKGROUND

1.1 GNI (UK) Limited ("**GNI (UK**)"), the licensee affected, is pleased to have the opportunity to respond to NIAUR's Notice under Article 14(2) of the Gas (Northern Ireland) Order 1996 - Proposed Modification to the Gas Conveyance Licence held by BGE (UK), Condition 2.2 Rate of Return provisions ("**NIAUR's Notice**"). NIAUR is aware that GNI (UK) has supported, and from an early stage invested heavily in, the development of the gas industry in Northern Ireland. GNI (UK) has a strong track record of working closely with NIAUR and other stakeholders to develop the industry in the best interests of customers. This is the context within which GNI (UK) responds to NIAUR's Notice, as set out below.

1.2 We set out, in the Appendix, a history of the licence. In summary, GNI (UK)'s gas conveyance licence was first issued in 2002. In the period to 2004 there were a number of meetings and correspondences between GNI (UK) and NIAUR regarding what would happen post construction of (all) the pipelines; wherein (1) GNI (UK) highlighted concerns regarding, in particular, the open nature of the equity element in its original licence, and associated uncertainty as to the value of the key infrastructure projects it had under construction; and (2) the parameters within which NIAUR could trigger post construction changes of financing were discussed. In July 2008, certain modifications were agreed to the licence to give effect to the outcome of these and subsequent discussions. A new licence issued to GNI (UK), which provided it with the certainty required as regards fixing certain components in its rate of return, or Weighted Average Cost of Capital (WACC), for the duration of the licence. In particular, Condition 2.2, Annex A, paragraph 5 provided for the calculation of the rate of return using the usual components, including the cost of debt, the risk free rate , return on equity and the level of gearing. The cost of debt was to be reviewed at each price review, and the other three components were fixed, whereby Condition 2.2:

(a) hard-coded the 72.5% level of gearing (thereby reducing the equity proportion from 30% to a less favourable 27.5%);

(b) locked in a 15% return on equity for the remainder of the licence (as opposed to the original 15% which had been at the discretion of NIAUR);

(c) set the gearing effect at 0.38%.

1.3 NIAUR now proposes to amend this Condition 2.2 to remove that certainty codified in the licence since 2008. Against that background, we set out in the remainder of this document GNI (UK)'s serious concerns about the proposed modification. In particular we set out our understanding of the reasons for, contents of, and implications arising from, the proposed modifications in NIAUR's Notice, and GNI (UK)'s position in relation to each such element.

2. **SUMMARY OF ARGUMENTS**

NIAUR Arguments

2.1 The stated purpose of NIAUR's proposed modifications is to amend the parameters within which NIAUR may set GNI (UK)'s rate of return, over a price control period, and in advance of the next price control period on 1 October 2017, which takes effect for the period October 2017 to September 2022. NIAUR's Notice goes on to describe its approach for setting a rate of return, should it decide to modify the licence, at the next price control review.

2.2 Section 2 of NIAUR's Notice sets out NIAUR's rationale for the modification proposal. GNI (UK) understands the following to be the reasons for the proposed modifications:

(a) the rationale for fixing the rate of return in 2008 no longer applies;

(b) that the regulatory practice has changed such that NIAUR's approach, as reflected in Condition 2.2 (inserted in 2008) is out-of-step with norms in other regulated sectors and merits some review; and

(c) NIAUR could better achieve its statutory objectives if it could alter the fixed components of the rate of return, including facilitating the possibility of 100% debt funding.

GNI Concerns

2.3 GNI (UK) has serious concerns about the proposal set out in NIAUR's Notice. GNI (UK) considers that NIAUR is wrong, and that its reasons are flawed, as regards why it needs to modify the licence and, consequently, its entitlement to do so. GNI (UK) further objects to NIAUR's approach to setting a rate of return, by reference to the modified licence. GNI (UK) believes NIAUR to be wrong for at least the following reasons:

(a) NIAUR wrongly assumes that the "absence of mutualisation" is a sufficient trigger for it to review the fixed components in the rate of return. This assumption is incorrect as a matter of fact and law;

(b) NIAUR wrongly suggests that the rationale for fixing the rate of return no longer applies;

(c) NIAUR's proposed modification is based on a flawed and incomplete assessment, and will under-remunerate GNI (UK) for the investments it has made in developing the project;

(d) the proposed modification is likely to result in ex post expropriation; this is an issue that has recently arisen in other regulatory decisions in Northern Ireland and which has been adjudicated on by the Competition Commission (now CMA). In previous decisions, the Competition Commission has found ex post expropriation to be unacceptable and against the customer interest;

(e) it will damage investor confidence in NI regulatory processes and undermine future infrastructure investment in Northern Ireland; and

(f) it will be to the detriment of consumers.

2.4 Before elaborating on each of these concerns below, GNI (UK) summarises its own case for why the current Condition 2.2 (with its fixed components) is justified and why there is no basis for seeking to modify the licence, as follows:

(a) maintaining the fixed components in GNI (UK)'s rate of return for the remainder of the licence provides a true reflection of GNI (UK)'s investment risks in the pipeline projects undertaken since 2002. The fixed components form part of a formula which was calculated to provide a fair remuneration to GNI (UK) to be spread over the lifetime of its licence. Any review leading to modifications to the components which will reduce GNI (UK)'s rate of return will, correspondingly, not reward GNI (UK) for the risks that it undertook and those it continues to undertake. The current fixed components in the rate of return, therefore, assist NIAUR in carrying out its functions having regard to the need to ensure that licence holders are able to finance the activities which are the subject of the obligations imposed upon them, as NIAUR is required to under Article 14(2)(b) of the Energy (Northern Ireland) Order 2003;

(b) fixing the components in GNI (UK)'s rate of return provided, and continues to provide, the necessary regulatory certainty for GNI (UK) to ensure the construction, funding and maintenance of the pipelines within its licensed area;

(c) maintaining the fixed components in GNI(UK)'s rate of return will continue to provide broader regulatory stability fostering investor confidence in Northern Ireland's gas and other utilities projects, demonstrating that a hard-coded agreement for the lifetime of an asset will be honoured. Investors in future infrastructure will therefore be able to discount the risk of regulatory opportunism when considering future investments in regulated assets; and

(d) by ensuring the status quo, and satisfying the requirements at (a) to (c) above, a fixed rate of return for GNI (UK), in turn, benefits consumers. It ensures that there is a stable regulatory climate in which significant investment decisions to improve efficiency and competition in the energy infrastructure sectors in Northern Ireland may be made at a reasonable cost, absent premium for regulatory risk. It thereby facilitates NIAUR in meeting its principal objective, namely to protect the interests of consumers of gas supplied by authorised suppliers, wherever appropriate by promoting effective competition, as laid down in Article 14(1) of the Energy (Northern Ireland) Order 2003.

2.5 NIAUR's Notice suggests that the existing Condition 2.2 does not provide the best outcome for customers. GNI (UK) disagrees with this. In fact GNI (UK) maintains that the certainty provided by that Condition provided the basis for GNI (UK)'s significant and sustained investment in Northern Ireland infrastructure over the past two decades. This certainty, which was discussed throughout the course of construction of GNI (UK)'s pipelines and codified in 2008, therefore allowed for the construction of key gas infrastructure in Northern Ireland which has secured key customer benefits, including the following:

(a) the facilitation of the construction of the ESB Coolkeeragh gas power plant (400MW CCGT) in Derry in 2005;

(b) the facilitation of the 'Ten Towns Licensed Area' (including towns across NI such as Newry, Ballymena, Antrim, Armagh, Banbridge) which connects to GNI(UK)'s pipelines and which has enabled over 28,000 customers to switch to cleaner and cheaper natural gas;

(c) increased security of supply of the NI gas network via the connection of the South North Pipeline to IC2 (Gas Networks Ireland's second subsea Interconnector with Scotland) thereby creating an effective ring main in the event of any unforeseen outage; and

(d) the facilitation of the NI 'Gas to the West Project' which will see the gas network be extended to Fermanagh, Tyrone and Strabane (by Mutual Energy/SGN) in late 2016 and in 2017.

3. INSUFFICIENT TRIGGER FOR NIAUR TO REVIEW THE RATE OF RETURN

3.1 GNI (UK) refers to the chronology in the Appendix, which outlines the history to, and evolution of, the licence and the dialogue between the parties as to same. GNI (UK) considers that, to the extent that there is any conflict between its chronology and the narrative at paragraphs 2.7 -2.12 of NIAUR's Notice, GNI (UK)'s account is to be preferred.

3.2 NIAUR suggests, at paragraph 2.9 of NIAUR's Notice, that the fixing of three components of the rate of return *"resulted in a higher rate of return for GNI (UK) than would otherwise have been the case, had GNI (UK) not agreed to facilitate mutualisation"*. NIAUR's apparent trigger for the review of the rate of return is stated as follows:

> *"2.11 Discussions on mutualisation continued after the price control determination. While these discussions are ongoing and may yet progress, we must move forward with our preparatory work for the next price control for GNI (UK) in the interim.*
>
> *2.12 We recognize that only GNI (UK) and its shareholder can decide whether the assets should be sold. However, in the absence of mutualisation we consider that the rationale for the current licence conditions should be reviewed to determine whether they continue to facilitate the best outcome for customers."*

3.3 It is difficult to gauge how NIAUR has taken the view that there is an "*absence of mutualisation*", and that this alone is a sound reason for reviewing the fixed rate components and thus allowing NIAUR decide what is an appropriate rate of return. There appears to be no valid basis for NIAUR's decision to review the fixed components of the rate of return at this juncture. GNI (UK) submits that NIAUR is not entitled to undertake such any such review in the manner proposed in NIAUR's Notice.

3.4 Moreover, GNI (UK) considers that the requirement for certainty as to its rate of return, which underpinned its original investment, remains, and that this mitigates in favour of leaving Condition 2.2 unchanged at this point.

4. **NIAUR'S FLAWED ASSESSMENT**

4.1 NIAUR's Notice summarises (under the heading "**Consumer impact**") its reasons for seeking to modify the licence as follows: *"The proposed modification will permit the Authority to set a rate of return which better reflects prevailing market conditions and the level of risk borne by the licence holder. Consumers will benefit from the more efficient allocation of capital that will follow the alignment of risk and return".*[1]

4.2 NIAUR's Notice (at paragraphs 2.13 to 2.36) purports to analyse the "appropriateness" of GNI (UK)'s rate of return licence conditions. NIAUR summarises its task as regards establishing an appropriate rate of return as follows (at paragraph 2.13): *"In essence the objective is to set a rate of return that reflects not only current market conditions, both debt and equity, but also reflects the level of risk associated with an investment in the regulated company as compared to systematic market risk. By setting rate of return in this way regulators balance their statutory duties to on the one hand protect the interests of consumers while on the other ensuring that the regulated company can adequately finance its regulated activities."*

4.3 However, NIAUR's assessment of the rate of return focusses on a (flawed) assessment of the market rate, and appears to overlook the particular circumstances of the investment made by GNI (UK) at the time of that investment. It fails to take account of the risks that GNI (UK) has undertaken, and how these compare with the levels of risk associated with NIAUR's identified set of comparators.

NIAUR's rationale for modifying the licence is, therefore, based on a partial and flawed assessment of GNI (UK)'s fixed rate of return. NIAUR's approach to assessing an appropriate rate of return will under-remunerate GNI (UK) for the risks that it undertook in developing the investments. Therefore, GNI (UK) considers that, in its assessment of the appropriateness of GNI (UK)'s rate of return licence conditions, NIAUR has not lawfully balanced its statutory duties to the consumer and the licensee.

NIAUR's reasons

4.4 NIAUR's Notice then seeks to explain its rationale for modifying by reference to the three fixed components comprising the WACC:

(a) **Cost of Debt:** "*the current licence drafting is therefore not ideal in that it is based on a traditional bottom up approach to constructing the cost of debt rather than a more contemporary approach which applies directly observable data*" (at paragraph 2.19);

(b) **Cost of Equity:** "*the Utility Regulator could therefore more effectively carry out its statutory duties if the licence was modified such that it could set the cost of equity in line with prevailing market rates*" (at paragraph 2.28); and

(c) **Gearing:** *"We consider that the UR could more effectively fulfil its statutory duties if the licence was modified such that it could set the gearing ratio in a way that better reflected the*

[1] NIAUR's Notice p. 1

costs of debt and equity funding and to facilitate the possibility of 100% debt funding" (at paragraph 2.35).

GNI (UK)'s response

4.5 With regard to the cost of debt, NIAUR itself freely admits in NIAUR's Notice that this aspect of the licence does not impede it fulfilling its functions, stating (at paragraph 2.19) that *"the 2012-17 price control determination demonstrates that this has not unduly constrained the Utility Regulator in meeting its statutory duties"*, and merely adds that it does merit some review. GNI (UK) contends that this is not a sufficient basis to justify any such review.

4.6 As regards the cost of equity and gearing, NIAUR's reasons for seeking to modify these aspects of the WACC appear to be based on its analysis of prevailing market rates. On the basis of its analysis NIAUR notes that:

(a) *"the cost of equity in the current licence is substantially above current market rates"* (at paragraph 2.27); and

(b) *"it is likely that the current gearing ratio in combination with the high value put on equity is leading to a more generous allowance to GNI (UK) than is necessary to finance its activities"* (at paragraph 2.31).

4.7 In relation to moving to a 100% gearing ratio, NIAUR also refers to discussions with GNI (UK) concerning the circumstances in which mutualisation might be triggered, namely if NIAUR could demonstrate that the following three conditions were met:

(a) that it is in the economic interest of customers in NI;

(b) that there has been no progress on all-island tarification; and

(c) that GNI (UK)'s economic stake in the development of the network is fairly remunerated and not prejudiced as a result of the foregoing.

4.8 GNI (UK) notes that if NIAUR were simply to enforce a gearing ratio of 100% when setting GNI (UK)'s allowed rate of return, it would not reflect GNI (UK)'s actual financing structure at present, and therefore would not fairly remunerate GNI (UK). If NIAUR were to impose a decision that GNI (UK)'s rate of return should be calculated on the basis of a 100% gearing ratio, such a decision would be grossly unfair and without precedent. This would be inconsistent with the third condition for mutualisation listed above. Furthermore, in circumstances where mutualisation would require the debt-funded purchase of GNI (UK)'s equity interest at a fair price, and associated changes to the regulatory framework to support a mutualised entity, it is disingenuous of NIAUR to suggest that calculating GNI (UK)'s rate of return on the basis of 100% gearing is reasonable.

Market rates vs lifetime rates

4.9 NIAUR's analysis compares the licence rates of return which are modelled on a lifetime view, with a snapshot of today's prevailing market rates. A fixed return over the life of a long-lived infrastructure project cannot be compared with spot rates at a point in time and inferences drawn as to whether the overall return to the investor is 'too low' or 'too high'. As this is a false comparison, NIAUR's conclusions by reference to this snapshot are flawed and unsubstantiated.

4.10 NIAUR and GNI (UK) adopted an appropriate approach to assessing whether GNI (UK)'s rate of return was reasonable at the time that its rate was set. The assessment was made by considering the risks that GNI (UK) accepted when entering into the project and agreeing to the licence terms. It was determined by the parties at that time (and fixed in the licence) that, over the lifetime of the project, an average return of 15% at that time was an appropriate remuneration for those risks.

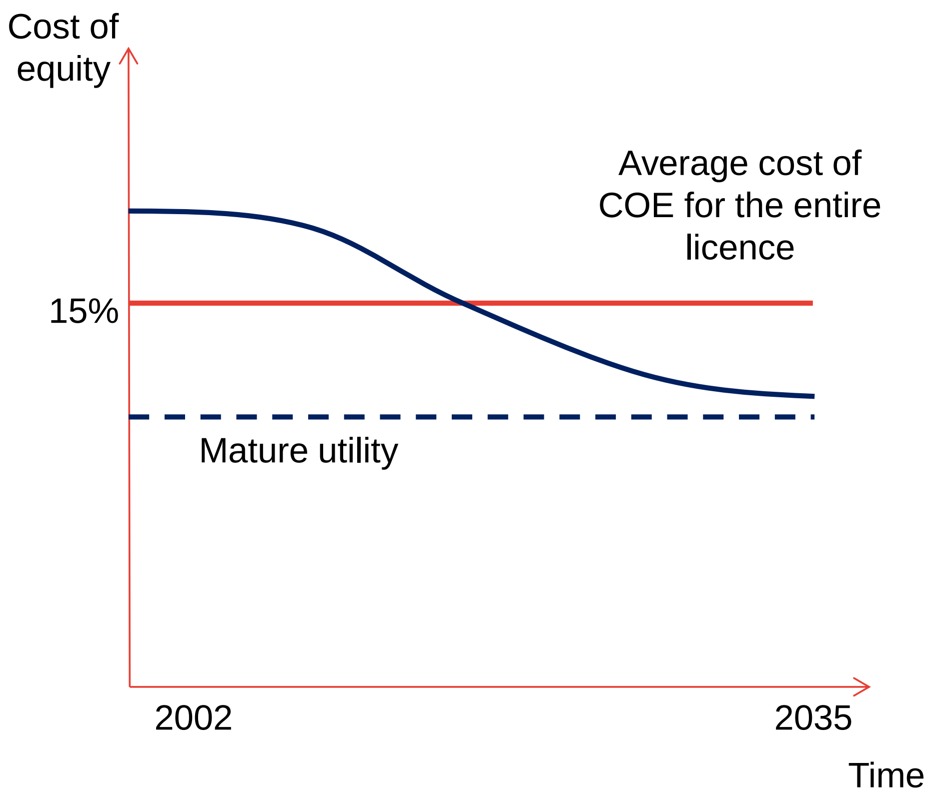
4.11 There are significant risks in building and operating pipeline assets, and these risks will vary over the lifetime of a project. In particular:

(a) **Construction and cost risk**: in all large infrastructure projects, such as building gas pipelines, there are significant construction risks. For example, problems are often identified in the construction phase, which can result in higher building costs than were expected. Unexpected delays in the construction phase can also lead to higher costs than were anticipated;

(b) **Inflation risk**: in running a long-term project, some cost commitments are likely to be made over a period of a few years. For example, commitments will be made to pay back debt investors by a specific amount and also on wage deals. These commitments are likely to be made in nominal terms, which means that an inflation assumption would have to be made when the deal is struck. Since allowed revenues are set in real terms, GNI (UK) were taking on a risk that inflation would be different in outturn from the expected level of inflation. If the actual level of inflation turned out to be lower than the expected level, GNI (UK)'s revenue could be adversely impacted.

4.12 These risks are higher earlier on in the lifetime of the project, as shown in the diagram below, and lower towards the end of the project lifetime. For example, construction and cost risks are lower as the project enters maturity.

Exhibit 1. Risks over the lifetime of pipeline



Source: Frontier Economics

Models for remuneration of investment

4.13 One approach to funding is to set a high cost of equity during the construction phase, and then to set a lower cost of equity for the post construction phase, as the level of risk borne declines. However, this is not the approach that was chosen by NIAUR. Rather, the choice of a fixed 'flat' return on equity explicitly set for the lifetime of the asset, necessarily implies that the additional risk premium arising in the construction phase is effectively 'smoothed' and recovered over the asset lifetime. This means that GNI (UK) is remunerated at the same rate over the lifetime of the asset, instead of being rewarded more significantly at the time it took on the higher risks. This also means that GNI (UK) was under-remunerated at the start of the project, and will recover this deficit by receiving returns that are higher than the average rate of return in the latter phases of the project (see Exhibit 1 above).

4.14 The cost of equity agreed and set out in the licence is what NIAUR and GNI (UK) both considered in 2002 to be the appropriate average over the life cycle of the project. It was agreed – by both parties - to be the appropriate rate at which the equity investors needed to be compensated over the entire licence period. Therefore, clearly, at the time the economic terms of GNI (UK)'s licence were fixed, NIAUR considered that 15% was a reasonable level of return to reward GNI (UK) for its investment risk.

4.15 GNI (UK) also notes that NIAUR is only proposing to make a change to one element (the WACC) of the current GNI (UK) licence conditions. When NIAUR and GNI (UK) agreed on the current GNI (UK) licence conditions, various decisions were made, and ultimately an "in the round" decision was taken about the reasonableness of the package as a whole. For example, GNI (UK) bears the risk of deviations between actual and allowed operating expenditure and the licence provides a limited mechanism for ongoing capex, and these would have been considered alongside the components of GNI (UK)'s rate of return. It is not appropriate for NIAUR to cherry-pick only one aspect of the arrangement it has previously made, since these decisions were made on a holistic basis at the time.

4.16 From NIAUR's Notice, it does not appear to have conducted any analysis of whether the lifetime returns to GNI (UK) over the course of the project and taking into account the risks previously borne by GNI (UK), is appropriate. NIAUR has compared today's market rates against the licence rates - this means that the comparison is being made at a point in time when the asset is already built and risks have diminished - and from that comparison, has inferred that returns are too high. This is entirely inappropriate. Such a snapshot comparison of GNI (UK)'s fixed rate of return against currently low market rates is irrelevant, and making a licence modification on such a basis is analogous to demanding a refund after an insurance term has ended without damage.

4.17 NIAUR appears to suggest that the potential for GNI (UK) to be mutualised should be considered when assessing whether the current rate of return is reasonable. For example, it states that "*this resulted in a higher rate of return for GNI (UK) than would otherwise have been the case, had GNI (UK) not agreed to facilitate mutualisation*".[2] However, conditions on mutualisation are not relevant to an assessment of the reasonableness of GNI (UK)'s current rate of equity return. As NIAUR acknowledges, discussions on mutualisation continue.

NIAUR'S flawed calculations

4.18 NIAUR's Notice sets out a number of calculations which purport to demonstrate that GNI (UK)'s licence rate of return is significantly greater than current market returns. NIAUR concludes that components of GNI (UK)'s rate of return on equity are fixed "*at levels which are significantly out of step with recent price control determinations by the UR and other regulators*".[3]

4.19 For the reasons set out above, GNI (UK) does not accept that the comparison to current market returns is the appropriate benchmark. Notwithstanding that, GNI (UK) considers that NIAUR's calculations are inherently flawed, for at least the following reasons:

(a) NIAUR's conclusion that its analysis provides evidence that "*the cost of equity contained in the current licence is substantially above current market rates*" is flawed.[4] NIAUR sets out the equity market return assumptions and asset beta estimates that have been used

[2] NIAUR's Notice, para 2.9

[3] NIAUR's Notice, para 2.36

[4] NIAUR's Notice, para 2.27

by a range of regulators between 2012 and 2015. However, these figures cannot be used to draw any conclusions about GNI (UK)'s fixed rate of return, because any such comparisons would not be like-for-like, for the following reasons:

(i) first, the cost of equity figures that NIAUR estimates are in real terms, whereas the quoted 15% return in the licence is in nominal terms;

(ii) secondly, the equity market assumptions and asset beta estimates used in NIAUR's calculations are based on different gearing figures to GNI (UK)'s; and

(iii) thirdly, the figures used by NIAUR are from different scenarios, with different conditions and risks to those faced by GNI (UK). The comparison that NIAUR draws in paragraph 2.27 in particular is therefore misleading.

(b) NIAUR states (in paragraph 2.30) that the difference in gearing between GNI (UK) and the gearing ratios typically used by other regulators "*must be seen in the context of GNI (UK) receiving a much higher cost of equity than other regulated companies*". This statement is incorrect for the following reasons:

(i) first, as explained above, it is misleading to suggest that GNI (UK)'s cost of equity is much higher than other regulated companies on the basis of NIAUR's evidence; and

(ii) secondly, it is a fact of regulatory finance that if a company has a higher gearing ratio, its cost of equity is likely to be higher than a company with a lower gearing ratio.

(c) NIAUR further appears to suggest that it could "*more effectively carry out / fulfil its duties*" [5] if GNI (UK)'s gearing was set to 100%. This would be entirely inappropriate as it would not accurately represent GNI (UK)'s funding structure and would therefore not provide it with sufficient returns to cover its actual cost of finance. GNI (UK) does have equity investors, as it is not mutualised, and these equity investors need to be remunerated for the risks that they bore in the early phases of the project (as explained earlier). Neither is it clear this would result in NIAUR fulfilling its duties better, as the result would be to undermine the climate for investment in Northern Ireland, and to lead new investors to include a premium for regulatory risk in the cost of any new utility infrastructure investments, increasing customers' bills.

(d) NIAUR points to other infrastructure projects at paragraphs 2.32 – 2.35, and seems to suggest that these alternative projects provide evidence that GNI (UK) should be remunerated on the basis of a higher gearing ratio and could be 100% debt financed in future. The fact that other projects, such as the Belfast Gas Transmission Pipeline (BGTP) and the Northern Ireland Energy Holdings (NIEH) high-pressure pipelines for the Gas to the West project, are funded in different ways, and have different risk and reward balances is, in fact, irrelevant to this decision. To put it another way, the mere existence of arrangements based on 100% debt funding cannot be used to imply

[5] NIAUR's Notice, paras 2.28 and 2.35

that GNI (UK) should receive lower returns. Such an assertion would fail to acknowledge the other differences between the regulatory arrangements of these projects and those of GNI (UK), in particular that these projects were set-up to be lower risk, lower return investments. At paragraphs 3.5 – 3.10 of the NIAUR's Notice, NIAUR does recognise that these other projects have regulatory mechanisms that reduce investment risks. However, GNI (UK) considers that NIAUR does not pay due regard to these differences. In any case, such recognition of these differences does not detract from GNI (UK)'s point that this comparison is irrelevant; GNI (UK) is not 100% debt-financed, and would not be fairly remunerated if its rate of return was calculated on the assumption that it was.

5. EX POST EXPROPRIATION

5.1 NIAUR's proposed modification would result in removing the fixed terms on the lifetime return on equity, and replacing it with the following: "*rate of return on equity…be determined by the Authority to apply at and with effect from each Review Date taking account of (amongst other relevant considerations) the prevailing market rates at the time of the determination*".[6]

5.2 If NIAUR intended to honour the existing licence terms which fix the return on equity at 15% over the asset lifetime, there would be no reason to modify the licence. Therefore, the only rational assessment of the modification is that NIAUR intends to replace the fixed terms with variable terms to be set by it, at each price control.

5.3 This would amount to an expropriation of returns, which GNI (UK) could not accept. As explained above, the agreement – now reflected in the licence – to fix the return on equity at an average level over the asset lifetime was jointly reached. Therefore, for its part, NIAUR must have considered that it was setting a fair total return for GNI (UK) and for its customers - otherwise, it would not have agreed to such terms.

5.4 The rate was agreed upon at average return of 15% over the lifetime of the asset, to fairly remunerate GNI (UK) for the risks it was set to undertake. As set out in detail above, the nature of an average return and GNI (UK)'s risk profile means that GNI (UK) was under-remunerated in the early phase of the project (i.e. 15% was below its actual required return in the early phases), and is set to "re-coup" this deficit in later phases of the project. If the return on equity were to now become variable and be based on prevailing market conditions, it is highly likely that GNI (UK) would not be able to recover the cost of equity 'deficit' from the early part of the project as initially intended.

5.5 Therefore, the total return that GNI (UK) would receive for the investments that it made, and risks that it accepted when starting the project, would be lower than the total return that NIAUR committed to providing and considered was fair for GNI (UK) and for its customers in 2008.

6. DAMAGE TO INVESTOR CONFIDENCE

6.1 Making such a change would significantly undermine regulatory credibility for any future tenders and licences in the energy infrastructure sectors in Northern Ireland, as investors

[6] NIAUR's Notice, Annex 1, p. 24

would no longer have confidence in recovering what they are promised under licence terms and conditions. This would ultimately be to the detriment of customers through an increase in the actual cost of capital for all future projects.

6.2 The Competition Commission (CC) recognised these concerns in its Final Determination of the Phoenix Natural Gas Limited (PNGL) case in November 2012. The CC considered the potential effects on regulatory uncertainty and the actual cost of capital of an adjustment to PNGL's total regulatory value (TRV) and a reduction in PNGL's fixed rate of return. The CC found that:

(a) (in relation to the TRV adjustment) "*we expect that this would lead to a perception of regulatory uncertainty, as investors may assume that UR's future actions could be unpredictable…investors may anticipate that in addition to normal commercial risks there could be greater uncertainty in the future about the regulatory environment, and thus increased risks that returns on investment will not be realized in the way or to the extent that is expected. This is likely adversely to affect investment decisions in the future*";[7] and

(b) (in relation to the rate of return) "*we think that there was adequate justification for not departing from retaining a fixed rate of return for the remainder of the original 20-year period that incorporated a return for project-specific risk*".[8]

6.3 This shows that the CC considers that retaining a fixed rate of return can be justified where that return was set to remunerate project specific risk, and that any changes to fixed licence agreements could significantly affect regulatory certainty.

7. CUSTOMER DETRIMENT

7.1 The agreement between GNI (UK) and NIAUR facilitated investment in the gas industry in Northern Ireland. The fact that this agreement ensured GNI (UK)'s investors would be fairly remunerated over the lifetime of the assets, enabled GNI (UK) to invest in potentially risky projects that were ultimately of benefit to Northern Irish gas customers (as outlined at paragraph 2.5 above).

7.2 If NIAUR were to go ahead with its proposal, as clearly explained above, GNI (UK) would no longer receive a fair return for the risky projects that it has previously entered in to. This expropriation of GNI (UK)'s returns will reduce investor confidence in the utility sectors regulated by NIAUR. This is because, as highlighted by the CC in the Phoenix Natural Gas case, decisions such as that proposed by NIAUR would lead to uncertainty as investors may conclude that NIAUR's future actions could be unpredictable.

7.3 Such a reduction in investor confidence and regulatory certainty is likely to reduce investment in infrastructure projects in Northern Ireland, and increase the required returns for those investors who continue to finance such projects. This will be to the detriment of all customers of the utility sectors regulated by NIAUR, as they are likely to receive a poorer service, and have higher bills .

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[7] Competition Commission, Final Determination in Phoenix Natural Gas Limited Price determination, para 8.89

[8] Competition Commission, Final Determination in Phoenix Natural Gas Limited Price determination, para 7.81

8. **CONCLUSION**

8.1 GNI (UK) is deeply concerned about the proposal outlined in NIAUR's Notice. If NIAUR intended to abide by the licence terms in respect of the fixed return on equity at 15% over the asset lifetime, there would be no reason to commence this review and seek to modify the licence. Hence, the only reason for the proposed modification to the licence condition can be an intention on NIAUR's part to vary the licence and reduce the rate of return. In so doing, NIAUR is resiling from the regulatory bargain made with GNI (UK) pursuant to which it provided GNI (UK) with certainty as to its return in exchange for its investment in Northern Ireland infrastructure.

8.2 GNI (UK) has provided a response on the following key aspects of NIAUR's Notice:

(a) GNI (UK) considers that NIAUR has failed to demonstrate that there is a sufficient basis in fact and law for it to review the fixed components in GNI (UK)'s rate of return as agreed in its licence;

(b) GNI (UK) contends that NIAUR's proposal is based on a flawed and incomplete assessment. It does not agree that a comparison of its fixed rate of return with current market rates can be used to determine whether the fixed rate of return is reasonable;

(c) reducing GNI (UK)'s rate for return will under-remunerate GNI (UK)'s investors for the risks they previously accepted in developing the project. This will be to the detriment of consumers and will damage investor confidence in the regulator and undermine critical future infrastructure investment in all of the utility sectors regulated by NIAUR in Northern Ireland; and

(d) GNI (UK) notes that ex-post expropriation such as that proposed has been the issue in other regulatory decisions in Northern Ireland and has been adjudicated on by the Competition Commission (now CMA). In previous decisions, the Competition Commission has found such ex-post appropriation to be unacceptable and acting against the customer interest.

8.3 Notwithstanding that GNI (UK) disagrees with the principles underlying NIAUR's assessment, GNI (UK) has identified flaws in NIAUR's calculations on the cost of equity. NIAUR's comparison of GNI (UK)'s rate of return with current market rates is not like-for-like, and therefore unreliable.

8.4 GNI (UK) invites NIAUR to give due consideration and sufficient weight to its concerns and submission on the proposed modification. GNI (UK) is amenable to providing any necessary further detail to NIAUR of its position, as summarised above, and to elaborating upon the impact of the proposed modification on GNI (UK)'s operation of the licence. NIAUR is obliged, in order properly to discharge its statutory functions and duties, to have proper regard and to respond to GNI (UK)'s submissions and to consider the serious impact on GNI (UK) should its licence be modified. We trust that NIAUR will accordingly give due consideration to this response and will respond fully to the serious concerns raised by GNI (UK) in this response.

APPENDIX

CHRONOLOGY OF THE CONVEYANCE LICENCE

(a) December 2002: original licence granted:

  (i) for North West Pipeline (to the then new ESB Power Plant in Coolkeeragh in Derry), the South West Pipeline and any spurs;

  (ii) contained provisions for 15% return on equity with equity being no more than 30% (i.e. gearing of at least 70%);

  (iii) GNI(UK) bore construction costs on its own balance sheet until construction completed.

(b) Construction of North West pipeline commenced in 2003.

(c) Also in 2003 there were a number of meetings and correspondences between GNI (UK) and NIAUR regarding what would happen post construction of (all) the pipelines:

  (i) during this time GNI (UK) highlighted concerns regarding in particular the open nature of the equity element in the original licence, thereby leaving GNI (UK) with some uncertainty about the value of the projects;

  (ii) discussions were also held regarding the parameters within which NIAUR could trigger post construction changes of financing.

(d) The matters referred to in (c) above were generally agreed in June/July 2004 (albeit there still remains some points in issue between GNI (UK) and NIAUR as to the specifics). A new licence was to be issued in time to give effect to these discussions. The key points arising were as follows:

  (i) gearing to be set at 72.5% with equity remaining unchanged at 15%;

  (ii) further discussions in relation to how mutualisation might be facilitated if 3 criteria could be demonstrated:

    (A) that it is in the economic interest of NI customers;

    (B) that there has been no progress on all island tarification; and

    (C) that GNI (UK)'s economic stake in the development of the network is fairly remunerated and not prejudiced as a result of the foregoing.

(e) Construction of the North West Pipeline completed in the 04/05 gas year.

(f) Further discussions and correspondences took place in 2005 and 2006 where further detail regarding the proposed licence changes were discussed.

(g) Construction of the South North Pipeline was completed in the 06/07 gas year.

(h) 2007 saw the first significant price control discussions completed which included the discussion of wording of a licence modification to give effect to the price control decision.

(i) In July 2008 the licence modifications were agreed and a new licence was issued to GNI (UK) which provided the required certainty for GNI (UK) as regards fixing certain components in GNI (UK)'s rate of return, or Weighted Average Cost of Capital (WACC), for the duration of the licence.