



Paul Jackson
Inquiry Manager
Competition Commission
Victoria House
Southampton Row
London WC1B 4AD

29 November 2013

Dear Mr Jackson

I refer to your notice dated 8 November 2013 inviting any interested party to make a submission in relation to the Provisional Determination of the Northern Ireland Electricity Limited (*NIE*) price control by the Competition Commission (the *Commission*).

We are concerned that the outcome of the Commission's NIE investigation may have important consequences for Phoenix Natural Gas Limited (*PNGL*). We provided a submission to you dated 30 May 2013 (the *May submission*) which focussed on particular areas where we felt PNGL was in a position to offer some observations. We are following this up with a brief submission in response to the Commission's invitation to comment on its Provisional Determination.

PNGL welcomes the Commission's Provisional Determination findings that as a general principle it is undesirable to revisit events occurring during periods covered by past regulatory settlements¹ and that a very strong public interest case would be required to justify an adjustment affecting a past settlement². This reaffirms the position the Commission set out within its PNGL12 determination.

PNGL also welcomes the clarifications the Commission has made regarding the inefficient spend clause, and the examples the Commission provides for things it would not expect to fall within the scope of such a clause.³ It is hoped that these clarifications limits the scope for the Northern Ireland Authority for Utility Regulation (the *Authority*) to make further retrospective adjustments in future.

The Commission's recognition of the risks of regulatory micro-management⁴ and provisional conclusion that the risks associated with introducing a reporter outweigh any benefits⁵ are also welcomed by PNGL.

There are three aspects of the Provisional Determination where PNGL believes that the Commission's provisional findings may have an adverse read across to the regulatory environment for PNGL and other regulated companies under the jurisdiction of the

¹ Para 15.84.

² Para 15.85.

³ Para 5.126.

⁴ Paras 5.64, 5.244 and 18.18.

⁵ Paras 17.18 and 17.20

Commission. These relate to the calculation of the WACC, the Commission's approach to financeability, and the treatment of pass-through costs. We discuss each in turn below.

WACC

As PNGL noted in its May submission, there are a number of differences between PNGL and NIE which mean the approach to calculating the WACC for NIE is likely to be different to the approach required for PNGL. In particular:

- i. there are differences between the activities that PNGL undertakes relative to NIE, and in the sectors in which both companies operate; and
- ii. the regulatory models for the two companies are different: in particular, the Profile Adjustment for PNGL implies longer cash flow duration relative to NIE.

However, while these factors distinguish the two companies, certain aspects of the Commission's methodology for determining NIE's WACC may have relevance for PNGL's future WACC determinations.

PNGL is therefore concerned about the low vanilla WACC of 4.1% that has been provisionally determined for NIE. This is the lowest WACC allowance of any UK regulator, and is substantially lower than the WACC determined by UR for NIE in its RP5 Final Proposals.

In particular, we are concerned that the Commission has rejected an uplift to the WACC to account for a Northern Ireland premium relative to GB. PNGL continues to believe that there is strong evidence of a Northern Ireland premium on the cost of debt relative to GB, and that the appropriate application of financial theory would imply this premium should also be applied to the cost of equity⁶.

PNGL appended a paper to its May submission written by an independent academic, Professor Ian Cooper of the London Business School, which considered the potential for a Northern Ireland premium and the implications for the WACC. Professor Cooper's analysis supported our view that Northern Ireland companies should receive a premium to both debt and equity relative to GB.

In considering this and other submissions, the Commission has stated:

"We do not think that we can rely on any of these theories in order to adjust our estimates of NIE's cost of equity.

*This is because there is a possibility that any higher risk that bondholders bear (or perceive that they bear) might be offset by lower risk borne by equity holders. In other words, it is possible that, instead of being a consequence of a higher underlying business risk, any higher risk borne by debt holders might be merely the result of a different allocation in the case of NIE of an equivalent business risk between equity and debt."*⁷

⁶ We note that differences between PNGL and NIE could cause the observed premium on debt yields to be driven by different factors for each company. For example, the Commission has suggested NIE's ownership by ESB could potentially be a driver of the observed premium on NIE's bonds (Para 13.63).

PNGL considers the Commission's reasoning is incorrect. Well-established finance theory rests on the notion that debt and equity are contingent claims on common underlying assets. This means the cost of debt and the cost of equity are related to each other. Given the primacy of recovering debt in the event of default, an increase in default risk for debt investors by definition increases risk for equity investors.

The Commission's contention that an increase in debt risk might somehow reduce risk to equity directly contradicts this fundamental principle of finance theory. In support of its contention, the Commission suggests that NIE's bondholders may have perceived a risk that NIE's owner could draw on NIE's cashflows to support its own financial position. However the Commission rightly recognises that regulatory ring fencing conditions mean that such a theory cannot be relied upon. But even absent regulatory ring-fencing, the circumstances in which a given default risk can be transferred from equity to debt are not apparent, and the Commission does not explain how that could be the case.

The low WACC decision could also be a cause of the financeability concerns highlighted by the Commission, which we discuss further in the next section.

Overall, PNGL therefore does not believe the Commission's reasoning is sufficient to reject an uplift to reflect Northern Ireland risk. PNGL therefore urges the Commission to re-consider its WACC determination.

Financeability

The Commission found that its provisional determination has resulted in concern around NIE's interest cover ratios for RP5, in particular the PMICR. However, the Commission states that NIE has a number of options available to it to alleviate these financial concerns. These options include limiting dividends and raising finance in the form of equity or equity-like instruments⁸.

PNGL is concerned at the implication of the Commission's determination that financeability tests should take as a presumption that equity investors can be called on to alleviate distress, and the implied conclusion that there would not be an impact on required equity returns if equity investors were indeed expected to do so. While this may happen in practice, to assume that this occurs undermines the purpose of the financeability tests.

During the PNGL12 inquiry, UR adopted a similar approach to its financeability assessment by building in the assumption that dividends would flex in the event of financial distress, such that financial ratios recover rapidly from any negative shock. As PNGL argued strongly to the Commission⁹, adjustments to the dividend profile may be considered as a possible solution to a financeability problem *when it occurs*. However, it is not appropriate to assume dividends are varied when assessing *if there is a financeability problem*. The financeability test should therefore determine whether the company is financeable under a set of proposed price control conditions, *given the returns required for debt and equity*. This is why standard practice is to fix dividend assumptions and gearing to the required levels in financeability analysis.

⁷ Para 13.102 – 13.103.

⁸ Para 16.46

⁹ See for example PNGL's Statement of Case para 5.60 and 5.61, and Supplementary Submission Section 8 and Annex 5.

PNGL would therefore be concerned if the Commission's approach for NIE established a precedent in which financeability concerns can be dismissed on the grounds that equity investors can alleviate the distress. Such an approach, were it applied by regulators in the future, would not properly reflect the public interest in securing that regulated utilities can finance their activities, including through both debt and equity. Further, we consider that if this approach was to be retained, investors might perceive that the regulatory framework assumes away financeability problems rather than seeking to identify any genuine financeability concern, which could result in an increase in the required cost of equity for regulated utilities.

Treatment of pass-through costs

The Commission has stated its view that whether or not a particular cost should be subject to full pass-through to customers should not depend on whether that cost is controllable, or even semi-controllable¹⁰. This is a departure from the regulatory norm. PNGL considers that the established practice that uncontrollable costs should be treated as pass-through is in the public interest. Exposing companies to risk that they are unable to control or mitigate is likely to push up the cost of capital.

In particular, we note the Commission's decision that rates costs are not subject to pass-through. This is despite the fact that a rating re-valuation is due to occur in the middle of NIE's price control. The Commission has suggested that cost pass-through may be more appropriate if it is not possible to achieve a reasonable expenditure forecast, and if the scale of the uncertain cost item is large¹¹. PNGL does not consider that reasonable and accurate rates forecasts can be determined, given the mid-period re-valuation.

Ofgem treats business rates as a pass-through item, subject to the DNOs demonstrating that they have taken appropriate actions to minimise rates. PNGL considers that this solution for rates is a more reasonable approach than that proposed by the Commission, and would be in the public interest.

We are happy to discuss with you any aspect of these comments.

Yours sincerely

Ivan Bell
Commercial Operations Director
Phoenix Natural Gas Limited

¹⁰ Para 5.319

¹¹ Para 5.323