

**Decision published pursuant to Article
14(8) of the Gas (Northern Ireland)
Order 1996**

**Modifications to GNI (UK)'s Gas
Conveyance Licence**

29th June 2016



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference

Act with integrity.

Abstract

This paper sets out the Utility Regulator's decision to make modifications to the gas conveyance licence granted to BGE (UK) in February 2002. The modifications amend the parameters within which the rate of return on capital employed by the licence holder over a price control period may be set. This document summarises the responses received to the statutory consultation and our consideration of these responses. It also includes the text of the modified licence condition.

Audience

This decision is likely to be of interest to the licensee affected, other regulated companies in the energy industry, government and other statutory bodies and consumer groups with an interest in the energy industry.

Consumer impact

The modifications will enable the Utility Regulator 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.

TABLE OF CONTENTS

DECISION PUBLISHED PURSUANT TO ARTICLE 14(8) OF THE GAS (NORTHERN IRELAND) ORDER 1996	3
1. Introduction.....	4
2. Consideration of Responses Received	6
<i>Insufficient Trigger to Review Rate of Return</i>	7
<i>Flawed Assessment</i>	9
<i>Ex-Post Expropriation</i>	17
<i>Damage to Investor Confidence</i>	20
<i>Customer Detriment</i>	24
3. Conclusion.....	25
<i>Next Steps</i>	25
4. Explanation of the Licence Modifications.....	26
Annex 1: Licence Modifications	27

DECISION PUBLISHED PURSUANT TO ARTICLE 14(8) OF THE GAS (NORTHERN IRELAND) ORDER 1996

In pursuance of its powers under Article 14(1) of the Gas (Northern Ireland) Order 1996 (as amended) (the "Gas Order") the Northern Ireland Authority for Utility Regulation (hereafter referred to as the Utility Regulator) hereby publishes in accordance with Article 14(8) its decision to proceed with the making of modifications to paragraph 5 of Annex A of Condition 2.2 of the gas conveyance licence granted to BGE (UK) Ltd on 12 February 2002 (the "Licence").

In accordance with Article 14(8) of the Gas Order:

1. Section 1 of this Decision Paper states the effect of the modifications.
2. Section 2 of this Decision Paper states how the Utility Regulator has taken account of any representations made to the notice published by it pursuant to Article 14(2) of the Gas Order, on 4 February 2016.

The modifications shown in Annex A to this Decision Paper shall have effect from 23 August 2016.

Dated this 28th June 2016.

1. Introduction

- 1.1. The Utility Regulator's principal objective in carrying out the duties associated with its gas functions is to promote the development and maintenance of an efficient, economic and coordinated gas industry in Northern Ireland, and to do so consistently with the fulfilment of its objectives set out in the European Gas Directive¹, and by having regard to a number of matters, as set out more fully in the Energy (Northern Ireland) Order 2003.
- 1.2. In line with these duties this document sets out our decision to modify paragraph 5 of Annex A of Condition 2.2 ('Rate of Return') of the gas conveyance licence granted to BGE (UK) Ltd in February 2002 (the Licence).
- 1.3. For the reasons set out in Section 2 of this Decision Paper we consider that the modifications set out in the notice published by the UR pursuant to Article 14(2) of the Gas Order, on 4 February 2016 should be made without change. The determination for the price control period commencing on 1 October 2017 will be made in accordance with the modified licence condition.
- 1.4. The effect of the modifications is that the rate of return on capital received by the licence holder during a price control period, will be determined by the Utility Regulator, so as to best reflect both prevailing capital market conditions and the level of risk borne by the licence holder, rather than being determined by reference to a calculation based on the cost of equity being fixed at 15% per annum post tax (nominal) and the gearing ratio

¹ Directive 2009/73/EC of the European Parliament and the Council of 13 July concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC

being fixed at 72.5% of total capital employed.

- 1.5. A notice under Article 14(2) of the Gas Order proposing the modifications and seeking comments from interested parties was published by the Utility Regulator on 4 February 2016. The consultation closed on 31 March 2016 and generated one response. This response was from the licence holder itself (which on 1 August 2015 changed its name, to GNI (UK) Ltd and is referred to as GNI (UK) from this point forward).
- 1.6. In section 2 we consider each of the points made by GNI (UK). The final text of the modified licence condition is also attached to this document.

2. Consideration of Responses Received

- 2.1. As noted in section 1 we received one response – from GNI (UK) – to the statutory consultation notice published on 4 February 2016. In their response GNI (UK) stated that they had serious concerns about the proposal, that the Utility Regulator is wrong and that our reasoning is flawed as to the need for the modifications and consequently our ability to make them.
- 2.2. GNI (UK) objected to our proposal to modify the licence condition such that the rate of return would be set in accordance with the provisions of the modified condition. In their response GNI (UK) set out a number of specific reasons for the objection, each of which is set out below along with our consideration of the issue raised.
- 2.3. As an introduction to their detailed response to our proposals GNI (UK) set out in broad terms the reasons why they considered the current licence conditions to be appropriate and should not be modified. These are that having fixed components in the rate of return is justified because they:
- Provide a true reflection of GNI (UK)'s investment risks in the pipeline projects undertaken since 2002. Any reduction in the rate of return will, correspondingly, not reward GNI (UK) for the risks that it undertook.
 - Provide and continue to provide, the necessary regulatory certainty for GNI (UK) to ensure the construction, funding and maintenance of the pipelines.
 - Provide broader regulatory stability fostering investor confidence in Northern Ireland's gas and other utility projects.
 - Benefit consumers by ensuring that significant investment decisions

may be made at reasonable cost, absent premium for regulatory risk and thereby facilitate the Utility Regulator in meeting its principal objective.

2.4. More particularly GNI (UK) contend that:

- The Utility Regulator is not entitled to review the rate of return provisions because the 'absence of mutualisation' is not a sufficient trigger for such a review.
- The Utility Regulator is wrong in suggesting that the rationale for having fixed components in respect of the rate of return calculation no longer applies.
- The modifications are based on a flawed and incomplete assessment and will under-remunerate GNI (UK) for investments it has made.
- The modifications are likely to result in ex post expropriation which in other cases has been found by the Competition Commission (now the CMA) to be unacceptable and against the consumer interest.
- The modifications will damage investor confidence and be to the detriment of consumers.

We have considered GNI (UK)'s representations and set out below our response to them.

Insufficient Trigger to Review Rate of Return

2.5. GNI (UK) states that the Utility Regulator wrongly assumes that the "absence of mutualisation" is a sufficient trigger for it to review the fixed components in the rate of return and that this assumption is incorrect as a

matter of fact and law.

- 2.6. GNI (UK) further states that there appears to be *'no valid basis for the Utility Regulator's decision to review the fixed components of the rate of return at this juncture'* and that the Utility Regulator is *not 'entitled to undertake any such review in the manner proposed'*. GNI (UK) specifically questions our view that there is an 'absence of mutualisation' and states that it finds it difficult to gauge how this alone is a sound reason for reviewing the fixed rate components, allowing us to determine an appropriate rate of return.
- 2.7. In short GNI (UK) contends that the Utility Regulator is not entitled to undertake a review of the licence condition without a specific and/or formal trigger to do so.

Our Response

- 2.8. The key point to note in response to the above proposition is that the Utility Regulator does not need a 'trigger' in order to undertake a review of whether existing licence conditions (whether in GNI (UK)'s licence or any other licence) continue to facilitate the best outcome for customers. The Utility Regulator is entitled to consider and review the suitability and appropriateness of existing licence conditions at any time. More particularly it should do so periodically not only as a matter of good regulatory practice but also in recognition of actual or potential changes in circumstances and/or market conditions and developments.
- 2.9. There is no principle which prohibits or discourages the Utility Regulator from carrying out a review of the appropriateness and continued suitability

of existing licence conditions at any given time or which requires a particular 'trigger' for any such review.

- 2.10. It is not therefore incorrect, as a matter of law or fact, for the Utility Regulator to review the continued appropriateness of the rate of return provisions in the licence and, having done so, to propose (and make) modifications to such provisions.
- 2.11. Notwithstanding all of the above, the carrying out of the review and making the associated modifications is wholly appropriate in circumstances where mutualisation is not likely to take place anytime soon.

Flawed Assessment

- 2.12. GNI (UK) claim the Utility Regulator is wrong in suggesting that the rationale for fixing the rate of return no longer applies. GNI (UK) also states that the Utility Regulator's proposed modifications are based on a flawed and incomplete assessment, and will under-remunerate GNI (UK) for the investments it has made in developing the project.
- 2.13. GNI (UK) state that the Utility Regulator's assessment of the returns earned by GNI (UK) when compared to market rates is flawed and failed to take account of the risks that GNI (UK) undertook, or how these compare with the comparators identified by the Utility Regulator.
- 2.14. With regard to the cost of debt component of the Weighted Average Cost of Capital, GNI (UK) notes that in our consultation we stated that the current licence condition had *'not unduly constrained the Utility Regulator in*

meeting its statutory duties' and contends therefore that there is no sufficient basis for the review.

2.15. With regard to the gearing component GNI (UK) states that if the Utility Regulator were *'simply to enforce a gearing ratio of 100% it would not reflect GNI (UK)'s actual financing structure at present, and therefore would not fairly remunerate it'*. and that, *'such a decision would be grossly unfair and without precedent'*.

2.16. With regard to the return on equity component GNI (UK) state that a *'fixed return over the life of a long-lived infrastructure project cannot be compared with spot rates at a point in time'*. Consequently the method of analysis used by the Utility Regulator to assess whether or not the return on equity received by GNI (UK) was flawed. GNI (UK) also argue that the current figure was agreed by both GNI (UK) and the Utility Regulator and fixed in the licence for the lifetime of the projects as appropriate remuneration for the risks borne by GNI (UK). These risks included:

- Construction and cost risks common to all large infrastructure projects.
- Inflation risk if the actual level of inflation turned out to be lower than the expected level, GNI (UK)'s revenue could be adversely impacted.

2.17. GNI (UK) note that such risks are higher during the construction phase of the project and then tail off over the project lifetime, leading to an uneven pattern of risk over time. GNI (UK)'s states that the approach taken in their case was to grant a flat return on equity over the project lifetime. This means that GNI (UK) was under remunerated during the construction phase of the project and consequently now requires a period when returns are greater than current risk levels might suggest.

- 2.18. GNI (UK) takes the view that the return on equity *'agreed and set out in the licence is what the Utility Regulator and GNI (UK) both considered in 2002 to be the appropriate average over the life cycle of the project'*. And that the *'Utility Regulator considered that 15% was a reasonable level of return to reward GNI (UK) for its investment risk'*.
- 2.19. GNI (UK) goes on to say that rate of return was part of an "in the round" decision taken about the reasonableness of the package of arrangements set out in the licence. For instance GNI (UK) *'bears the risk of deviations between actual and allowed operating expenditure'* and in addition there is *'a limited mechanism for ongoing capex'*. They argue therefore that the Utility Regulator is acting inappropriately by cherry-picking only one aspect of the arrangements.
- 2.20. GNI (UK) is of the view that a comparison between current market rates of return and those set out in the licence is inappropriate as it ignores the risks that have already been borne by GNI (UK). In the response GNI (UK) claims that it is *'analogous to demanding a refund after an insurance term has ended without damage'*. GNI (UK) also states that mutualisation is not relevant to an assessment of the reasonableness of GNI (UK)'s current rate of equity return and in any case discussions on mutualisation continue.
- 2.21. GNI (UK) goes on to challenge our analysis of the data which led us to conclude that the current licence has led to returns that are *'significantly out of step with recent price control determinations by the UR and other regulators'*.
- 2.22. GNI (UK) make the following points with regard to the cost of equity:

- The Utility Regulator's estimate are in real terms, whereas the return in the licence is in nominal terms;
- The equity market assumptions and asset beta estimates are based on different gearing figures to those in the licence;
- GNI (UK) faces a different pattern of risk from the comparators cited.

2.23. GNI (UK) make the following points with regard to the gearing ratio:

- It is misleading to state that the GNI (UK) return on equity is high and so this cannot be a reason for a gearing ratio of 72.5%;
- In regulatory finance a company with a higher gearing ratio will have a higher return on equity than an equivalent company with lower gearing ratio.

2.24. GNI (UK) goes on to state that any suggestion that the gearing ratio should increase to 100% would be *'entirely inappropriate as it would not accurately represent GNI (UK)'s funding structure..... equity investors need to be remunerated for the risks that they bore..... the result would be to undermine the climate for investment in Northern Ireland and lead new investors to include a premium for regulatory risk increasing customers' bills'*.

2.25. Finally, GNI (UK) state that the comparison with, for example Belfast Gas Transmission Limited to justify a higher gearing ratio for GNI (UK) is irrelevant. Such comparators are funded differently and have different risk and reward balances from those of GNI (UK). *'The mere existence of arrangements based on 100% debt funding cannot be used to imply that GNI (UK) should receive lower returns. These projects were set-up to be lower risk, lower return investments'* and the Utility Regulator's analysis

does not pay due regard to these differences.

Our Response

- 2.26. Throughout their response GNI (UK) assert that the proposed modifications represent the breach of some form of agreement that was reached between themselves and the Utility Regulator to fix the return on equity for the project lifetime. However, no evidence is presented in support of this assertion. GNI (UK) appears to have (wrongly) assumed that the current licence drafting represents some form of agreement - it does not. Licence conditions are subject to change. There is no legal impediment to the Utility Regulator modifying a licence condition should it be appropriate to do so to better facilitate its statutory objectives. It is certainly not the case that once a licence condition is in place no modifications can be made to it. Indeed, in respect of this particular case, we specifically made reference to the possibility of licence modifications in this area in our price control determination of October 2012.
- 2.27. We note that GNI (UK) argue that it is not appropriate to compare market rates at a point in time with the returns that GNI (UK) is to receive over the lifetime of the project. They go on to argue that the comparator companies which we have used face a different risk profile from those faced by GNI (UK). While GNI (UK) have made these assertions they have failed to provide any quantitative or qualitative evidence in support of them.
- 2.28. With regard to the first point we find the GNI (UK) argument to be flawed when judged against the current licence. The cost of debt component, which at a gearing ratio of 72.5% makes up a significant proportion of total returns, is set at each price control period with prevailing market rates. It is

also important to note that in the Capital Asset Pricing Model (CAPM) the Market Returns to Equity component is not a point in time estimate but rather a measure of average returns that equity investors have received from the stock market over many decades. It is therefore not correct to characterise the use of the Capital Asset Pricing Model as some form of point estimate. In reality it is a measure of long-term market returns adjusted for systematic risk.

2.29. With regard to the second point the comparators we used were all regulated UK utilities with a range of exposures to systematic risk. The objective of any comparison is not to find an exact match but rather to create a distribution of plausible outcomes which GNI (UK) can be assumed to fall within. With a pre-determined level of allowed revenue and no ongoing requirement for capital expenditure we would anticipate that GNI (UK) would have an exposure to systematic risk at the lower end of the distribution. While GNI (UK) claims it's risk profile is very different from the comparators provided they failed to provide any analysis or evidence to back this assertion up.

2.30. In addition to our response to GNI (UK)'s general comments we have also considered a number of the more specific points that were raised.

- In our analysis we specifically adjusted the 15% nominal return on equity using an inflation estimate of 2.0%. This gives an equivalent figure of 12.75% real which is still significantly above what a Capital Asset Pricing Model would suggest is reasonable.
- In general terms, higher levels of leverage and gearing will go hand in hand with higher returns on equity for firms with similar levels of net

cash flow risk. Equity investors are expected to absorb deviations in net cash flows so that debt repayments are maintained. The more stable net cash flows are the less of an equity premium is required for a given level of leverage. As GNI (UK) has a guaranteed revenue stream through the revenue cap mechanism and is no longer required to make capital investments it is expected to have very stable net cash flows. In these circumstances the level of equity returns seems excessive with regard to the assumed gearing ratio.

- It is recognised that Premier Transmission and Belfast Gas Transmission are not entirely comparable with GNI (UK). In particular whereas GNI (UK) is exposed to operating cost risk, the other two licence holders are not as they have an operating cost pass through mechanism. On the other hand all three share a characteristic which sets them apart from a typical regulated utility. That is they are not involved in the construction of new infrastructure, which is a significant source of risk to net cash flows. During the Gas to the West licence award process we consulted on the impact this different treatment of operating costs would have on the rate of return. In our [Determination](#) we estimated the impact as being equal to a 0.22% increase. At present Belfast Gas Transmission and Premier Transmission are 100% debt funded at a rate of return equal to 2.5% real. This indicates that GNI (UK) would be able to fund its activities at a much higher gearing ratio and at a much lower rate of return than is currently the case.
- The gearing ratio of 72.5% set out in the licence is purely for the purpose of calculating the rate of return. There is neither a presumption nor a requirement on GNI (UK) to finance their business in this way. In their response GNI (UK) provided no detail as to the actual way in

which they have financed this regulated activity. GNI (UK) is part of the Ervia Group. The conveyance licence discussed in this paper is only one of a number of licences held by GNI (UK) in the United Kingdom and Republic of Ireland. This would make it very difficult to make assumptions about the allocation of various sources of capital within GNI (UK) to fund this particular licensed activity. We do note from the statutory accounts filed by GNI (UK) for the year ending 31 December 2014 that the total equity due to the parent company was £3.5m out of total liabilities of £250m. In the notes to the accounts it is stated that 'the company has an interest bearing facility of £165m with respect to the North West and South North pipelines²' provided by the parent. As at 1 October 2014 the Regulatory Asset Base for the pipeline assets funded by the licence was £141m. In setting a rate of return economic regulators do not normally attempt to replicate the financial structure of the regulated business. The methodology is rather to apply a gearing ratio that might be employed by an efficiently managed business. Theory suggests that overall returns should not vary with the gearing ratio, however it is recognised that this theory is disrupted by the differing tax treatments of debt and equity. That is not to say that economic regulators have no interest in the financial structure of regulated businesses. They do for the purpose of ensuring the financial stability of the regulated business and ensuring it is able to withstand financial shocks. Rather than stipulating a particular gearing ratio, however, they have tended to put in place licence conditions requiring the licence holder to sustain a particular credit rating. Viewing this as a more flexible and efficient means of ensuring financial stability over time.

² Page 28 IV Finance Charges

- 2.31. We are surprised that in their discussion on the need to be remunerated for risk GNI (UK) failed to mention the unique mechanism for setting capital allowances set out in condition 2.2.2 of the original licence granted in 2002. This mechanism greatly reduced GNI (UK)'s exposure to construction risk which is recognised as the main source of risk in this investment.
- 2.32. The capital allowance was set after construction and materials contracts had been struck between GNI (UK) and their contractors, removing this cost risk for investors. There is also a pain gain mechanism with the impact of cost deviations being shared between the licence holder and consumers. Taken together these licence conditions remove a great deal of the risk that an investor would normally be exposed to during the construction phase.

Ex-Post Expropriation

- 2.33. GNI (UK) asserts that *'the proposed modifications are 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'*.
- 2.34. In paragraph 5.3 of their response GNI (UK) state that the proposed modifications would amount to *'an expropriation of returns'*. That the current licence reflected an agreement jointly reached *'to fix the return on equity at an average level over the asset lifetime'*. The Utility Regulator would not have agreed to such terms had we not considered them fair.

2.35. GNI (UK) states that an ‘*average return of 15% over the lifetime of the asset fairly remunerated it for the risk undertaken*’. GNI (UK)’s risk profile means that it was under-remunerated in the early phase of the project and is set to “re-coup” this deficit in later phases of the project. If the return on equity was to be based on current market rates, however, GNI (UK) would not be in a position to recover this deficit. As a consequence GNI (UK) would receive lower returns than the Utility Regulator agreed to in 2008.

Our Response

2.36. The Utility Regulator does not agree that the modifications represent an ex-post expropriation of returns. The modifications will not result in GNI (UK) being deprived of or required to return any of the benefits that it has previously gained from being the licence holder. Rather the modifications merely provide for the Utility Regulator to determine the individual components of the licence holder's rate of return so that they better reflect prevailing market conditions in future periods.

2.37. Throughout the response GNI (UK) assert that the modification of the licence in 2008 was the result of an agreement between the licence holder and the Utility Regulator that the rate of return on equity should be ‘fixed’, ‘hard coded’ or ‘locked in’ over the lifetime of the licence. However, no evidence is provided in support of this assertion. We have reviewed the correspondence which preceded the modification of 2008 and can find no evidence of such an agreement. This is not surprising given that it was envisaged that at some point in the medium term that mutualisation, which is 100% debt financing of the assets, could take place and therefore changes made to the fixed components of the rate of return.

- 2.38. As we have noted above the Utility Regulator is not prevented or prohibited from carrying out a review of the appropriateness and continued suitability of existing licence conditions at any given time. Neither is there a requirement for a particular 'trigger' in order to conduct any such review.
- 2.39. We note that GNI (UK) have argued that a fixed return over the lifetime of the project allows them to re-coup a deficit in remuneration which they suffered during the early part of the project, in particular during pipeline construction. We would have expected that in support of this argument GNI (UK) would have provided some quantification of the level of risk between various stages of the project and value of any outstanding remuneration to be recovered during future periods. However, GNI (UK) restricted their response to a theoretical discussion on these matters.
- 2.40. In the absence of such information we could only attempt to address the issue by reviewing the correspondence which preceded the modification of 2008. This review did not indicate that the issue formed any part of the justification for the current licence drafting.
- 2.41. We do not contend that there is no variation in risk over the lifetime of a pipeline project, and would agree that the construction phase carries the greatest level of risk for investors. In recognition of this the original licence granted in 2002 set out in condition 2.2.2 a unique methodology for setting the capital allowance for the pipeline. The objective of this unique methodology was very much to reduce the cost risk carried by GNI (UK).
- 2.42. The allowance was set after construction and materials contracts had been struck between GNI (UK) and their contractors, removing this cost risk for

investors. There is also a pain gain mechanism with the impact of cost deviations being shared between the licence holder and consumers. Taken together these licence conditions, which have been in force throughout the construction of the network, and which remain in force, remove a great deal of the risk that an investor would normally be exposed to during the construction phase.

2.43. Finally, it is also relevant to note that if there was a particular reason for giving the licence holder a guaranteed return over the lifetime of the project any such reason would have applied not only in respect of the return on equity component but also the cost of debt which at a gearing ratio of 72.5% makes up a significant proportion of total returns. Yet the cost of debt is not fixed but is reviewed as part of any price control.

Damage to Investor Confidence

2.44. GNI (UK) states that the proposed modification *'will damage investor confidence in NI regulatory processes and undermine future infrastructure investment in Northern Ireland'*.

2.45. In paragraph 6.1 of their response GNI (UK) state that the proposed modifications *'would significantly undermine regulatory credibility in Northern Ireland, as investors would no longer have confidence in recovering what they are promised under licence terms. This would ultimately be to the detriment of customers through an increase in the actual cost of capital for future projects'*.

2.46. GNI (UK) noted the Competition Commission determination on the

Phoenix Natural Gas Price Control (November 2012) in which the effect on regulatory uncertainty and cost of capital as a consequence of adjusting either Phoenix's regulatory asset value or a twenty year guaranteed 7.5% rate of return was considered.

2.47. GNI (UK) noted that with regard to the regulatory asset value the Competition Commission stated; *'we expect that this would lead to a perception of regulatory uncertainty, as investors may assume that UR's future actions could be unpredictable'*.

2.48. They also noted that with regard to the rate of return the Competition Commission stated; 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'*.

2.49. GNI (UK) argue that this demonstrates 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'*.

Our Response

2.50. The Utility Regulator does not believe that the proposed modifications would significantly undermine regulatory credibility, nor for that matter impact it adversely in any way. Although GNI (UK) assert that there was an agreement at the time of the modification in 2008 to maintain return on equity at 15% for the lifetime of the project, they have failed to produce any evidence of such an agreement and we have found none in our review of the relevant contemporary correspondence.

2.51. Indeed, given the discussions on future mutualisation, it is the case that in the event of mutualisation GNI (UK) should certainly have expected modifications to be made to the current provisions given that such mutualisation would involve 100% debt financing of the assets.

2.52. It is also the case that we have been in discussions with GNI (UK) regarding the current rate of return licence conditions since the previous price control review. While the main focus of these discussions was on the possibility of proceeding to mutualisation, we were clear that in the absence of progress towards that objective we would review the present licence conditions. In our [Determination](#) on the 2012-17 price control review, published 5 October 2012 we stated that:

‘We will consider the need for significant changes to the cost of capital licence conditions in the near future, taking on board whether the conditions which applied at the time the conditions were put in place still apply.’

2.53. As previously noted the Utility Regulator is entitled to consider and review the suitability and appropriateness of existing licence conditions at any time. More particularly it should do so periodically not only as a matter of good regulatory practice but also in recognition of actual or potential changes in circumstances and/or market conditions and developments.

2.54. In light of the above, it would seem unlikely that GNI (UK), being a rational investor, could not have expected that the present licence conditions to be subject to review and potential modification. We do not believe therefore that rational investment decisions will be adversely impacted by the proposed modification.

- 2.55. With regard to the issue of the Competition Commission review of the Phoenix Natural Gas (PNG) price control raised by GNI (UK). We have given careful consideration to whether the two cases are materially similar but we are satisfied that they are not. In the case of PNG, the argument made by PNG before the Competition Commission was that the proposal involved a retrospective adjustment to remove existing value from the RAB which would damage investor confidence.
- 2.56. The facts in the GNI (UK) case are different and there is no equivalent adjustment in this case. GNI (UK) refers to 'an expropriation of returns', by which it means not continuing to guarantee a 15% return on equity for the rest of the recovery period. However, that change is prospective in nature. It lacks any element of retrospectivity (or, in consequence, expropriation).
- 2.57. In addition, GNI (UK) itself acknowledges in its response that the original 2002 licence conditions created uncertainty. However, these were the licence conditions in place when the North West and South North pipelines were constructed (see the annex to GNI(UK)'s response paragraphs (e) and (g) for the dates by which construction was completed). Therefore the investors could not have relied on the 2008 licence conditions as these did not exist and must instead have relied on the 2002 conditions which GNI (UK) acknowledges allowed for an uncertain and discretionary rate of return.
- 2.58. For these reasons we do not consider that the views expressed by the Competition Commission in the case of PNG are directly comparable or of relevance to the circumstances of this case.

Customer Detriment

2.59. GNI (UK) argues that the current agreement between themselves and the Utility Regulator ensured '*that investors would be fairly remunerated over the lifetime..... of potentially risky projects that were ultimately of benefit to Northern Ireland gas customers*'. The proposed modifications would mean that GNI (UK) no longer received a fair return. This amounted to an expropriation of GNI (UK) return which as the Competition Commission had concluded in the Phoenix Natural Gas determination '*would lead to uncertainty as investors may conclude that the Utility Regulator's future actions could be unpredictable*'. Such an outcome would result in investors seeking higher returns resulting in higher bills for consumers.

Our Response

2.60. The Utility Regulator notes that this line of argument rests on the premise that there was some form of agreement between the Utility Regulator and GNI (UK) that the current licence conditions would never be modified. However as clearly set out above there was no such agreement.

2.61. In the absence of this premise the Utility Regulator does not consider that this line of argument is sustainable. The proposed modification will permit the Utility Regulator to set a rate of return that better reflects the level of risk associated with the investment and in line with market conditions. Our analysis suggests that the current rate of return is likely to be well above what current market conditions and the level of risk associated with the investment would normally indicate was appropriate. Therefore the modification will facilitate more appropriate regulatory decisions leading to lower costs for consumers in the longer term.

3. Conclusion

- 3.1. The Utility Regulator has considered GNI (UK)'s representations fully but remains of the view that the proposed modifications should be made for the reasons outlined in this Decision Paper.
- 3.2. We have also concluded that the licence modifications will better facilitate the achievement of our statutory objectives.
- 3.3. We are therefore proceeding to make the modifications set out in Annex 1.

Next Steps

- 3.4. This paper represents the Utility Regulator's final decision on licence changes to the rate of return conditions in the GNI (UK) conveyance licence.
- 3.5. The modifications have effect from 24 August 2016.

4. Explanation of the Licence Modifications

4.1. The licence modifications which will have effect from 23 August 2016 are shown (in mark-up form) in Annex 1.

4.2. The modified licence aims to ensure that the Utility Regulator may determine the cost of debt, the cost of equity, and the gearing ratio at each price control review taking relevant considerations into account. So as to give effect to this objective we have:

- defined the return on equity, the gearing ratio and the cost of debt such that the Utility Regulator may determine the value of each at the time of the price control review;
- deleted the definitions of the risk free rate, the market rate for debt and the gearing effect; and
- in the mathematical formula used to calculate the rate of return, have included a single debt term d_t and replaced the existing term g with the temporal term g_t to represent the gearing ratio.

Annex 1: Licence Modifications

The licence modifications below will take effect from 23 August 2016. The extent of the licence modifications below is limited to Condition 2.2. Annex A, paragraph 5 Rate of Return, of GNI (UK)'s Gas Conveyance Licence.

- Deletions are indicated by text which has been struck through.
- Additions are indicated by red text highlighted in yellow.

ANNEX A: ACTUAL REQUIRED REVENUE FORMULA

This Annex forms part of Condition 2.2.

5. Rate of Return

The applicable Rate of Return is expressed on a vanilla weighted average cost of capital basis and will apply to the North West Pipeline, South North Pipeline, and each of the Spurs and any associated Postalised Distribution Pipelines.

- (a) The ~~regulatory allowed~~ nominal weighted average rate of return in month m is calculated according to the following formula:

$$r_{m_t} = [1 + g_t ((1 + d_t r_{t+1} r_{t+1}) \cdot (1 + i_t) - 1) + (1 - g_t) \cdot re_t]^{1/12} - 1$$

where:

r_{m_t} is the nominal weighted average rate of return in month m ;

~~r_{f_t} is the real Risk Free Rate in Gas Year t which shall mean:-~~

- ~~(i) with respect to the period from the First Operational Commencement Date until the date of the first review, being 1st October 2007, 2.7%;~~
- ~~(ii) with respect to the period thereafter, a rate set to reflect market rates prevailing at the time of the review;~~

~~r_{p_t} is the regulatory allowed real risk premium on debt in year t, calculated as follows:~~

$$\del r_{p_t} = \del MRDP_t + \del EoG_t$$

~~Where:~~

~~MRDP means the market rate for debt premium excluding the gearing effect and :~~

- ~~(i) with respect to the period from the First Operational Commencement Date until the date of the first review, being 1st October 2007, is set at 1.45%;~~
- ~~(ii) with respect to the period thereafter, market rates for the debt premium, excluding gearing effect, of similar utilities at the time of the review;~~

~~EoG This rate is set at 0.38%, reflecting the gearing effect, for the period $m=1$ to $m=300$ inclusive and is not open to be reset at the time of~~

each review;

re_t is the ~~regulatory allowed~~ nominal **post tax** rate of return on equity in Gas Year t and shall ~~equal 15% for t = 1...25~~ **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;**

g_t is the ~~regulatory allowed~~ level of financial gearing **as determined by the Authority to apply at and with effect from each Review Date;** and shall be constant at 72.5% for $m = 1...300$ inclusive.

d_t **is the cost of debt as 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.**

(b) The regulatory allowed real weighted average rate of return in month m is calculated according to the following formula:

$$rr_m = \frac{(1 + rn_m)}{(1 + i_m)} - 1$$

(c) The regulatory allowed nominal weighted average rate of return in Gas Year t is calculated according to the following formula:

$$m_t = (1+r_m)^{12} - 1$$