Phoenix Natural Gas Limited (PNGL)
Price Control Draft Proposals 2012-2013

January 2012

CONSULTATION RESPONSES

1.1 Our consultation on the draft proposals for PNGL's next price control review closed on 21 October 2011. We received non confidential responses from the following organisations:

- PNGL
- Northern Ireland Electricity (NIE)
- firmus energy
- The Consumer Council (CCNI)
- National Energy Action NI (NEA)
- Manufacturing NI
- Fitch Ratings

1.2 One further response was marked as confidential.

1.3 In the pages overleaf we have summarised the principal points made in each of the non-confidential responses, and our response in turn to each of these.

Comments from respondents other than PNGL

In the section below we address the non confidential responses excluding PNGL's. The PNGL response is dealt with in the section that follows after.

Ref	Organisation	Comment	Our response
1	**The Consumer Council**	The CCNI welcomed the downward pressures that our proposals would exert on energy prices, and the corresponding benefit to consumers. However, the CCNI was concerned about the credit ratings negative watch issued by Fitch, and sought assurance that our proposals will not raise the level of perceived risk to all utilities in NI to a level that creates extra costs for consumers.	We have carefully considered our position and are progressing with decisions that are consistent with our statutory duties. We are always mindful of how our actions impact on utility consumers, not just over the price control period in question but also over the medium to long term. We do not believe our decisions will have any impact on the perceived risks to the electricity and water industries. The issues are unique to PNGL and are a one off. Furthermore, our decisions will not lead to extra costs for gas consumers; rather, our decisions will decrease costs for consumers.
2		The CCNI asked us to reconsider our proposal to allow PNGL to retain a 7.5 per cent rate of return.	We ourselves have recognised and acknowledged that PNGL's rate of return is high relative to other regulated industries in GB. For example, the range of weighted average cost of capital (WACC) allowances – specifically their pre-tax equivalents as we have calculated them – granted in recent price control decisions (from regulators such as Ofgem, Ofwat, the ORR and the Competition Commission) ranges from 5.5 per cent (Ofgem, 2009) to 6.1 per cent (Ofwat, 2009). This issue is dealt with in more detail in Section 7 of the decisions paper. However, given the totality of the price control package we are offering, on balance we are content to retain PNGL's rate of return at 7.5 per cent.
3		The CCNI was supportive of our proposed treatment of deferred capex.	No comment.
4		The CCNI was supportive of the downward pressure our proposed treatment of historic outperformance would exert on energy prices, but sought assurance that this would not raise the level of perceived risk to all utilities (see earlier comment, Ref 1).	See earlier response, Ref 1.

Ref	Organisation	Comment	Our response
5	**The Consumer Council**	The CCNI questioned the appropriateness of the allowance to PNGL for advertising, marketing and PR.	We recognize that allowing adverting and marketing into the PNGL cost allowance has added significantly to the size of the PNGL asset base and benefited the company to meet its connection targets. We calculate that the total amounts to c£37 million (2010 prices) since 1996 and reflects the regulatory support that the gas industry has received. On balance we believe it was appropriate to make allowance for promoting the gas industry given our principal objective in gas and the challenges of growing the market. We agree that at some point, it may no longer be appropriate to grant PNGL an allowance for advertising, marketing and PR. At the moment we consider it appropriate to move to an output-based mechanism that will still grant PNGL an allowance, but only for connections actually achieved. In the medium to long term, we envisage reducing this allowance downwards, with the possibility of eventually doing away with it altogether.
6		The CCNI expressed concerns that PNGL does not operate an asset risk management system, and that this may result in consumers overpaying for network maintenance.	Hence our decisions to reduce the network maintenance allowance. Furthermore we expect PNGL to develop a suitable system, and will be monitoring this over the course of the price control.
7		The CCNI questioned the appropriateness of granting PNGL an allowance for entertainment, especially at a time when consumers are struggling to cope in these strained economic times.	We have based our decision on HMRC guidance on non taxable employee benefits.
8		The CCNI questioned the appropriateness of granting PNGL its full allowance request for IT, especially since the company has consistently underspent against its IT allowance in previous price controls.	We have amended our decision for IT, reverting to our original thinking to grant PNGL an allowance based on the average spend over calendar years 2007 to 2009. The rationale for this move can be seen in the final decisions document.
9		The CCNI suggested that incentives for connecting new customers should be targeted at those households in fuel poverty, and not by tenure. More generally, the CCNI wondered if we could do more to encourage the switch to gas in the PNGL licence area.	To date no one has been able to propose a method to accurately identify the fuel poor. Focusing connection incentives to this group is therefore not possible at this time. Should this change in the future, we would be willing to consider it in future price controls.
10		The CCNI recommended that guaranteed standards of service be included in the price control by way of incentives and penalties.	Guaranteed service standards in the gas industry are still being considered and developed by our office, in conjunction with the industry. We are therefore not in a position to consider the inclusion of incentives and penalties on such standards at this time.

Ref	Organisation	Comment	Our response
11	**Fitch Ratings Limited**	Fitch's main comments were as follows: • The proposed adjustment to PNGL's TRV in respect of historic outperformance is not provided for under the current licence. • We have not made public our intention to make this adjustment at any time following the 2007 licence modifications, meaning this adjustment has not been anticipated. This does not support a view of reasonable, predictable and transparent regulation of gas distribution networks in NI. • In keeping with good regulatory practice, Fitch would have expected any proposed licence modifications to be forward looking. • Reading the consultation paper, consumer interests appear to be emphasised at the expense of investor interests. • We should expand our financeability test to take account of reasonable downside scenarios, and include the payment of dividends to equity holders.	We have carefully considered our position and are progressing with decisions that are consistent with our statutory duties. Our consultation and decision documents emphasise the consumer interest; they are doing so because of the terms in which our statutory duties are written. This does not mean that we have had no regard to the investor interest. As we have explained in our decisions document, while there is a balance to be struck between a number of factors, consumer and investor interests are not necessarily inimical to each other. In particular, we have considered carefully how our actions might impact on the financeability of PNGL, not just over the price control period in question but also over the medium to long term. Since our initial proposals we have continued developing our assessment of financeability and include an expanded analysis in the final decisions document. Our analysis demonstrates that PNGL remains inherently financeable under our final decisions. We acknowledge that the existing licence conditions do not contain a mechanism for the adjustment of the 2006 value of TRV. However, this does not mean that the value cannot be adjusted in line with our statutory powers. We have explained in our decisions document why we consider that, applying our statutory duties to the question, an adjustment should be made by way of modification to the licence conditions. The outperformance adjustment will be 'forward looking'. It would not seek to remove from PNGL the benefit that it has had from the inclusion of outperformance in the TRV during the 2007 to 2011 period. The treatment of deferred capex is symmetrical with how we treat unpredictable and/or unforeseeable additional capex costs in PC03 i.e. "logging up" and "logging down". For reasons we explain in our response to PNGL's submissions (below), PNGL does not have any legitimate expectation of a continuation of the value of TRV as set in 2006, and it is appropriate, and in line with established regulatory precedent elsewhere, for the benefits of previous outperformance to be shared with consumers. Although we stated in the 2007 licence modifications public consultation that outperformance is shared based on regulatory practice elsewhere, we accept that we could have set out in greater detail the mechanism for achieving this. We have set out clearly here and in the final decisions documents that these decisions deal with historical outperformance and will bring PNGL more in line with standard regulatory practice going forward. As a further step we will consider setting out a clear regulatory statement that will consolidate and reiterate our plans for future price controls of gas distribution networks in NI, as we have done for NI Water. PNGL has been fully consulted on our proposals and it is being consulted again now on the drafting of a modification necessary to give effect to the amendment of TRV. However it is not clear how 'grandfathering' the outperformance so the full amount continues to be paid by customers until 2046 would be a balanced response to a lack of clarity in 2007 as to the time at which outperformance would be shared with customers. Indeed, this would be inconsistent with regulatory practice elsewhere. We recognise and give all due weight to the importance of regulatory certainty, but this principle must necessarily be considered in the light of all other relevant factors which are appropriate to consider on any price control review. We have only decided on changes where we consider they are fully justified in the light of our statutory duties.

Ref	Organisation	Comment	Our response
12	**National Energy Action NI**	NEA was supportive of our proposals exerting downward pressure on energy prices. NEA also suggested that we develop proposals around social tariffs to help the fuel poor.	We acknowledge NEA's suggestion on social tariffs. However the introduction of social tariffs is a policy decision for government, not the regulator.
13	**Northern Ireland Electricity**	NIE had concerns about what it perceives to be an 'arbitrary' adjustment to the PNGL asset base, and the impact this may have on the ability of regulated companies in NI to secure equity and debt finance at reasonable cost.	We have carefully considered our position and are progressing with decisions that are consistent with our statutory duties. These decisions do not constitute any kind of 'arbitrary' adjustment to TRV. The adjustments are being made for the reasons explained above in responding to the comments made by Fitch Ratings. NIE describes the proposals as a potential 'expropriation', but there is no basis at all for this analysis (which indeed is not explained or justified in the NIE response). As noted above, we are mindful of how our actions might impact on the financeability of the regulated companies in Northern Ireland, and on the importance of regulatory certainty, not just over the price control period in question but in the medium to long term. We have not seen any evidence to suggest that our proposals will have any impact on the perceived risks to the electricity and water industries, and indeed they are consistent with GB precedents in their treatment of outperformance by its sharing with consumers. Our decisions will not result in unnecessary additional costs to consumers.

Ref	Organisation	Comment	Our response
14	**firmus energy**	firmus made the following comments: • firmus noted the two year control period, citing the rationale to align PNGL's next price control with that of firmus. However, firmus suggests it would not be appropriate to compare the companies when undertaking an aligned price control, given the difference between the two companies (e.g. scale, maturity, licence parameters). • firmus welcomed our approach to setting opex allowances, whereby we opted to focus on the six largest cost lines. • firmus commented on the TRV adjustment, suggesting that any such adjustment needs to be done on an open and transparent basis. It implied that our actions may increase perceived regulatory uncertainty. • firmus questioned the reasoning why billing costs for PNGL should rise as a result of competition.	We issued a public consultation on the rationale for aligning the price control of PNGL and firmus in 2014. Benchmarking the two companies is considered worthwhile for us to undertake. There are other benefits too, all of which can be read in our consultation (see our website, the paper was published in January 2010). We acknowledge the comments on the TRV adjustment. But see earlier responses: Ref 1, Ref 11 and Ref 13, as well as our response (below) to PNGL's submissions. In formulating our decisions, we considered the levels of switching that the market is likely to experience and had taken account of the switching processes whereby the proposing supplier is responsible for the physical meter read. We therefore consider that we have already reduced PNGL's billing allowance sufficiently.
15	**Manufacturing NI**	Manufacturing NI welcomed the downward pressure our proposals will exert on energy prices. However, MNI expressed some concerns about the adjustment to the TRV, stating that it appeared to be outside of the terms of the licence.	Where appropriate, and acting in a manner consistent with our statutory duties, it is right that we attempt to exert downward pressures on prices. We have carefully considered our position and are progressing with decisions that we believe are consistent with our duties. As we have indicated elsewhere, the licence does not contain an existing mechanism for making an adjustment to the TRV as we propose. This is why we stated in the draft proposals in paragraph 10.4 that we will need to modify the licence in order to give effect to the adjustment. The modification will need to be made under Article 14 of the Gas Order which will require a statutory consultation, to which PNGL must consent in order for the modification to take effect; or alternatively will require a reference to the Competition Commission.
16	**Confidential response**	The response marked as confidential was supportive of our proposals. In particular, the response set out some arguments to further support our conclusion that PNGL remains inherently financeable.	We have considered carefully how our actions might impact on the financeability of PNGL, not just over the price control period in question but also over the medium to long term. Since our initial proposals we have continued developing our assessment of financeability and include an expanded analysis in the final decisions document. We agree with this respondent and our analysis demonstrates that PNGL remains inherently financeable under our final decisions.

PNGL response

The response from PNGL was 81 pages long, and divided into six sections. For ease of reference, in the table below we have set out where in the PNGL document each comment has been made. Our responses set out below should also address the issues raised in a letter from the PNGL Chairman, Peter Ritson, to our Chairman on 27 October 2011.

Comment	Our response
<u>**Section 2 and 3**</u> **General commentary on adjustment to TRV** PNGL did not agree with the proposed adjustment to the TRV. This included both the proposed adjustment in respect of deferred capex, and the adjustment in respect of historic outperformance.	PNGL believes the 2006 discussions and subsequent 2007 licence modifications (collectively termed the "2006 Agreement" in the PNGL response) allowed it to retain deferred capex and outperformance in its asset base earning the full rate of return until it is fully depreciated. We are said to have gone back on the "2006 Agreement" – an issue with which we deal in the next section – and it is alleged that our proposals are in any case inconsistent with regulatory precedent. PNGL has also indicated it was not given the opportunity to discuss the appropriateness of our proposals in advance of publication. As to regulatory precedent, our proposed treatment of deferred capex and outperformance is consistent with established good practice. Our approach continues to be to remove all the benefit accruing to a regulated company from the deferral of projects, and we have no reason at present for believing that to be inappropriate or inconsistent with good practice. This is also symmetrical with how we treat unpredictable and/or unforeseeable additional capex costs (i.e. "logging up" and "logging down") and is consistent with what we set out in the 2007 price control determination where we stated we would review deferred cash within the asset base. With regards to outperformance, our proposed treatment is consistent with best practice. Outperformance from the historic period of 1996 to 2006 was rolled up at the prevailing rate of return and capitalised at the end of 2006. The price control over the period 2007 to 2011 provided investors with a return on this outperformance value. An adjustment to the asset base at the end of the period delivers a sharing of outperformance with consumers, and is consistent with how regulators typically treat capex outperformance. Finally, we note the PNGL statement that it was not given the opportunity to discuss the appropriateness of our proposals in advance of publication. PNGL rightly points out that our price control team began engaging with its price control team around 18 months ago to discuss the review. However, our engagement with any licence holder in the build up to a price control is primarily an information gathering exercise to inform our thinking and subsequent consultation. When we have all the information we require to develop proposals we set them out clearly and consult on them with both the company and the wider public. Licence holders, in the same way as all interested parties, are then given a sufficient period of time to consider our price control proposals through the consultation process. PNGL had eight weeks to consider our draft proposals once these were published and we continued to engage with the company right up to the publication of our final decisions. The public consultation process, and the opportunities that PNGL has had during that process to liaise with us, provided it with an appropriate opportunity to consider our proposals and respond to them accordingly. Moreover, PNGL will also have a further opportunity for comment in the consultation process relating to any amendments to the licence under Article 14 of the Gas Order. Considering all of these matters, assessing them in the light of our statutory duties, and having full regard not only to PNGL's but to all consultation responses, it is right for us to proceed on the same basis as was originally outlined in our consultation.
<u>**Sections 2 and 3**</u> **Legitimate expectation** PNGL stated that it has a legitimate expectation that it should be allowed	PNGL stated that the 2007 licence modifications and the discussions which preceded them allowed it to retain deferred capex and outperformance in its asset base until 2046. PNGL suggested that it expected that this position would be unchanging, referring at one stage to having a "legitimate expectation" that this should be the case, and claimed to have acted in reliance on that expectation. We have considered these submissions carefully, and looked back to the history of what PNGL calls the "2006 Agreement". In

Comment	Our response
to retain deferred capex and outperformance in its asset base until 2046.	summary, we found nothing in either the 2007 licence modifications, or the discussions surrounding them, which was designed to, or did in practice, offer any assurance to PNGL that the retention of deferred capex and outperformance in its asset base would not be revisited during future price control reviews. We would not have offered such an assurance, and in any event would consider such an approach to be inconsistent with and overridden by the statutory duties by which we are bound, and inconsistent with regulatory practice elsewhere. We have, however, taken into consideration PNGL's statements as to what it may have believed, correctly or incorrectly. With all of these factors in mind it remains appropriate for us to proceed as originally proposed. We discuss these issues more fully below. • ***Did the 2006 discussions and 2007 licence modifications create an expectation?*** In the light of the representations from PNGL we have carefully considered whether anything that we have written or said, or anything that could be implied from what we have done, would have led PNGL to expect that the position regarding its retention of outperformance and deferred capex would not be revisited and that it would retain the benefit of one or both in its asset base until 2046. Nowhere in the 2007 licence modifications, or in the discussions preceding them, is it stated that the issue of PNGL's retention of deferred capex and outperformance in its asset base would not be revisited during future price control reviews. If we had meant to give that assurance – which we did not at any stage intend to do – we would have stated it clearly. There is a clear comparison with our treatment of the rate of return (see below). PNGL stated that the value for TRV in 2006 was regarded by it and "any reasonable observer" as "fixed and binding" and that any attempt to re-open it would be inconsistent with the terms of its licence. PNGL further stated that the fact that the licence was modified in 2007 to include an agreed mechanism for recovery of this value in future price control review periods indicates that the 2006 TRV value was meant to form a base for future price controls. It appears to argue that it should have been assumed that this approach was unchangeable in future. It is correct that the formulae contained in Condition 2.3 of the licence provide a mechanism for recovering TRV and we acknowledged above that the existing licence conditions do not contain a mechanism for the adjustment of the 2006 value of TRV. However, we do not agree that the value to be recovered was intended to be, expressed to be, or is as a matter of fact, unchangeable at the 2006 level. The fact that the 2006 value for TRV was incorporated into the licence in 2007 does not either say or imply that the value for TRV will not be changed in future reviews. This mechanism for change comes from our powers under the Gas Order, and nowhere in the licence, or in the discussions surrounding it, was it ever stated or implied that this power would not be used to modify the value for TRV. Indeed it would have been extremely unusual for us to give such an assurance as its fulfillment could conceivably conflict with our statutory duties at some future point, as indeed it would have done now had it been given. PNGL stated: *"PNG's licence is both clear and explicit as to how a price control review should be conducted. Specifically, and crucially, it states precisely the TRV for 2006; sets out how $TRV_{F,2006}$ is to be adjusted to reflect additional capital expenditure between regulatory periods; sets out how allowable costs and hence total revenues are to be determined; and identifies the return that PNG's investors are entitled to make on their investment."* We agree that the licence states a 2006 value for the TRV and provides a means by which it can be adjusted following price control reviews. It is important to note, however, that the licence does not state that it is incapable of modification using our statutory powers to modify it. It does not state that the 2006 value for TRV cannot be adjusted. We do not agree, therefore, with PNGL's view that the inclusion of the value for 2006 TRV in the 2007 licence indicates that it is to be fixed and binding on us in future reviews. Where we have wished to set a provision for a specific time period this has been expressly stated on the face of the licence, as is the case with the fixing of the rate of return at 7.5 per cent until 2016. Even that

Comment	Our response
	would have been capable of being modified through the normal licence modification processes had we considered it appropriate to do so in the light of our statutory duties, but it indicates that where we intended in 2007 that an element of the price control would not be changed for a period of time we said so clearly. The provisions concerning the rate of return were set at the same time as those relating to the retention of deferred capex and outperformance. If, therefore, we had wished to indicate that the latter would also not be reviewed for a period of time we would have expressly provided for it in the licence in the same way. PNGL suggested that the fixed nature of the TRV at the 2006 value can be implied from the discussions surrounding the 2006 review and our actions since 2007. PNGL described the 2007 amendments to the licence as a "package" or an "agreement" which should be viewed as an all-inclusive whole. It stated that it accepted the 2007 amendments on this basis and it is therefore not open to us to seek to re-visit individual amendments in isolation. In support of this view PNGL pointed out that all of the proposed modifications to the existing licence were presented in a single letter of 27 October 2006 and that Terra Firma's reply of 8 November 2006 states that "*the overall package that is being offered is acceptable*". The letter of 27 October 2006 does not state that the elements of the price control are to be treated in such a way, and it also does not use a term such as "agreement" to describe them. It refers instead to "proposals", "amendments" and "modifications", and makes clear that everything set out in it was subject to public consultation. Likewise, the setting out of the proposals in a single letter does not mean that they were indivisible. Instead it was simply a matter of convenience and common sense, the alternative being separate correspondence on each individual issue. PNGL stated that it is unfair of us to review individual amendments to the 2007 licence as it cannot re-open other elements of the 2006 review such as selling off its transmission business. We respond to this more fully below, but in short do not accept that PNGL has been disadvantaged any way – it has, for example, sold its transmission business for full value plus a premium; to do so was in no sense any kind of detriment to the company. It is true, as PNGL states, that we considered the 2007 amendments to the licence as being compatible with our statutory duties, and therefore in the interests of consumers, at that time. But this does not mean that they are set in stone. We apply our duties in considering the price control on each review, and propose modifications to the licence whenever it is consistent with them to do so. It would not be in the interests of consumers now if we did not amend the value for TRV as part of the current price control review, given that this is effect of applying our duties in this case, recognizing that PNGL has had the benefit of outperformance during the 2007 to 2011 period, and taking into account that it is consistent with best regulatory practice for such benefits to be shared with consumers. We do not agree, as PNGL has suggested, that the fact that the calculation for the 2006 TRV was postponed to allow audited numbers to be used indicated that it was not to be reviewed in the future as one thing does not follow from the other. Specifically with regard to the retention of deferred capex, it was expressly stated in our PC03 determination that the issue of deferred capex *would* be subject to review and the two relevant passages from that document are actually contained in PNGL's response. We stated in our PC03 determination that it was intended that future projects would be reviewed to ascertain whether or not they are actually needed "*and if it would be in customers' interests to use the allowances contained within the asset base for other construction activities*". We clearly envisaged that some projects may not be needed and that it would be in customers' interests to use the costs for other construction activities. Having completed the review we have determined that it is not practical to use the cost for other construction activities and so propose to remove the relevant allowances from the asset base. This is equivalent to what we set out in 2007. PNGL also stated that the issue of retention of deferred capex was discussed in 2001 and that we agreed with its position as contained in a paper submitted to us at that time. It is true that we did not make adjustments in 2001 but the issue was subsequently revisited and was the subject of further discussion in the 2006 price control review. Our position on deferred capex in

Comment	Our response
	2001 was based on conditions as they existed at the time and did not at any stage imply a decision that the issue would not be reviewed again leading to a different conclusion. Indeed the fact that the matter was reviewed again in 2006 following previous discussions in 2001 makes this entirely obvious. In conclusion, therefore, we do not agree with PNGL that there is any (express or implied) basis for its contention that the issue of its retention of outperformance and deferred capex was not to be revisited in subsequent reviews/licence modifications. There is no objective basis for this belief. • ***What is the effect of applying our statutory duties now?*** In coming to conclusions as to how we should approach this price control review, we are necessarily seeking to act in accordance with our statutory duties, as our decisions document makes clear. Having reviewed our files regarding the 2007 licence modifications and the discussions leading up to them, a number of things are clear. Namely that: (1) a sum in respect of deferred capex and historic outperformance entered the asset base in 2006; (2) in deriving this sum, no assessment was made as to whether this represented genuine efficiencies; and (3) this sum did not include sharing with consumers based on regulatory practice elsewhere. However contrary to PNGL's interpretation none of the documents from 2006 or 2007 make any commitment to this sum remaining in the PNGL asset base until 2046. As explained in our decisions document, we are compelled by our statutory duties to see that this outperformance is shared with consumers, and plan to implement this by way of asset base adjustment at the end of 2011. Such an approach is consistent with how other regulators typically treat capex outperformance. If we were to make no adjustment to the TRV, this would effectively result in PNGL retaining all of the benefit of deferral and underspend, creating a transfer of value of around £74.4 million from customers to shareholders that will earn the full rate of return going forward. It is clearly inappropriate that customers should pay PNGL such an outsize reward, remembering of course that this relates to investments that were never made and did not need to be financed. We appreciate that we must also take account of issues relating to the financeability of PNGL in discharging our duties. We have therefore carried out a thorough and robust assessment of PNGL's financeability to satisfy ourselves that the company can continue under our decisions to finance the activities which are the subject of obligations placed on it, and that it can raise finance at an appropriate cost of capital. Our full assessment on financeability is contained in the final decisions document. PNGL remains inherently financeable under our decisions. We have also taken into account the decisions made by PNGL since 2006 which, it suggests, were taken on the basis that the value for TRV was unchangeably fixed at the 2006 rate. For the sake of clarity we do not accept that the taking of these actions, nor our failure to comment on them at the time, establishes that there was any expectation in this regard. We have considered all of the above and weighed the best interests of consumers, in terms of the benefit they will receive from a change, against the retention of the relevant sums within the existing TRV. We conclude that, at the present time, we would not be acting compatibly with our statutory duties if we did not seek to modify the TRV. • ***PNGL's position and the interests of fairness.*** Finally, although there is no convincing evidence to support PNGL's claim of a legitimate expectation that the 2006 value for TRV would not be revisited, and noting that our statutory duties in any event lead us to change the TRV figure in the licence conditions, we have in the interests of fairness fully considered PNGL's arguments for allowing the company to retain the value of previous outperformance and deferred capex. We have treated PNGL fairly as it has had the opportunity to comment on our proposals as part of the consultation process. It will also have a further opportunity for consultation regarding any amendments made to the licence under Article 14 of the Gas Order. For the reasons given in the last section, however, when we weigh the effect on consumers should we take no action against the

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<tr><th>Comment</th><th>Our response</th></tr>
<tr><td></td><td>consequences for PNGL if we do, we conclude that in the circumstances it would not be unfair to PNGL or in any way contrary to our statutory duties to make the proposed amendments to the value of the TRV contained in the current licence.

Therefore, having taken into account PNGL’s comments on the issue of its expectation and considered our statutory duties it is right for us to proceed as indicated in our decision document.</td></tr>
<tr><td><u>Section 2</u>
The proposals are inconsistent with the terms of the PNGL licence</td><td>PNGL stated that the licence, in its current form, does not enable an adjustment to the TRV as we propose. This is true, which is why we stated in the draft proposals in paragraph 10.4 that we will need to modify the licence. The modification will be taken forward under Article 14 of the Gas Order, which will require a statutory consultation, to which PNGL must consent in order for the modification to take effect, or alternatively give rise to a possible reference to the Competition Commission if PNGL withholds its consent.</td></tr>
<tr><td><u>Section 2</u>
The proposals are inconsistent with the terms of the PNGL licence</td><td>PNGL argues that as part of the 2006 discussions and subsequent 2007 licence modifications it had to make a number of concessions. In return for these, PNGL argues that the value of TRV which was established as part of the 2006 discussions and subsequent 2007 licence modifications should remain fixed in the licence since PNGL cannot now withdraw what it has previously done. According to PNGL these concessions were:

• The sale of its transmission business, thereby denying PNGL’s investors the opportunity to earn either a return on this investment or to realise its potential value on the open market.
PNGL received the full value of the business plus a significant premium for the sale of its transmission business. It has been able to distribute this money to its shareholders or invest it elsewhere. For this reason this cannot be considered a ‘concession’ that caused a detriment to PNGL. When the PNGL transmission business was ‘mutualised’ this did lead to customer ‘benefits’ in the region of £25 million (2007 prices). As we have always made clear these ‘benefits’ reflect a transfer of risk to customers and should not be portrayed as a concession by the selling party. Likewise the mutualisation of the PTL transmission business which delivered customer benefits of c£41.5 million (2005 prices) was not a concession by the seller. Taking a view from 1996 to 2006 when the transmission asset was owned by PNGL the regulatory treatment was supportive of shareholders in reducing risk while allowing healthy rates of return.

• The reduction in the rate of return.
Again, this was not a concession by PNGL. This reduction in the rate of return did provide a reduction in prices to customers and this was reflected in our setting out of the benefit at £25 million (2006 prices). However the 2007 licence modifications fundamentally changed the nature of the risks facing the company and the balance of risks between the company and its customers. The reduction in the rate of return was fully justified based on the reduction of risk alone, not as a concession from the company as part of the 2006 discussions and subsequent 2007 licence modifications.

• The write-off of a loss to the supply business relating to the legacy contract issue.
As a result of long term contracts entered into by the Phoenix supply business, it suffered a loss of £9.7 million. PNGL had proposed that it manipulate distribution charges in order to offset the loss. We considered that this proposal would be in breach of the licence and we consulted on enforcement action in May 2006. We were content that this issue could be resolved by ensuring appropriate revenues were paid by Phoenix’s supply business to PNGL and thus reduce the PNGL underrecoveries. On this basis we agreed not to proceed with legal enforcement and a possible fine. This did not cause any kind of detriment to PNGL.

PNGL has also argued that it made a large concession in agreeing to the treatment of underrecoveries given that it could not raise prices due to regulatory pressure. However we had no power to prevent PNGL from increasing prices and PNGL’s commercial decision not to do so underline the difficulties with this option and the overall risk inherent in the original licence before we agreed to the licence modification. Furthermore, the treatment of underrecoveries in the 2007 licence modifications was more generous than that which would have been allowed under the 1996 licence.</td></tr>
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Comment	Our response
<u>Section 2</u> **The proposals are inconsistent with principles of good regulation**	The thrust of PNGL's argument is that standard regulatory practice is to review the value of the asset base in light of what has occurred within the most recent control period. It argues that our TRV adjustment relates to what has occurred in previous control periods, i.e. controls there were set prior to the most recent period of 2007 to 2011. Given the nature of the PNGL licence and history it is not possible to have identical treatment with standard regulation. However our decisions are consistent with the standard regulatory approach. Outperformance from the historic period of 1996 to 2006 was rolled up at the prevailing rate of return and capitalised at the end of 2006. The price control over the period 2007 to 2011 provided investors with a return on this outperformance value. An adjustment to the asset base at the end of the period delivers a sharing of outperformance with consumers, and is consistent with how regulators typically treat capex outperformance. We find PNGL's position that it should receive a reward for outperformance for up to 50 years to be inconsistent with the principles of good regulation. With this in mind, our decisions for historical outperformance relate only to whether benefits that PNGL received during the period 2007 to 2011 should continue from 2012, and does not involve revisiting price control periods before 2007. This is consistent with standard regulatory practice.
<u>Section 2</u> **The proposals cause inappropriate regulatory uncertainty**	Nothing said or done in 2006/7 makes any commitment to the sums representing outperformance and deferred capex remaining in the PNGL asset base until 2046, as PNGL now argues. Those sums were always subject to review and amendment in accordance with the licence conditions and/or our powers to modify those conditions under the Gas Order. This process of review and revision is entirely normative in regulatory practice across all economic regulators. Nonetheless we acknowledge the powers that this gives regulators must be used carefully and with good reason to ensure that investors have confidence that a regulator will not act in an arbitrary fashion. The detail in our papers explains the unique circumstances which warrant the decisions we have set out. As explained in our draft proposals, we consider that the effect of our statutory duties is that outperformance should be shared with consumers, and plan to implement this by way of asset base adjustment at the end of 2011. Such an approach can be considered to be consistent with how other regulators typically treat capex outperformance, and ought not to be surprising. We do of course fully recognise that regulatory certainty is valuable and helps in the long term to reduce the cost of capital. And we do agree that it is important for the regulator to communicate its intention in a clear fashion and we do take on board comments from PNGL and Fitch in relation to this issue. The PNGL case is a complex one with a unique history. The adjustment to TRV will mean that all the historical outperformance issues have been dealt with and will move PNGL towards a more standard approach. The specific circumstances we are dealing with here will not arise again. It is also unlikely that any alleged cost of regulatory uncertainty would result in a higher cost of capital than is already reflected in PNGL's 7.5 per cent rate of return. For these reasons there are strong arguments for explaining to investors these particular circumstances and assuring them that we are committed to the principles of best regulatory practice and allowing NI regulated companies to finance their activities as we have done since our inception. The decisions that we are now taking in no way diminish our commitment to ensure that customers pay back in full the cost of efficient investment. If we were to take no action, this would effectively result in PNGL retaining all of the benefit of deferral and underspend, creating a transfer of value of around £74.4 million from customers to shareholders that will earn the full rate of return going forward. It is clearly inappropriate that customers should pay PNGL such an outsize reward, remembering of course that this relates to investments that were never made and did not need to be financed. None of the adjustments will leave any stranded assets. Since we acknowledge the importance of the cost of capital, we have carefully considered the impact our decisions may have on the ability of PNGL to attract affordable finance. We have carried out a thorough and robust assessment of PNGL's financeability to satisfy ourselves that the company can continue to raise capital at a reasonable rate. Our full assessment on financeability can be seen in the final decisions document. PNGL remains inherently financeable under our decisions. Considered in the light of our statutory duties, it is right for us to proceed as indicated in our decisions document.

Comment	Our response
<u>Section 3</u> **The proposals are inconsistent with the 2006 discussions, and with what was agreed in PC03**	PNGL's arguments here echoed what was said in Section 2 of its response. It claims that deferred capex featured as part of the TRV assessment in the 2006 discussions and subsequent 2007 licence modifications, and that it remains a fixed and binding element of the TRV. PNGL also argued that the methodology we have employed to calculate an appropriate TRV adjustment is inconsistent with how deferred capex was valued in the 2006 discussions and subsequent 2007 licence modifications. We have considered these submissions but disagree with them. As indicated above, we always said that deferred capex would be subject to a review during the control period that followed the 2006 discussions and subsequent 2007 licence modifications (i.e. during PC03). In fact, PNGL's own response acknowledged this to be the case. Where PNGL disagrees with us concerns the way we have calculated the adjustment, stating that we had somehow committed ourselves to a different approach than that in our draft proposals. PNGL has implied that: (1) the value of deferred capex had already been settled in the 2006 discussions and subsequent 2007 licence modifications and was fixed; and (2) this agreed sum would effectively be deducted from PNGL's capex allowances but the associated outputs (or suitable substitutes) would still be expected to be delivered. However, PNGL's submissions appear to be self-contradictory – that is, PNGL requested further allowances for deferred projects even though the monies for these were already in its asset base. On the value of deferred capex, PC03 is clear that this will consider the '*deferred cash within the asset base*'. We have set out in detail how we have calculated this figure and this is consistent with PC03 and appropriate. PNGL has not put forward arguments as to why our calculation is not appropriate (other than in respect of the management fee uplift). Moreover, we did not commit ourselves to any particular approach to deal with deferred capex. We did set out in PC03 that the review would look at whether it would be appropriate to consider using deferred capex within the asset base for other construction activities. On review we determined that this approach would be impractical given the limited large capex projects in the pipeline. Our approach is in any event equivalent in principle to our proposals in PC03, since we could now substitute the deferred cash amount in the asset base against total future capex which would produce the same revenues for PNGL. However, our approach is more practical and easier to implement accurately. Furthermore, the methodology we have employed in our decisions to calculate the adjustment is consistent with the policy of our office on deferred capex. It is also symmetrical with our policy in PC03 where unpredictable and/or unforeseeable additional capex is allowed into the asset base when it is incurred even where it has not been included in forecast allowances i.e. "logging up" and "logging down". Examples of this include extensions to connect new I&C customers such as Precision Liquids, Contour Global, the McQuillan Quarry, and Bombardier. Finally, to understand the true cost of each deferred project, we must include an uplift for the management fee, which is an overhead incurred in respect of capex. PNGL recovers this cost from customers through its inclusion as a capex allowance, and it is not unreasonable to assume that – in the long term – the quantum of the management fee is directly proportionate to the level of capex activity. For this reason it is appropriate to apply an uplift when attempting to value the full cost of each individual project.
<u>Section 3</u> **The proposals are inconsistent with the principles of incentive-based regulation**	Deferred capex as an issue is being consulted on publicly as part of our cross-directorate initiative to develop consistent, coherent and best practice price controls across our office. The existing policy position on deferred capex is to remove all the benefit accruing to a regulated company from the deferral of projects, and we have no current reason to believe this to be inappropriate. This is also symmetrical with how we treat unpredictable and/or unforeseeable additional capex i.e. "logging up" and "logging down". On the issue PNGL raised about inconsistency with the treatment of deferred infill and feeder mains in PC03, we would emphasise that our proposals in this price control are in relation to capital projects that do not include infill and feeder mains. More specifically, all deferred infill and feeder mains are treated within outperformance and so PNGL has been allowed a reward for this. Whilst it could be argued that PNGL should get no benefit from such deferral, we felt it necessary to draw a line somewhere between deferred capex and outperformance. We have adjusted the outperformance calculations to ensure there is no overlap between our proposals now and PC03.

Comment	Our response
<u>Section 4</u> **General commentary on financeability** PNGL stated that our proposals will likely result in a credit rating downgrade, and that this will impact on consumers by way of increasing PNGL's cost of capital.	We have carefully considered our position and are progressing with decisions that are consistent with our statutory duties. We are mindful of how our actions might impact on the financeability of PNGL, not just over the price control period in question but also over the medium to long term. We recognise the points raised by PNGL on the impact our decisions may have on its ability to attract finance at a reasonable cost. We have therefore carried out a thorough and robust assessment of PNGL's financeability. On choice of ratings, our focus on an investment grade is appropriate and consistent with the licence. Our full assessment on financeability can be seen in the final decisions document. PNGL remains inherently financeable under our decisions. PNGL also highlighted the importance of a '*supportive regulatory framework*' to the investment community. The evidence in relation to PNGL since 1996 clearly demonstrates that such a framework exists in NI and this is supported by our principal objective to promote the gas industry. We have taken a number of actions over the years to ensure the industry continues to grow. The most relevant is the decision to restructure the PNGL licence when the original business plan failed to prove viable. This allowed an investment grade credit rating for PNGL. It is not clear what the credit rating would have been without the 2007 licence modifications. Other examples of a supportive regulatory framework include adverting and marketing allowances, sales team manpower allowances, allowing free connections to all customers, postalisation of transmission assets to reduce risk, and an understanding approach to licence breaches e.g. illegal development. With reference to the letter of 27 October 2011 from PNGL's chairman, Peter Ritson, our analysis indicates that under our decisions: (1) PNGL remains inherently financeable; (2) the company will be able to maintain an investment grade credit rating, as required under the licence; and (3) there are no compelling reasons why PNGL's non executive directors will be unable to fulfill their duties to supply the necessary certificates as required under the licence.
<u>Section 5</u> **General commentary on changes from May draft** In its response PNGL indicated dissatisfaction that some aspects of our draft proposals differed from an earlier working draft that we had shared with it (specifically, the section on opex and capex allowances) in May 2011. PNGL also expressed surprise at some aspects of our draft proposals because we had suggested a different approach during working level meetings whilst developing the price control.	The draft we shared with PNGL in May on the allowances was always indicative. At no point did we suggest that by sharing an early working draft with PNGL we were somehow committing ourselves to what was in that draft. It should be noted that our overall opex and capex allowances in May amounted to c£24.9 million and c£23 million respectively. In our draft proposals published in August the respective allowances were c£26.9 million and c£24 million. Overall the shift in allowances was clearly favorable to PNGL, not detrimental. Similarly our price control team met with the PNGL price control team regularly over the course of 2010 and 2011. During these meetings our team may have shared their thoughts at that time as to how various aspects of the price control might be approached. However, once again we would reiterate that at no point did we suggest that by sharing these thoughts that we were somehow committing ourselves to what was being discussed. Furthermore, PNGL had eight weeks to consider our draft proposals once these were finalised and published. We are content that the public consultation process has given PNGL adequate time to consider our proposals and respond to them accordingly.

Comment	Our response
Section 5 **Indexation** PNGL suggested that our proposal to apply an unadjusted "X" factor is inappropriate for two reasons. First that we are effectively double counting efficiencies because of the bottom-up approach taken in allowance setting. And second, that we are not being consistent with decisions made by our office in other price controls.	On the first point, there is no double counting of efficiencies in our approach. We agree that we have scrutinized costs and set what we consider to be an efficient allowance, but in many instances these allowances are based on historic actual costs over the period 2007 to 2009. Setting allowances using performance over this period as an indicator (in some cases, one of several) has allowed us to assess what we consider an efficient allowance. However, the allowances relate to the 2012 calendar year, meaning there are two further years between the end of 2009 and the beginning of 2012, during which time we would expect PNGL to continue to find efficiencies. For this reason it is entirely appropriate to inflate costs from our 2010 price base to nominal monies of the day in 2012 and 2013 at a rate lower than the increase in the RPI. In our case, we have opted for one per cent less than the RPI. Another way to emphasise our point is that the allowance setting process determined where the efficient frontier is, which is entirely appropriate. We then apply an RPI-X uplift which implicitly assumes that the efficient frontier continues to move year-on-year, which is again entirely appropriate. There is therefore no double counting. On the second point, that we are not being consistent with other price controls set by our office, PNGL is referring to the SONI price control where "X" was set at zero. SONI is not a network operator and as a result most decisions made in that price control have limited bearing on the decisions that we should make in gas distribution price controls.
Section 5 **Advertising, Marketing and PR** PNGL put forward numerous arguments against the proposed "A+M+PR" mechanism, and instead urged us to grant a higher allowance and that more of it should be fixed in nature i.e. not output-related.	The CCNI questioned why PNGL requires an allowance at all for advertising, marketing and PR. It suggested that PNGL's rate of return should be sufficient to allow the company to fund its marketing activities itself, and highlighted that Ofgem does not grant an explicit allowance for this activity. (For our response to the CCNI comment, see Ref 5). The reasons why we have developed this mechanism are clearly laid out in our decisions document. It is worth noting that since its creation in 1996, our office has allowed PNGL cumulative allowances of around £37 million (2010 prices) for advertising, marketing and PR (not including indirect costs, such as manpower). Our original proposals remain appropriate.
Section 5 **Billing** PNGL has requested that the allowance for billing specifically related to the level of switching activity be set at a variable rate, instead of at a fixed level. This is to ensure that PNGL does not carry the risk that switching activity is greater than forecast, and hence the fixed allowance for switching-driven costs too low.	PNGL's rate of return is sufficient to enable the company to carry some risk, in particular one of this nature where the quantum of monies involved is relatively small. Furthermore, this price control covers only two calendar years, which further limits the downside risk to PNGL should the outturn level of switching exceed forecasts. Our original proposals remain appropriate. (Also, see our response to the comment on billing made by firmus energy.)
Section 5 **Emergencies** PNGL provided new information relating to the number of emergency calls the company responded to in 2010. The figure for 2010 was markedly	We acknowledge and welcome the new information provided by PNGL (although we would add that PNGL only provided limited information from 2010 in respect of those areas for which it sought further allowances). Naturally we were unable to incorporate the data from 2010 in our draft proposals, given that these were developed at a time when only data from 2007 to 2009 were available. We note that the volume of emergency calls in 2010 is markedly higher than previous years. However, it should also be remembered that the winter of 2010 was extreme with two prolonged periods of substantially sub-zero temperatures. It may not be appropriate therefore to base future expectations of emergencies volumes on the outturn in 2010.

Comment	Our response
higher at 14,791 than the average of the three years of 2007 to 2009, at around 12,600. PNGL argued this demonstrated a pattern of increasing emergency costs, and requested that its full allowance request be granted.	In setting the emergency allowance, we employed engineering consultants PB Rune, to examine PNGL's emergency costs at a detailed level, including the benchmarking of costs against comparable gas distribution networks in GB. We included the full chapter on emergencies from the PB Rune report in the appendices of our proposals document. We remain satisfied that the recommendations from PB Rune are based on sound and reasoned analysis. Furthermore, the allowances we are granting in 2012 and 2013 – at c£1.8m and c£1.9m respectively – are higher than both the allowances granted in the previous price control and the level of PNGL's actual spend in 2009 (the most recent year for which we have audited data). In other words, our decisions will see an increase in the allowance for emergencies.
<u>Section 5</u> **Entertainment** PNGL stated that it would be more appropriate for us to consider entertainment costs in the context of market development and requested that we either allow or disallow the costs of client and corporate entertainment in that context.	We have based our decisions on HMRC guidance on non taxable employee benefits, which we consider appropriate.
<u>Section 5</u> **Fleet Costs** PNGL put forward a number of arguments to support the case for a higher allowance.	These costs were treated under the "Smaller Items" approach, which was to grant the average actual cost over the three year period of 2007 to 2009. Our original proposals remain appropriate.
<u>Section 5</u> **Information Technology** PNGL stated that to include CAG costs – which PNGL considers to be unquantifiable at this point – in the IT allowance places too much risk on PNGL. PNGL also requested clarity with regards to the suggestion that we may consider granting an additional allowance in some instances.	We have amended our decisions for IT, reverting to our original thinking to grant PNGL an allowance based on the average spend over calendar years 2007 to 2009. The rationale for this move can be seen in the final decisions document.
<u>Section 5</u> **Insurance** PNGL put forward a number of arguments to support the case for a higher allowance for insurance.	PNGL's argument suggests that it has a limited ability to control the cost of insuring its network, which is largely driven by the state of the insurance market in general. This would seem to suggest the company wants insurance costs to be treated like a pass through cost, which we do not consider appropriate. PNGL's rate of return is sufficient to enable the company to carry risks associated with a fixed insurance allowance as we are proposing. PNGL's description of its risk based on one pipeline (SNIP) is inconsistent with the fact that its network is now connected to the South-North Pipeline and is not dependent on SNIP. Furthermore in its argument, PNGL points out its excellent record in non-claims to date,

Comment	Our response
	which would suggest the company should be able to negotiate more aggressively for competitive rates. In our draft proposals we used the Ofgem benchmark in the existing Gas Distribution Price Control Review of 1.04 per cent of turnover. This applied to the Business Insurance element of the overall insurance cost. For Fleet and Building Insurance, we used the three year average approach. Our original proposals remain appropriate.
Section 5 **Manpower** PNGL put forward a number of arguments to support the case for a higher allowance, effectively disputing the reduced allowances we had proposed for the CEO and directors in PNGL.	We commissioned remuneration consultants to consider the appropriateness of the remuneration packages of the senior management in PNGL. Our consultants' analysis included benchmarking against suitable comparators in NI and GB. Their findings indicated that the allowances sought by PNGL for the CEO and directors were higher than those which would be expected for an organisation such as PNGL. We therefore adjusted the allowances downwards. We would point out that in our assessment of manpower costs, we granted PNGL's request for additional FTEs in full, on the basis that PNGL's proposed total headcount in 2012 and 2013 is at a level that can be considered efficient, when benchmarked against comparable organisations. However, we know that PNGL historically has successfully managed to carry out its operations whilst carrying a number of vacant positions. An argument could be made therefore that PNGL can indeed carry out its operations with fewer FTEs than we proposed. However, on balance, we are comfortable allowing PNGL its full requested FTEs. Our original proposals remain appropriate.
Section 5 **Network Maintenance** PNGL put forward a number of arguments to counter our proposal to disallow an allowance for the development of PAS55, and to apply a reduction of 10 per cent to network and meter maintenance costs.	We disallowed the development cost of PAS55 for two reasons: (1) we had suggested in the previous two price controls that PNGL develop and implement PAS55, but so far the company has not done so; and (2) it is considered best industry practice and would in fact be beneficial to PNGL. We also note, by way of comparison with other regulators, that Ofgem has never granted an allowance of this nature. PNGL's counterargument rests on the notion that Ofgem disallowed the development cost of PAS55 because the GDNs were able to retain the benefits that were derived from its use over the five year price control. PNGL said that we should grant it the development allowance, and that we should allow it to benefit from use of the system for a time by way of granting the full allowance for network maintenance. PNGL did in fact get the benefit of a full allowance for network maintenance in the period 2002 to 2006, and over this period the company dramatically outperformed on this cost line, saving 25 per cent (or c£500k). So it is wrong to assert that PNGL has not had the opportunity to benefit. A review of actual versus allowed spend from 2007 to 2009 shows this trend of outperformance continuing. Furthermore, as PNGL did not in fact develop PAS55 it now has to operate to a maintenance schedule based on manufacturer recommendations. As PNGL itself acknowledges, the development of PAS55 for the GDNs led to benefits which Ofgem allowed the GDNs to keep over the five year price control. Implicit in this is that operating to PAS55 standards is more efficient than operating to manufacturer recommendations. And it is not appropriate that consumers should have to pay a higher sum for network maintenance, given that PNGL has opted not to develop and implement PAS55 to date. In light of PNGL's track record of outperforming in this area, and the arguments put forward about PAS55, our 10 per cent reduction to network and meter maintenance costs remains appropriate. We do however acknowledge and welcome the work the company is currently undertaking to develop and implement PAS55.

Comment	Our response
Section 5 **Rates** PNGL requests that rates be treated as pass-through.	An allowance for rates for PNGL has in the past been assessed using a formula based on revenues and various assessment factors as advised by Land and Property Services. This approach results in a fixed allowance determined *ex ante* in the price control. To date PNGL has managed to significantly outperform on rates. However, going forward the company is concerned that a fixed allowance approach may potentially leave it short of its actual rates bill. Therefore PNGL is seeking rates as pass-through. It is not appropriate that the company should get to outperform on rates historically (during which time the formula approach was not challenged), but now that there may be potential for underperformance PNGL is seeking to have this risk removed. Our original proposals remain appropriate.
Section 5 **Telephone and Postage** PNGL put forward a number of arguments to support the case for a higher allowance.	These costs were treated under the "Smaller Items" approach, which was to grant the average actual cost over the three year period of 2007 to 2009. Our original proposals remain appropriate.
Section 5 **Travel and Subsistence** PNGL put forward a number of arguments to support the case for a higher allowance.	These costs were treated under the "Smaller Items" approach, which was to grant the average actual cost over the three year period of 2007 to 2009. Our original proposals remain appropriate.
Section 5 **Capex** PNGL did not agree with our treatment of the management fee, whereby this cost was apportioned to the various capex activities and embedded in the allowed unit rates. Our approach results in the quantum of the allowed management fee being determined by the actual outputs delivered over the control period. PNGL disagreed with this approach stating that the management fee is largely fixed in nature, and that the allowance should therefore be granted as a fixed allowance. PNGL also pointed out a transposition error.	It is entirely appropriate that PNGL should be remunerated as far as possible based on the actual outputs it delivers. Furthermore, PNGL's rate of return is sufficient to enable the company to carry a risk such as that resulting from our output-based allowance for the management fee. Our original proposals remain appropriate. We also acknowledge and have corrected the transposition error.

Comment	Our response
Section 5 **Treatment of Unforeseeable/Unpredictable Costs** PNGL did not agree with our proposal to introduce a de minimis threshold of £100k below which additional allowances will not be considered.	Allowances set in a price control should under normal circumstances be sufficient for the company to deliver its programme over the control period. However, in order to offer at least some protection to the company in the event something genuinely unforeseeable and/or unpredictable arises – and its financial impact is of a significant enough magnitude (i.e. £100k or greater) – then we are happy to consider an appeal by the company for an additional allowance. However PNGL's rate of return is sufficient to enable the company to carry the risk of unforeseeable and/or unpredictable events below this threshold of £100k. By way of comparison, the equivalent de minimis threshold in GB is £500k.
Section 6 **A Brief History of PNGL** PNGL sought to clarify what it felt was a selective representation of the company's history from its inception to current day.	First and foremost, the brief history of PNGL that we documented in our draft proposals was intended to illustrate how the risk-reward profile of PNGL has altered over the years. We do not consider it to be a complete history and recognise that parts of the story were omitted. For example, in its response PNGL stated that our account of its history fails to recognise the benefits the 2006 discussions and subsequent 2007 licence modifications delivered to customers. We acknowledge that our description of events was not (or intended to be) comprehensive, but we do not see how demonstrating (or not) that the 2006 discussions and subsequent 2007 licence modifications delivered benefits to customers detracts from our main point that the 2006 discussions and subsequent 2007 licence modifications removed risks from PNGL. Furthermore PNGL's own account of its history fails to recognise the significant benefits that the 2006 discussions and subsequent 2007 licence modifications delivered to it. We would acknowledge that the 2006 discussions and subsequent 2007 licence modifications benefited customers and the gas industry in general, since the alternative (i.e. no licence modifications) would have resulted in a price spike. However, PNGL does not seem to acknowledge that in the absence of the licence modifications, it would have been a very risky prospect to assume that under the 1996 licence its investors would have recovered all of their investment by 2016, let alone the significant returns expected on these investments. Bearing this in mind, a neutral observer may conclude that the 2006 discussions and subsequent 2007 licence modifications had an element of regulatory rescue to it. It is questionable therefore to argue that the company's 8.5 per cent rate of return was fully deserved in light of the significant risks it faced, given that when these risks materialised the company was effectively rescued by regulatory intervention. Based on some of the comments made in the PNGL response we would disagree about our views on the link between risk and reward. For example, PNGL does not seem to acknowledge or recognise the significance of the removal of volume risk, even though it states in its response that volume outturns are largely driven by factors outside its control, such as weather and temperatures. PNGL implies that the replacement of a volume driver with a connection driver places an equivalent risk on the company. While it is true that this was our original intention we do not agree that the mechanism in place is an equivalent risk, since PNGL itself acknowledges that it cannot influence temperatures (and hence outturn volumes), whereas the company should have much greater control over factors that drive outturn connections. PNGL also challenged our assertion that the risks the company faces from 2012 onwards are lower than the risks it faced in the past. We strongly disagree. In the past PNGL faced a significant amount of construction risk as it sought to develop its network. Now that the network is largely complete, future capital works are largely incremental in nature as the company seeks to make connections to its already built network. Therefore construction risks are significantly less going forward than they have been in the past. In addition, and as we have already stated, it is wrong to argue that the removal of volume risk has somehow been equally offset by the introduction of a connections incentive, since PNGL has much greater control over factors that drive outturn connections. We remain satisfied that our brief narrative demonstrates that the risks facing PNGL have changed since 1996, and that the corresponding rate of return awarded to the company may not fully reflect these changes. As we stated earlier in response to the

Comment	Our response
	Consumer Council's comment on PNGL's rate of return (see Ref 2), the range of weighted average cost of capital (WACC) allowances – specifically their pre-tax equivalents as we have calculated them – granted in recent price control decisions (from regulators such as Ofgem, Ofwat, the ORR and the Competition Commission) ranges from 5.5 per cent (Ofgem, 2009) to 6.1 per cent (Ofwat, 2009). This compares to a WACC of 7.5 per cent for PNGL.