Regulation & Commercial

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Your ref
104/12
Our Ref

Date
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Contact / Extension
Alan Michie
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Dear Grant,

RIIO-T1: Initial Proposals for National Grid Electricity Transmission and National Grid Gas

This response is from SP Transmission Limited. The attached appendix covers questions from Chapter 7 of the Finance Supporting Document relating to the annual iteration process and the financial model. In summary, we recommend that:

- Actual RPI values should be included as part of the annual iteration process.
- Incentive scheme revenue should not be included in the PCFM. If this incentive information is to be published then it should be done separately.

I should also highlight that we believe that finalising the financial model and developing and completing the financial handbook are areas that require particular focus, by all parties, over the coming months. We have not yet seen a draft of the financial handbook describing how the transition from our Fast-track Final Proposals to PCFM financing will be effected and preserved through iteration without compromising our Fast-Track Final Proposals position. However, we are pleased at the constructive progress we are making on this matter and we believe that the strong working relationship we have with the Ofgem team will help ensure that our concerns are resolved.

Yours sincerely,

Alan Michie
RIIO T1 Project Manager
SP Transmission

Appendix

Question 10 TIRG annual iteration process adjustment

We agree that an adjustment needs to be added to the annual iteration process to reflect actual TIRG transfer values as provided by the TIRG licence condition mechanism. The revised values would replace the forecast transfer values into Core RAV and ensure that the financial model reflects correct TIRG revenues post transfer. The TIRG annual iteration adjustment would also need to cater for the impact of actual spend on debt and capital allowances pool values at the transfer date as these values also need to be reflected in base revenue calculations post transfer. Finally, adjustments through the annual iteration process need to cater for changes to project phasing/timing e.g. a one year delay in project completion.

Question 11 – Views on the financial model

1. RPI Indexation – The following comments apply to both the financial handbook and the financial model. We understand that it is not intended to update the RPI Indices in the financial model to reflect actual RPI through the annual iteration process; instead the RPI indices will remain fixed at the forecast values assumed in final proposals. Previously we have raised our concerns regarding this at financial modelling meetings at Ofgem and reiterate our concerns here:

a. We believe that not updating the RPI indices to reflect the actual RPI will result in incorrect values for debt and capital allowances pool additions and other values in the tax computation and therefore result in incorrect adjusted tax allowance values when calculating the MOD term – our modelling suggests that applying relatively small changes in RPI to the model has a significant impact on the revenues that customers pay;

b. Paragraph 4.8 of the financial model handbook states that "financial amounts which are in nominal prices e.g. RRP totex will be deflated to 2009-10 prices on the basis of actual RPI". We agree with this;

c. Paragraph 4.9 of the financial model handbook states that "the PCFM uses nominal prices for some internal tax calculation functions" but the model uses "RPI forecast values set at the outset of the price control and hard coded into the model". While we agree that tax calculations need to be done in nominal we also believe that updated tax calculations for the purposes of the annual iteration should reflect actual RPI not forecast RPI.

d. Using forecast RPI in the financial model in respect of capex will mean that the incorrect (higher/lower) nominal values will be added to capital allowances pools in the capex additions line for each pool. Over the course of the eight years of the price control this could result in a significant variance to actual capital allowances pools with the resulting impact on the capital allowances deduction in the financial model tax computation; hence network operators could be over/under funded for taxation.

e. The average debt is also likely to be incorrect because, in most years of the price control, there is a significant difference between the two major components (revenue and totex) so a difference in RPI indexation (actual v forecast) would have a material impact on average debt and hence the interest charge used in the tax computation.

f. When calculating the interest charge in the model the real cost of debt is adjusted by inflation; so a change in actual RPI compared with forecast RPI could have a material impact on the interest cost in the model for the purposes of the tax calculation.

g. Finally, not using actual RPI could result in the other two main components of the tax computation (revenue and opex) being significantly over/under stated with the corresponding over/under funding of the tax allowance.

h. The annual iteration process aims to adjust annual revenues to ensure that revenues reflect actual expenditure – some of these adjustments may be quite small. To be consistent with this aim the model needs to reflect the actual nominal expenditures experienced by the business when calculating any revisions to the tax allowance.

i. As a result we believe actual RPI values should be included as part of the annual iteration process.

2. The objective of the RIIO-T1 annual iteration process is to allow justifiable revenue adjustments to be made via the MOD term within the price control, rather than truing up at the end. This inevitably means that there will be materially greater revenue volatility from year to year within RIIO-T1 than would have arisen under the TPCR4 arrangements. Much of this will be difficult for third parties to forecast with certainty. Ofgem are separately consulting on steps to limit network charging volatility. It is important that Network Operators are not penalised for any volatility which arises expressly from Ofgem's RIIO-T1 Policy, and that stakeholders understand clearly the reason why their charges are volatile.

3. The annual iteration process and deployment of the PCFM in RIIO-T1 is a major regulatory innovation. We believe that Stakeholders would be reassured were Ofgem to publish a detailed illustration of how the complete iteration process is intended to operate, including the relevant Licence Conditions, Financial Handbook, RIGs (it is important to understand whether there will be any additional reporting requirements) and a detailed timeline covering the entire iteration process including any interactions with industry codes and any other statutory obligations on the parties involved.

Question 12 – Financial model include revenues from all incentive schemes

We believe that it is undesirable to include the revenue for incentive schemes in the PCFM. If this incentive information is to be published (which may well be desirable) it should be done separately.

The PCFM is one of the financial instruments which comprise the licence, and its sole purpose is to calculate the MOD term in the Revenue Restriction condition.

The main body of the licence determines the calculation of the remaining terms in the Revenue Restriction condition, so neither these terms nor their inputs are required by the PCFM. To include these additional values in the PCFM for presentational reasons simply complicates governance of the model, as some elements would presumably be subject to the Licence governance condition and others not.