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Dear Ian,

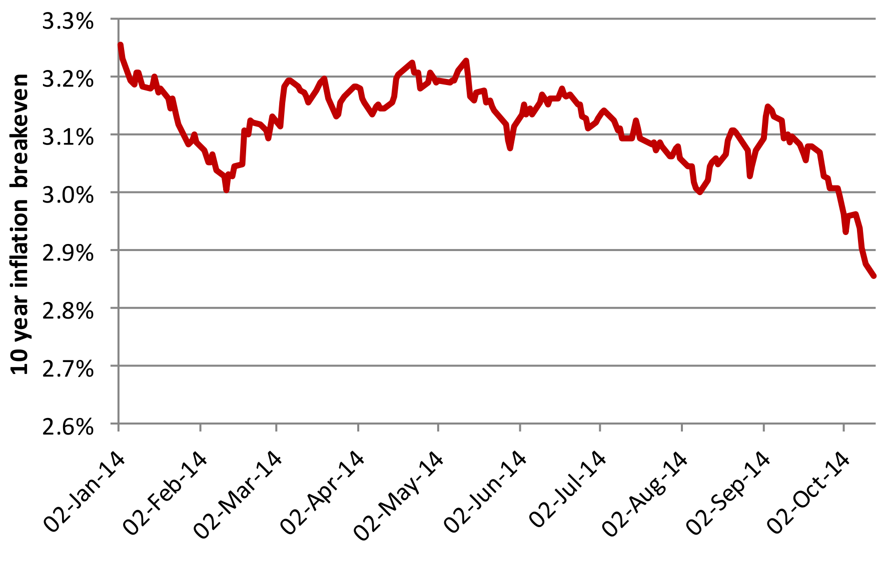
THE PROSPECTS FOR RPI INFLATION AND EMBEDDED DEBT

During our various discussions over the course of the year to date, on the extent that Ofgem's proposed trailing average will underfund the actual cost of debt, we have both adopted a baseline assumption that RPI inflation over the 2015-23 period will be 3.1%.

This assumption is critical for the translation of the industry's embedded cost of debt, which is predominantly based on fixed nominal debt issuances, into a real cost of debt for settling price control allowances.

You will no doubt have observed that the latest economic data has shown extremely weak inflation and inflationary pressure as at today. This suggests that inflation over the ED1 period is increasingly likely to be well below the 3.1% compound average previously suggested by the inflation breakevens (which you informed me was your basis for the 3.1% figure).

The market response to the recent news is shown in the chart below, which plots the inflation breakevens used in the debt index calculations over the course of 2014 to date.



As can be seen from the chart, inflation breakevens over the next eight years have fallen from the 3.0-3.2% levels seen during 2014 to mid-September to under 2.9% now.

Taking into account this news, the 10-20 year trailing looks set to underfund our cost of debt, and that of the sector, by more than we (and Ofgem) had previously anticipated. From a calculation based on Northern Powergrid's debt profile, we estimate that the change relative to the previously expected 3.1% RPI inflation to 2.9% adds about 11 basis points to our expected real cost of debt over the ED1 period.

This issue is in addition to the issue that we had already discussed – that the longer end of the inflation forward curve shows evidence of upwards-bias due to an inflation risk premium - which adds further to the underfunding (since inflation is likely to outturn lower over the next 10 years than the current inflation breakeven level.

Taking both issues into account, the total additional underfunding of the sector's cost of debt by a 10-20 year trailing average is approaching 20 basis points. This is of course on top of the circa 15 basis point under-funding Ofgem estimated at the time of the draft determination, taking the total expected under-funding to around 35 basis points.

Our position remains that Ofgem should calibrate the debt index trailing average at a level which can be expected to fund the sector's actual expected real cost of debt. But while we had previously believed that a 13 year trailing average would secure this, the latest macro-economic data and the resulting downwards revision of inflation expectations means that a longer starting point for the trailing average is necessary.

Based on the latest data, we now believe that the trailing average must start at 15 years and extend to 20 years *simply to cover the expected cost of debt of the sector in the ED1 period.*

I appreciate your time will be at a premium given you are about to enter the closing loop for Authority approval of the final determination. But if you would like to discuss the contents of this letter, or any other topics, please let me know and I will make myself available at your convenience.

With kind regards,

Keith Noble-Nesbitt
Economic Regulation Manager