Regulation & Commercial

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Your ref

Our Ref

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Dear Ian

Thank you for your e-mail of 29 August 2015, which followed our bi-lateral meeting on Wednesday 27th.

We welcome your recognition of the wide range of issues that we have with the draft determinations and your resolve to ensure that the final determinations are fully informed. We are also keen to reach a resolution which meets the requirements of our stakeholders. Although there is clearly still some distance to go, we are, nonetheless, hopeful that these issues can be resolved, prior to the publication of Ofgem's final determinations.

On Friday 29th, I copied to you a letter which I sent to Maxine Frerk that set out our concerns in relation to the financeability of SP Distribution and SP Manweb, arising from the RIIO ED-1 draft determination. Here, I would highlight that we shall need to spend the totex that has been disallowed and, in our case, only 46% of that deemed over-spend will be recovered through the operation of the efficiency incentive rate. Consequently, our interest coverage and other key financial ratios will deteriorate, as detailed in the letter. Moreover, our shareholder will be required to inject additional equity of around one quarter of a billion pounds, just to maintain our credit worthiness. In such circumstances, to imagine that shareholders will provide a blank cheque book to finance further investment in an effort to catch up with WPD but which would further reduce their return, does indeed appear simplistic and fails to recognise investors' legitimate expectations and requirements.

Notably, you recognise that the fast track benefits are likely to exceed significantly the pre-determined fast-track additional income of 2.5% of totex. This appears a stark admission, when any stakeholder reading the RIIO framework and RIIO-ED1 strategy and policy documents would have formed a reasonable expectation that the 2.5% of totex would be the only reward for the fast-tracked DNOs. Furthermore, in this context, the "Price control update provisions for WPD" (Licence Condition CRC 4C) might lead stakeholders and affected parties to believe that there would be a reasonable probability that normal track companies could do even better and that this would then also have to be passed on to the fast-tracked DNOs.

I set out, in the table below, how we calculated the c11% return that is available to WPD. The figures are taken from Ofgem's draft determinations and the Price Control Financial Model (PCFM) for WPD. We have applied WPD's efficiency incentive rate of 70% in calculating the additional return accruing to WPD.

Expected return for WPD

Headroom	RIIO-ED1 Total	Opening RAV	Average RAV	Equity RAV 35%	Annual Amount	Incentive Rate 70%	Additional Return
RPEs	485	5750		2012.5	60.63	42.44	2.11%
Smart Grid	140		6432	2251.2	17.50	12.25	0.54%
Efficiency	235		6432	2251.2	29.38	20.56	0.91%
IQI Additional Income	176		6432	2251.2	22.00		0.98%
Total Additional Return							4.54%
Cost of Equity							6.40%
Expected Return							**10.94%**

Sources: Table 2.6 of Cost Assessment Draft Determination Supplementary Annex
Additional income from Fast-track WPD PCFM Live Results Tab Cell N49

WPD is able to choose how much to reinvest of the additional funds it receives and will earn a return of between 6.4% (if they invest 100%) and 11% (if they invest none). Moreover, we observe that £235m of WPD's totex has been assessed as inefficient. We are bound to ask whether this is a proportionate reward for WPD (South West) which has been assessed as 14th in the latest set of efficiency scores.

The higher cost of equity, which WPD has been allowed, provides it with the opportunity to invest a greater proportion from retained earnings. The "pecking order" theory[1] of finance indicates that this is the preferred source of funds for companies. Also, in the presence of asymmetric information, which creates an adverse selection problem, new equity may have to be issued at a discount. This is the well-known "market for lemons[2]" phenomenon, as applied to corporate finance[3].

Furthermore, WPD is able to spend the RPE and SMARTs allowances spent on improving the condition of assets, reducing their average life, improving the gap in asset condition between WPD and the rest of the industry , investing to improve quality of supply, and investing to lower maintenance and other opex costs. All of these provide WPD with opportunities to outperform other DNOs and establish an unassailable industry leading performance for RIIO-ED2. We do not believe that this would be in the interests of customers at large, who would not benefit from the improved levels of reliability and service or even WPD's own customers who are being charged more.

All things being equal for WPD, with the standard-tracked DNOs, WPD's shareholders would then face an investment decision to invest and fund a cash outflow of £860m (equivalent to RPEs

[1] Myers, S.C., (1984) "The capital structure puzzle". Journal of Finance

[2] Akerlof (1970)"The Market for Lemons: Qualitative Uncertainty and the Market Mechanism", Quarterly Journal of Economics

[3] Myers and Majluf (1984),"Corporate Financing and Investment Decisions When firms Have Information that Investors Do Not Have", Journl of Financial Economics

£485m, SMART £140m and inefficiency £235m) and recover only £52m in ED-1 equivalent to 6% of the cash outflow (£860m * fast pot * 30%). The RAV would also increase by the slow pot of £206m resulting in £258m (30%) being funded in the long term. WPD does not face this investment decision as it can invest this 'war chest' amount in its assets, over and above the standard track DNOs, without any application of the efficiency incentive rate.

It appears that you are proposing that we should offer investors returns below 6% (as SPEN will have to overspend the allowed totex to meet its statutory and licence requirements, including those for the safety, quality and continuity of supply), while asking them to inject capital (as the allowed cost of debt allowance does not cover our interest payments), with little or no prospect of a dividend payment in the next 8 years, but yet always be ready to inject further capital should the DNO's investment grade credit rating be threatened, as a result of the balance of risk in the regulatory package being skewed to the downside, as compared to WPD. Furthermore, to undertake additional investment beyond that which has been funded, investors would have to be persuaded that there is a strong likelihood of gaining fast track rewards at RIIO-ED2, although we expect and customers hope that the scale of rewards provided to WPD would not be repeated. We are also mindful that at RIIO-GD-1 no companies were fast-tracked, which further increases uncertainty in the minds of the investors. Accordingly, we do not consider your proposition to be a reasonable proposition and certainly one which is unpalatable to investors.

Our capital structure is conservative and, unlike some other DNOs, we do not rely on highly geared holding companies to leverage equity returns. We emphasise that we are not looking to earn "super normal" profits, just a reasonable return.

Nevertheless, we are well aware that Iberdrola is able to earn higher returns on equity in the US. For example, the allowed return on equity for Distribution is greater than 9% and over 11% for Transmission (MRP). These are significantly higher than that proposed for SPEN. Faced with such a differential in available returns, it is extremely unlikely that our investor would choose to finance discretionary investment by SPEN.

If I understand the argument that you are seeking to make, it is essentially that the opportunity cost of funds should be the same for WPD, which was fast-tracked, and the other DNOs. As I have demonstrated, this is too simple an analysis. In any case, it does not support the 40bps reduction in the cost of equity which the remaining DNOs now face.

Yours sincerely

Scott Mathieson

Scott Mathieson
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