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Dear Hannah

Ofgem's Initial Strategy Document for RIIO-T1

National Grid welcomes the opportunity to respond to Ofgem's Initial Strategy Document for RIIO-T1.

The RIIO-T1 price control period comes at an important time for the UK gas and electricity markets. Over the next decade significant changes will take place in the gas and electricity markets driven by: the continued decline of North Sea gas; the need to decarbonise the generation of electricity (to meet current use as well as expanding to meet the demand created by new uses (such as heat and transportation)) and the replacement of existing assets. Whilst the direction of change is clear, the detail and timing of the changes remain broadly uncertain. The scope and scale of uncertainty facing the transmission networks over the next decade will therefore require a regulatory framework which will be adaptable and resilient to uncertainty.

National Grid has been a vocal supporter of the RPI-X@20 review and the resultant RIIO framework. Whilst we welcome many aspects of the RIIO proposals such as the longer term view, higher returns for better performing networks and the commitment to stakeholder engagement, we have grave concerns with the financeability proposals. Ofgem anticipate that networks will be required to invest £32 billion so it is clear that the RIIO price controls need to be attractive to investors. The current financial proposals however are more likely to discourage investment than facilitate it.

Financeability

Whilst we acknowledge Ofgem's public commitment to provide a regulatory framework that is pro-investment and financeable we have a number of key areas of concern including:

1. Asset lives

   At precisely the time that companies need to raise finance to invest in the networks, proposed changes to asset lives will defer cash receipts. While intergenerational equity is relevant to the choice of asset lives, the other considerations that led to the current policies remain equally valid. To date, Ofgem has failed to demonstrate why asset lives need to be extended, and their failure to do so has provoked negative a reaction among the investor community. Furthermore, depending on the choice of transitional arrangements adopted, the change in electricity asset lives could even lead to future consumers subsidising current consumers without justification.

   The asset life proposals are poorly conceived. The proposal for the gas industry is to retain the existing 45 year life because of the significant uncertainty over the future of the gas industry. While most scenarios show the gas industry assets remaining useful up to 2050, there are a number of credible scenarios where gas is significantly reduced within 30 to 40 years. It is clear that the

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absence of certainty is precisely the reason why asset lives should be reduced. In deferring the decision, the current proposals increase the risks to future cash flows in terms of increased stranding risk and increase the risk, to potentially reduced numbers of future consumers, of significant increases in network charges (on either a per unit or per customer basis).

Similarly, the proposed electricity asset life of 45 to 55 years ignores significant changes taking place in the industry, both in terms of increased usage of shorter life assets and material expenditure connecting assets with a shorter life than the connection assets themselves.

The change in asset lives increases the duration of cash flows and also increases regulatory risk. As outlined above, the proposals make significant changes to previous regulatory decisions despite the original rationale for those decisions remaining applicable. The recent consultation by the Department for Business Innovation and Skills (BIS) on the 'Principles for Economic Regulation' includes predictability within its principles for economic regulation and states:

- *the framework of economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence*

- *the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets*

In our opinion, the current proposals for electricity asset lives fail to meet this principle. Would-be investors in the industry will require additional return to compensate for the lack of regulatory predictability.

2. Cost of debt index

The current proposals for the cost of debt index systematically fail to finance the efficient debt costs of the networks. They make no allowance for inflation risk or costs such as new issue premia, facility costs, debt issuance cost, commitment fees, the costs of holding cash etc. Further, the index uses 10 year bonds and a 10 year trailing average despite evidence that the average tenor of debt is 18.6 years. To the extent that the cost of debt index does not adequately cover efficient debt costs, the returns received by equity holders will be impacted.

3. Equity return proposition

With regard to equity returns, while we agree that CAPM has a role to play in estimating the cost of equity, the approach must not be too theoretical and must consider the views of the investor community. We are entering an era where the challenge is no longer just about the return current investors require on their investment but is increasingly about allowing a return that will attract new investors and sources of finance. Consideration should be given to the increase in the cash flow risks the networks will be exposed to under RIIO and impact of increasing the duration of cash flows.

As explained more fully in our detailed response, recent years have seen significant changes in financial conditions, with a period of easy availability of credit leading up to financial instability, and followed by a relatively short period of relative recovery. It is still unclear what the long-run cost of capital will be following the financial crisis, i.e. what conditions will form the new 'normal'. There are, however, reasons to expect that long-term shifts in global investment and savings pattern may increase the cost of capital. In such circumstances, and particularly given the increased duration of price controls under the RIIO framework, it would be unwise to base estimates of the cost of capital on recent or short-run trailing averages of risk free rate and equity risk premium, and instead much-longer term average values should be used.

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In the absence of further information on the strength of incentives and uncertainty mechanisms it is not possible to be definitive on the required cost of equity at this stage. However, one thing that is clear is that with increasing cash flow risk and a need to set an allowed return that will be attractive to investors, the cost of equity that is allowed will need to be at least at the top end of the range proposed by Ofgem. As they stand, the RIIO proposals appear to increase significantly the risks that equity holders face, yet the range of equity returns proposed offers little or no upside from the current controls.

In addition to the financial aspects, we have a number of other concerns including the lack of development of a calibrated outputs incentive framework; the time available for quality stakeholder engagement to further inform our business plans and the approach to benchmarking and cost assessment.

Outputs and incentive framework
National Grid has actively supported the development of outputs through the working groups to date. We note that the time available to support these workstreams has been constrained by the RIIO timetable. Despite the best efforts of Ofgem representatives, the networks and other stakeholders, this has resulted in a December consultation document position which does not contain the level of detail originally envisaged by Ofgem. Had more time been available for the development of the outputs then further beneficial progress could have been made to ensure the resulting outputs are proportionate, innovative and deliver long term value for consumers.

Whilst it is acknowledged that the final framework structure is within the gift of the networks to propose within their well justified plans, the lack of development in the area of output incentives is disappointing. We do however note Ofgem's commitment to provide more detail on the upsides and downsides of the incentives in the forthcoming March strategy documents and we have committed to working with Ofgem where feasible to support this.

The interaction between the cost of equity, the incentive framework and the allowed uncertainty mechanisms is critical for networks to assess the risk balance and to consult with stakeholders on this balance.

Stakeholder engagement

National Grid welcomes the encouragement to engage with our stakeholders in order to ensure that our customers' and stakeholders' views are incorporated into our business plans. This is not a new activity for National Grid as through our customer surveys, planning consultation and industry forums we have been listening to customer and stakeholder views for a number of years. We have however increased our engagement activities in order to ensure our plans are fully unformed by stakeholder views.

In order that our plans can reflect stakeholder views, we have undertaken and will continue to undertake a series of stakeholder workshops throughout 2011 and thereafter. In order that best engagement practice can be followed and in light of the uncertainty facing the industry, some aspects of our engagement process will not be concluded in advance of submitting the July 2011 well justified plans. It is therefore anticipated that there may be some evolution in our assumptions or plans as a result of evolving stakeholder preferences. The fact that our plans will continue to evolve as stakeholder requirements mature and some aspects of uncertainty become clearer sits uncomfortably with the proposal to use the first business plan as the basis of the IQI incentive. We provide some further views on this in our detailed response.

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Benchmarking

Benchmarking is a key part of the evidence section within a well justified plan, and National Grid participates in a number of mature benchmarking studies, the results of which alongside many other aspects of comparative assessment we use as part of the management toolbox. Experience with new and evolving studies and our own assessment of high level public data has demonstrated to us the importance of a robust and mature analysis process. We have serious doubts about the ability to use a FERC data set as a robust basis of analysis. We would welcome further discussion on this proposal.

The next decade will require networks to invest in replenishing their existing assets and workforces whilst supporting the decarbonisation of the electricity industry and connecting new sources and demands for gas. The framework for RIIO-T1 must be robust enough to cope with the timing uncertainty we face as well as delivering sufficient incentives for networks to secure the investment required to deliver the challenging future requirements. We look forward to working with Ofgem over the next 24 months to ensure this balance is achieved. In the shorter term, we look forward to supporting Ofgem in developing some of the areas which require support prior to the issuance of the March strategy documents.

Yours sincerely

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By email