

RIIO GD1 – FINANCE DOCUMENT

CHAPTER 2 – Asset lives and depreciation

Question 1: Do you agree with our proposed economic asset lives for gas and electricity transmission and gas distribution?

NGN agrees with the basic tenet of the proposal that gas distribution networks have an asset life of at least 45 years whilst recognising that there remains some uncertainty over the utilisation of the networks in the longer term.

However, the implication of this proposal needs to be considered in the round with other elements of Ofgem's financial proposals notably the proposed change in capitalisation policy i.e. 100% of Repex to be added to RAV. As this package of proposals currently stand, they lead to a material reduction in regulatory allowed revenue and cash flow, with knock on effects on perceived risk in the sector, and resultant reduced credit ratings for GDNs. Both of these impacts will significantly increase the cost of capital, and impact financeability of the networks.

The economic asset lives of gas assets could be used as part of a basket of transitional measures in order to mitigate the cash flow issues. NGN estimate that, by our own circumstances, economic asset lives would need to reduce to less than 20 years for all of RAV in order to fully mitigate the reduced cash flow from the change in Repex capitalisation now being proposed.

Question 2: Do you agree with our proposals for the depreciation profile?

No. Uncertainty over the future use of the gas distribution network suggests active consideration should be given to adjusting the depreciation profile from straight line to front loaded across the whole of RAV not just in relation to post 2013 investment. This may also avoid future regulators having to address potential questions in relation to the recovery of outstanding RAV on stranded assets should such a situation arise.

The depreciation profile is also a measure which should be used to ensure sustainable levels of cash flow during RIIO-GD1.

Question 3: We invite views on our proposed approach to transition.

NGN support the use of transitional arrangements in order to mitigate any market disruption or concerns over financeability in relation to material negative impacts on cash flow. The current proposal to front load depreciation for new investment only does very little to address the problem in RIIO-GD1.

NGN believe that a combination of the fast/slow money split, depreciation profile and possibly asset lives should be used to mitigate the impact of reduction in cash flows from the decision on repex capitalisation.

CHAPTER 3 – Allowed return

Question 1: Is our approach for setting the allowed return appropriate, particularly in the context of an eight-year price control?

With reference to principles you have set out in Paragraph 3.2, we would agree that the proposed approach to assessing the level of return seems broadly appropriate. However there we have several key concerns with the proposed approaches to implementing these principles within the framework:

Cost of Debt

We believe the proposed debt indexation approach systemically under-allows for the cost of debt on three fronts:

- i) A simple 10-year trailing average implies that the average age since issuance of existing debt is approximately 5 years.
- ii) Using ten year bonds as the average does not reflect the increased costs to networks (assuming a normal yield curve) of issuing longer average tenors, (which companies use to manage their maturity profiles and risk profile).
- iii) No allowance is made for issuance costs such as legal, rating agency and bank costs and in the case of pre 2007, ongoing monoline guarantee costs. To argue as Ofgem does that past outperformance more than compensates for this is to penalise the networks for previous out-performance.

Cost of Equity

The initial range for cost of equity at this stage does not take into account several key factors that must be included in the evaluation of the cost of equity:

- The new risks likely to be associated with longer duration cash flows and, longer-term price controls;
- An incentive framework weighted heavily towards penalties for poor performance with reduced opportunities to earn rewards for good performance;
- The relationship between gearing and equity risk;
- The paucity of directly relevant market data; and
- The relative stability of market equity returns, when compared with the stability of the CAPM components of those returns.

When all of these factors are considered, they suggest that the effective range for cost of equity should be higher than that eventually considered for DPCR5 (6.3 – 7%) and the lower end of the range quoted by Ofgem would be way outside an appropriate range of equity returns.

Notional Gearing

The RIIO proposals set out that notional gearing should be determined on the basis of individual firms' exposure to cash flow risks. This would imply that the optimal level of gearing of firms with higher risk exposure would be lower, with equity acting as a buffer to absorb any variation in realised returns. The optimal level of gearing would therefore be determined by companies' underlying business risks, such as projected levels of capex, as well as the risks inherent in the package of regulatory incentives, taking into account the impact of current market conditions.

The RIIO principles will be implemented against the backdrop of very different market as well as regulatory conditions. These fundamental changes in conditions suggest that it would be incorrect to assume as high levels of gearing as in the previous price control reviews. There are at least three factors that point towards a lower level of gearing:

- The weakness of high gearing as exposed by the financial crisis;
- Significant and increasing capex requirements for energy networks;
- An increased onus on companies to resolve any financeability issues.

Question 2: What impact do our proposals for RIIO-T1 and GD1 have on the companies' cash flow risk, and does this have a material impact on how the allowed return should be set?

In NGN's view the current RIIO-GD1 proposals offer only a minimal positive impact on debt and equity investors' perception of cash flow risk from the extension to an 8 year price control. However, this is more than offset by stronger negative impacts on cash flow and perceived risk for the gas networks, which include;

- Change to 100% capitalisation of Repex;
- Uncertainty of the long term future of the UK gas industry; and

- Conservatism of investors when considering changes to the Regulatory formula, who generally prefer the predictable and stable regulatory regime the UK has enjoyed historically. They are unlikely to view that unpredictable and uncertain potential incentives will adequately de risk known reductions in cash flow from factors such as the 100% capitalisation of Repex.

NGN consider that all these factors will have a negative impact on credit ratings, and equity investors perception of risk in the sector, and that this should be taken into account when setting the allowed return, and any transitional arrangements used to mitigate the step change in risk that results under the RIIO proposals to adverse changes in the cash flow profiles and credit metrics.

Question 3: What considerations do we need to take into account when setting the notional gearing level?

The following factors need to be taken into account when setting the notional gearing levels;

- The level of capital expenditure required in the energy networks;
- The 'financeability' of the overall regulatory settlement, and the sustainability of this looking forward;
- The level of uncertainty in regulatory revenue, the overall risk that the companies are exposed to relative to the market, and the resultant impact on cash flows and credit metrics; and
- Actual gearing achieved across the sector, and the desire to support a number of investment models and capital structures within the regulatory settlement.

In reality the considerations above will help determine a feasible range for notional gearing, which can then be used to model structures in order to mitigate the overall regulatory Cost of Capital and the financeability risk.

We do not feel that companies which face higher capex than others should mechanistically be set lower target gearing. This could amount to awarding some companies a higher allowed return than others which does not appear equitable and also decreases regulatory objectivity and predictability.

Question 4: Is our proposed approach to setting the notional equity wedge appropriate?

Our understanding is that under RIIO the notional equity wedge will be determined in the first instance by companies in their business plan submission. Ofgem then has to assess in the context of the plan submitted whether the proposed equity wedge is appropriate.

The consultation document currently describes a process where Ofgem sets the notional equity wedge after the business plan submission. Ofgem in reviewing the business plan can not isolate a factor like the notional equity wedge determine its own view of the notional equity wedge and simply paste back into the plan. Any review must consider the plan in the round.

Question 5: Is our proposed mechanism for indexing the cost of debt assumption appropriate?

At this point we do not believe the proposed mechanism is appropriate. Introducing a greater degree of transparency as to how the cost of debt is to be determined is a positive step forward and that using a trailing average cost of debt is appropriate. In order to address some of the issues highlighted in our detailed response below we would suggest

- Bringing in additional indices that pick up different tenors and also contain energy network financings and perform therefore an averaging mechanism.
- Use more appropriate indices to determine the fair market value for A and BBB rated debt than the proposed Bloomberg indices.
- Whilst we believe taking a rolling average is appropriate to reflect a typical utility's debt financing programme, from the above analysis we don't believe that a 10yr index may give appropriate allowances for the longer term funding profile required for sustainable financing.

We would therefore suggest using the average of a 10yr and 20yr index may be more appropriate reflecting the longer dated nature of the underlying assets

Our understanding is that the proposed mechanism is broken down into 4 key steps;

- Comparison of the Bloomberg 10 Year BBB and 10 Year A-rated sterling bonds to the Bloomberg 10 Year index for nominal risk free rates to determine the average credit spread for the relevant data periods;
- To then combine this with the Bloomberg 10 Year Index for real risk free rates to determine the real cost of debt for the relevant data periods;
- To then use this to calculate the 10 year trailing simple average; and
- Use the output at March 2012 to set the initial cost of debt allowance, which will then be reset annually.

NGN consider this approach to have the following flaws;

- **The 10 Year A-rated sterling bonds index contains a small number of members**, with wide variances in the industry sectors. No UK energy network utilities are currently eligible for this index, which raises the question as to whether this is a suitable index to use for future price controls. Also this index is generated using only 30 bonds, and in actuality only 1 bond (RWE 6.5% 2021) appears to be driving the outputs. We also believe that the index contains both Portuguese and Israel government debt, which again casts doubt on the suitability of the index currently chosen. Therefore this index may well diverge substantially from the actual cost of financing utility debt ;
- Using the 10 Year A-rated or “BBB” index provides in our mind a better fit in terms of members, without fully removing the inherent weaknesses that will remain in using such an index. Bloomberg does not have any obligation to maintain these indices and bonds can fall in and out of the index with comparative ease, providing little consistency in the stability of the indices being relied upon.
- **When the cost of debt allowance updates annually, this may create a mismatch over time between the long term funding preferred by utilities and their cost of debt allowance received.**
- **Utilities tend to prefer debt funding with longer maturities than 10 years**, in many cases in the excess of 20 years. OFGEM’s assertion that this makes little difference to the cost of debt is incorrect when empirical evidence is evaluated.
- **Use of the Bloomberg Indices**
 - The methodology for the construction of the A-rated and B-rated Corporate Bloomberg indices is not as transparent as for other credit indices such as iBoxx/iTraxx. This is clearly illustrated by the inclusion of certain Sovereign names in the index while some more familiar major corporate names are omitted. To the best of our knowledge, major fund managers tend to use indices such as iBoxx/iTraxx rather than Bloomberg indices as a market benchmark; therefore, the Bloomberg indices are not subject to the same degree of scrutiny as other indices.
 - The pricing sources for Bloomberg Fair Value curves are also not as clear as iBoxx/iTraxx.
 - Since the current index baskets contain a selection of credits with very different risk characteristics to those inherent in UK regulated utility assets (i.e. non-UK credits, brand driven consumer good companies whose value derives from intangible assets etc), the return-data captured by the proposed indices may not necessarily correlate with the credit costs faced by Ofgem regulated utilities.
 - It is also widely documented that market indices may overstate the average performance of all the securities in a market as poor performers typically become ineligible and therefore drop out of the basket (e.g. auto co’s caused all BBB indices to rally when they went sub-investment grade).

- More generally, the Bloomberg Indices show secondary market spreads which do not capture the full funding costs faced by utilities. In particular:
 - Fees associated with issuance, listing, ratings etc; and
 - The costs of prudently managing liquidity risk (the cost of carry for prefunding is considerable given that utility credits typically fund 1to 1.5 yrs in advance and currently earn c.0.5% on cash).
- **Choice of 10 Year Maturity**
 - Energy network and UK utility companies tend to issue debt across the maturity spectrum to achieve a sustainable debt financing profile as well as to align with investor demand, particularly at the longer end of the curve in the Gilt market. To the extent that the 10yr point of the curve moves independently (shifts in curve shape / steepness) this may impact the effectiveness of the 10yr index in matching the actual issuance profile pursued currently by Utilities, particularly for longer dated issues
 - The introduction of a 10yr index could actually spur energy networks to pursue issuance closer to the 10yr point, in order to reduce the risk that they face to interest rates and the associated determination of the cost of debt other than the 10yr point. This has a number of implications:
 - Repeated issuance at the 10yr point is likely to drive yields higher at this point of the curve. Will there be sufficient investor demand for energy networks Issuances at this point in the curve given the traditional longer tenor funding profile?
 - Shorter dated financing will inherently increase the refinancing risk faced by Utilities at a time when levels of financing are expected to increase given significant capex programmes.
 - Does focusing on the 10yr point align with Ofgem's objective of a sustainable energy sector and to deliver long-term value for money network services for existing and future consumers? It would perhaps be more appropriate to use an average of 10yr and 20yr index to take account of the longer dated funding profiles of the sector.
- **Rolling Average And The Use of Nominal Credit Spreads.** Although we believe having greater transparency and trackability should both be viewed as a positive the proposed methodology does raise in our mind a number of questions as to the practicality of implementation:
 - Using a Rolling average. The rolling average assumes that the GDNs will refinance 10% of its existing debt every year. Does this give rise to significant refinancing risk should the index itself be matched? Also, given the increase in financing requirements over the coming years the cost of debt will be weighted towards the more recent years although the index will take a simple average of the last 10 years.
 - A 10 year rolling average would penalise GDNs in the event of a sharp rise in borrowing rates – it will take several years of higher rates before the allowed cost of debt rises significantly to compensate for the higher borrowing costs the Utility has to endure on the back of its refinancing. In this period it would have to fund this additional short fall, which is arguably inconsistent with Ofgem's focus on sustainable financeability.
 - Adding a nominal credit spread is different to how the bond market prices index linked bonds. While the starting point is the nominal yield, there is additional spread applied as a result of the index linked nature of the debt.
 - In addition, the use of a 10yr trailing average gives rise to a lag between changes in the market e.g. credit spreads, yields, new issue premia etc and the determined cost of debt set by Ofgem.

The current proposal may cause a substantial divergence between the allowed cost of debt and the actual cost of debt over time. This could encourage utilities to change funding strategies to reflect the indices chosen, rather than seek to match long life debt to long life assets. We have shared our detailed analysis of these indices at the Authority meeting on 27 March 2010 and would be happy to discuss this issue further.

Question 6: How should we account for the costs of issuing debt?

The cost of debt issuance is material and it is imperative that it should be included when calculating the cost of debt. Debt issuance costs are just as economically real as coupon payments – certainly all bond issuers and banks think so. To argue that past cost of debt outperformance is a reason not to allow these costs but not an appropriate and creditable reason not to account for these going forwards.

The networks will have to include this as part of their business plan submissions, however some of these costs are confidential to the companies and their counterparts, unless OFGEM looks at historical data and provides an estimate or considers that a neutral objective party may be able to collate information and analyse this so as to produce a level of market allowance.

Question 7: Is our range for the equity beta appropriate for the network companies? What factors might mean that we should use different equity betas for the different sectors and/or companies within a sector?

As recent price reviews by Ofgem, Ofwat and the Competition Commission (CC) make clear, there is a complete lack of directly relevant market data for estimating the equity betas of GB energy network companies—i.e., there is not one quoted standalone GB energy network.

The result has been heavy reliance on the stock performance of the small number of quoted water companies. This, along with the wide range of beta estimates that can then be constructed on the basis of this limited data, implies that Ofgem should be wary about placing reliance on this information.

The significant majority of the proposed equity beta range sits well outside of the estimates used in recent regulatory determinations in the UK. Considering this alongside the price controls that are informed by the RIIO conclusions to expose companies to greater risk implies the appropriate level for equity beta is at the top of the range proposed by Ofgem.

Question 8: Does our overall range for the cost of equity capture probable range for RIIO T1 and GD1?

The range for the cost of equity presented by Ofgem only considers “the market factors and the risk generally experienced in the recent past by regulated businesses”. Analysing the raw market data it can be seen how Ofgem may have arrived broadly at the range set out within the consultation paper.

However, the presented range does not deal with several key factors that will determine the appropriate range for the cost of equity. These include:

1. **Increased Duration of Cash-flows** – In deriving the range within the consultation document, Ofgem has relied solely upon the use of CAPM to estimate the cost of equity. However, the CAPM framework does not and cannot capture the dynamics of the cost of capital over time and in particular the impact of extending the duration of cash-flow implied by other proposed changes in the regulatory framework.

There are strong theoretical and empirical grounds for expecting the cost of equity for a regulated utility to increase with a longer duration cash-flow profile. Accompanying this response is a paper prepared by Oxera that sets out the detailed evidence to support this proposition.

2. **Impact on Financeability of lower cost of equity** – The lower end of the range presented by Ofgem will cause significant financeability issues for companies unless other compensating factors are introduced. At these levels, there is likely to be a requirement for significant additional equity injection and the deferral of any dividend to the next price control period.

The ability of the sector to continue to attract equity investment required to support the level of investment required to deliver a sustainable and low-carbon energy sector will be severely

damaged under these proposals. The stable and predictable environment, that is a key element of the framework for investors, is at risk of being impacted directly by these proposals.

3. **The ‘reasonableness’ of figures within the range** – Applying a range of cross-checks of the figures contained within the range suggests that the figures at the bottom-end of the range are unrealistic even at this early stage of the process. Comparing your range for the cost of equity with the implied cost of debt derived from your chosen index, provides a premium to the cost of equity of only 90-120bps. Given the potential additional risks to equity implied by the RIIO framework it is not clear what justification can be provided for such a low estimate of the relative risk of equity.
4. **Impact of recent economic climate** – estimates of relative equity risk (Beta) taken from recent history will be distorted by the ‘flight to safety’ driven by the economic uncertainty over the period from 2008. As the economy returns to a more stable environment, the longer run will see this position reversed and return to a more normal state.

Aspects of price controls which Ofgem itself highlights as relevant to assessing the risks faced by companies are:

- The efficiency incentive rate;
- The use of uncertainty mechanisms;
- The potential scale of penalties and rewards for output delivery.

Overall, one would expect price controls that are informed by the RIIO conclusions—not least, the need for powerful incentivisation of output delivery—to expose companies to greater risk. None of these factors has yet been effectively incorporated into the proposed cost of equity range. For many of these factors, the extent of that risk will not be known until key decisions on the form of the new price controls are taken.

The range proposed by Ofgem does not represent a reasonable probable range at this stage.

Question 9: Is the ex ante approach to the cost of raising equity, with a true-up at the next price control review appropriate for RIIO T1 and GD1?

The principle that the costs of raising new equity should be allowed for within price control allowance is correct and should be introduced in RIIO-GD1. The setting of an ex-ante allowance for efficiently raised equity financing costs required to fund the Slow Money element of Totex we believe provides the correct incentives for efficiency and should also be introduced on RIIO-GD1.

The principle of applying a true-up at the next price control period needs to be reviewed in light of the extended eight year price control period. This extended period will add to the additional cash flow risks that the wider package of proposals that the RIIO principles are introducing to the regulatory framework. A simple mechanism of annual ex-post adjustments within the price control mechanism could be formulated that reduces this specific risk whilst maintaining the incentives for efficient levels of costs of raising new equity.

CHAPTER 4 – Assessing Financeability

Question 1: Have we identified the correct equity and credit metrics?

Equity Metrics:

In determining the key equity metrics to employ in evaluating regulatory proposals, the key consideration must be that GDNs are able to continue to raise equity finance both within and across price control periods. As a starting point equity investors will be expecting to receive returns in line with the risk adjusted opportunity cost of capital (cost of equity) of investing in a specific company.

As such, the base equity metrics must be based upon an evaluation of the Return on Regulatory Equity (at the assumed notional level of gearing) including cash and dividend yield over the price control period.

These equity metrics will of course need to be considered within the context of the wider assessment of financeability in the medium to longer term. As such the duration and volatility of returns to shareholders must be considered within this framework to ensure that the incentives for equity investment are maintained throughout the period.

Credit Metrics:

Net Debt to RAV and PMICR are both appropriate to use as they are both key ratios looked at by credit agencies as well as being typical covenanted ratios in utility bank facilities. However, it should be noted that the methodology for calculating them differs between ratings agencies and is different again for loan covenants.

We believe that it is essential to include various other key credit metrics;

- Moody's published rating methodology also applies a weighting to RCF / Capex and FFO / Net Debt.
- The key Standard and Poor's (S&P) ratios which should also be included are FFO / Debt and FFO interest cover.

Again the FFO / Debt methodologies (and guideline levels) differ between agencies.

Question 2: Do the rating agency levels quoted provide the most appropriate levels?

The wide guideline ratio ranges as published by the rating agencies need to be considered carefully.

The rating agencies do not publish guideline ratios for separate bands within a rating level (i.e. only Baa or BBB, with no +/- or 1, 2, 3 etc.), and therefore the approach that should be taken by Ofgem should be to focus on ratios at the stronger end of the ranges given, rather than the bottom end which will likely not enable the energy networks to maintain their current "strong investment grade" credit ratings.

Access to, and pricing of, funding will differ markedly between networks rated Baa1 and Baa3 and it would not be appropriate to assume that a network delivering ratios at the weaker end of the indicative levels would be perceived as 'strong investment grade' and therefore the levels quoted in the table are not appropriate and should be targeted at 'strong investment grade' (Baa1) level only. It is imperative that the table is widened to capture the critical S&P cash flow ratios stated in the previous question response and associated guidance levels again to reflect BBB+ ratings criteria from S&P.

It is also imperative that company's maintain adequate long-term liquidity, as any concentration risk of access only to short term bank financing liquidity will create credit rating negativity. The ability for GDNs to access longer bank debt liquidity at acceptable pricing is fundamentally linked to preservation of "strong investment grade" credit ratings.

Of course assigned ratings also take into account several other factors other than ratios, including by business risk assessment.

Question 3: We invite views on the approach to assessing the appropriate level of notional gearing.

See earlier response to Chapter 3 Question 3.

CHAPTER 5 - Taxation

Question 1: Do you agree with modelling tax based on the proposals in the June 2010 Budget?

Broadly yes tax modelling should be based on extant legislation at the time the price control is introduced.

Question 2: Do you agree with modelling tax under UK GAAP pending adoption of IFRS reporting with any changes to be subject to the tax trigger?

No. This is not consistent with the other proposed change from the June 2010 Budget. Tax allowances should be set based on the switch to IFRS in 2013. Ofgem's proposal automatically penalise GDNs for a known change by the value of the deadband in the tax trigger.

It is clear that repex expenditure will be likely treated by HMRC as analogous to electricity deferred revenue expenditure. It is highly likely from the way HMRC follow accounts for similar electricity expenditure that under IFRS capitalised repex would be treated as capital with a deduction for accounts depreciation going forward.

Ofgem's base position in the RIIO-GD1 should be that the 100% deduction will cease and the tax trigger should operate in reverse if this proves not to be the case. Any other position would introduce uncertainty and unexpected future price changes.

The other major tax issue in IFRS is IFRIC 18 with the potential taxation of deferred revenue (i.e. capital contributions) which will be taxable.

Question 3: We invite views on the size of the dead-band

As a minimum for the IFRS change GDNs should be allowed to recover the full amount. Going beyond this the 1% trigger may be appropriate.

Question 4: Do you agree that clawback of the tax benefit of excess gearing in TPCR4 and GDPCR1 should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?

NGN agrees in principle with the proposal to spread over 8 years.

Question 5: Do you agree that clawback of the tax benefit of excess gearing should be updated every three years during the price control period?

This seems a reasonable approach and is consistent with the proposals for pension adjustments.

Question 6: Do you agree that the tax treatment of new incentives should be calculated using vanilla WACC?

At this stage we are not clear on the differences in tax treatment of incentives and would need to see worked examples to conclude on this matter.

CHAPTER 6 – Pensions

Question 1: Do you agree that the timing of true up adjustments for existing controls should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?

We agree with the proposal to spread the adjustments over the 8 year period.

Question 2: Do you agree that updated valuations for non fast-tracked companies should be the same as fast-tracked companies, i.e. 31 March 2011 unless no network company is fast-tracked, in which case updated as at September 2012 in time for final proposals?

This approach seems reasonable. However, the updated valuations of each pension scheme submitted at 31 March 2011 (or September 2012) should be based on the same actuarial assumptions that were adopted at the previous full actuarial valuation but updated to only allow for changes in asset values and market conditions. This will ensure that the approach used by each company for the updated valuations are consistent.

Question 3: Do you agree that the deficit funding rate of return should be derived from the range of benchmarked pre-retirement real discount rates? If not, which alternative option do you prefer?

No. In our view the rate of return used to set the revenue allowances for deficit contributions should be scheme specific and should be consistent with the approach used by the pension scheme trustees to spread the deficit at the last full actuarial valuation.

Question 4: Do you agree that same rate should apply to the calculation of the net present value of the true up adjustments?

Yes.

Question 5: Do you agree that deficit funding allowances and the true up to date in a RIIO price control period should be every three years rather than trueing up at the next eight-year price control?

Yes.

Question 6: Do you agree that PPF levies should be part of benchmarked total costs? If not, which should be the alternative option?

The vast majority of any PPF levy is payable in respect of established deficit or established liabilities built up before 2013 and is therefore not a reflection of the relative efficiency of the business in the relevant year being benchmarked and therefore in our view should be excluded from the benchmarking of total costs.

If PPF levies are to be included then these should only be included in any overall totex benchmarking costs and not in any of the disaggregated benchmarking given the relatively small amounts involved and difficulties of aggregating this across various activities.

Question 7: We invite views on whether the revised guidance to our pension principles is comprehensive and adequate for licensees and stakeholders to understand how the principles will be applied in RIIO controls and for network companies to prepare their business plan?

Broadly we understand Ofgem's revised guidance on the application of the principles. However, over the last two rounds of price controls the application of the principles has been revised considerably and this does have the effect of generating significant uncertainty in making long term pension funding decisions.

Our observations of the revised guidelines is that they could have the effect of encouraging pension schemes to follow the same general approach to avoid being singled out for review even when this might actually not be in the long term interests of customers.

CHAPTER 7 – Regulatory Asset Value

Question 1: How should we calculate the percentage of totex allowed into RAV?

The percentage of Totex allowed into RAV should be calculated in order to ensure the current relationship between cash flow and gearing is maintained, in conjunction with other potential compensating adjustments which could affect cash flow i.e. depreciation methodology, economic asset lives. Unless this is addressed, the networks are likely to experience credit rating downgrades as commented extensively in our other question responses.

Question 2: The proposed totex approach includes repex, business support costs and non-operational capex as part of totex.

Views are invited on whether totex should include:

- a) Repex
- b) Business support costs
- c) Non operational capex

There are benefits to including all the costs detailed above within Totex, namely;

- The incentives to out / under-perform are equalised across all expenditure types;
- It would also remove any boundary definition issues, and any cost allocation issues; and
- It would simplify understanding of the regulatory incentive framework.

However the decision on whether to include all these costs within Totex should take into account any negative impact on cash flows,

In the case of gas distribution we believe shrinkage gas and NTS exit charges should be specifically excluded from the definition of Totex. Shrinkage gas has a large element of gas through related to the gas price which is highly volatile. Similarly NTS exit charges are largely pass through items. Both are discretely identifiable costs not subject to issues associated with definitions and allocation of costs. Neither of these items sits readily in RAV.

Question 3: Should the definition of related parties include captive insurance companies?

We support the proposed approach of excluding captive insurance companies from the related party clause for the reasons outlined by Ofgem.

Question 4: In GDPCR1, we allowed GDNs to retain the proceeds of asset disposals in RAV for five years to incentivise GDNs to dispose of assets at competitive prices. We invite views on whether we should now remove this treatment, or extend it to electricity distribution operators and transmission operators so that we deal with all licensees on a similar basis.

We believe this is a critical element of incentive based regulation to dispose of assets where appropriate to do so and removing this would see no benefit to the network from any form of asset disposal. We believe this mechanism should continue.