Rachel Fletcher
Partner, Distribution

By e-mail to:
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Lakeside
30 The Causeway
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TW18 3BY

30th September 2010

Dear Rachel,

Re: Open letter consultation on Gas Distribution Price Control Review 2 – the way forward

1. Thank you for publishing the GDPCR2 Way Forward consultation at such an early stage in the price control process. Early engagement with stakeholders in this control will be critical, given the extent of change to the price control process introduced following the introduction of the RIIO model. This response is submitted on behalf of the Centrica Group of companies excluding Centrica Storage and is not confidential.

2. As you are aware, we are the largest integrated energy company in Great Britain that does not own any energy network interests. We are therefore well-placed to provide an unconflicted perspective on the issues that will need to be addressed during GDPCR2. We also currently spend over £2 billion each year on network charges, of which around £1.5billion will be reset from April 2013 (through the combination of GDPCR2 and the parallel transmission price controls). £1.1billion of these charges will be reset through GDPCR2 alone. British Gas customers, from whom we must recover these charges, therefore have a significant interest in the outcome of this control.

3. We are concerned about the potential impact upon household and business energy price that this control may have from April 2013, both in terms of potential increases and predictability. Many of the key issues outlined in your consultation have the capacity to apply significant upward pressure to gas distribution prices, most notably the level and treatment of replacement costs. Additionally, the uncertainty over future gas demand may lead to the consideration of assuming shorter asset lives within this price control.

4. Separately to this price control, changes to accounting standards are currently planned to require all gas distribution companies to adopt IFRS for subsidiary companies. If this is confirmed, National Grid has indicated that this will, in and of itself, increase distribution charges by around 8%. This creates a challenging backdrop for Ofgem as it will wish to ensure the revenue requirements of the DNs are met, whilst also ensuring an affordable outcome for consumers.

5. The gas distribution sector faces a number of significant challenges over the forthcoming price control period. As we have noted in previous responses as part of the RPI-X@20 review, the RIIO model has the potential to provide a robust framework to help support the industry with meeting these challenges. However, the framework will only deliver a price control that is truly in the interests of consumers if stakeholder engagement is placed at the heart of the price control process from day one. This is particularly the case, given many aspects of the control will be introduced for the first time (such as the concept of fast-

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tracking well-developed business plans so long as they are grounded on evidence of stakeholder need).

6. We agree with the majority of issues highlighted by Ofgem as being critical for consideration in GDCPR2. The key challenge will be addressing the breadth of issues facing the gas distribution sector while still maximising the benefit to consumers from the RIIO model. This should also be the first control at which major benefits are gained from comparative regulation in gas distribution, given that the majority of benefits of gas DN sales were always anticipated to flow through to customers by the time of the second control[1].

7. We are pleased that the consultation sets out some of Ofgem's initial thinking on both the issues to be addressed, and the application of the RIIO model. We hope that, through early engagement, real progress will have been made towards delivering a price control that represents value for money for consumers by the time that business plans are submitted by the GDNs for consideration by Ofgem next July.

8. In this response we set out our views on those issues we consider to be of critical importance amongst the key issues you raise in your consultation document, namely:
    - the treatment of replacement expenditure (repex);
    - financial issues (both relating to repex and the application of RIIO principles);
    - uncertainty and business planning;
    - environmental issues, the main focus being losses;
    - output-led regulation; and
    - the engagement process.

9. In addition we attach an annex prepared for us by CEPA, setting out more some of the key financial issues that we believe will need to be addressed at an early stage in this control.

Replacement expenditure

10. Repex constitutes the most material category of expenditure that will be addressed by GDCPR2. Ofgem's latest estimates of the cost of the whole gas mains replacement programme are in excess of £24billion. This is approximately double the original estimate of the cost of the project made by Transco in 2002. Repex therefore has a huge impact on the bills of our customers. We estimate that repex alone is responsible for around 20% of the gas distribution charges our customers pay (i.e. around £60million per annum per GDN, against an average revenue allowance of £300million). We understand that the current gas mains replacement programme, accelerated at the time of the last price control, is driven by an HSE requirement to carry out replacement by 2032, broadly according to a modelled schedule of which iron mains represent the greatest risk to the general public.

11. GDPCR2 represents the perfect opportunity to review the gas mains replacement programme to assess whether, after around eight years of work, the workplan agreed at the time of the last control still represents the best way of ensuring the safe transportation of gas. We understand that the HSE has agreed to bring forward a planned review of the programme to coincide with the price control. This review represents the ideal time to:

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[1] Potential sale of gas distribution networks businesses, Final Regulatory Impact Assessment, Appendix 6, November 2004, Page 51.

- assess how successful the programme has been to date in removing risk to the general public;
- estimate the benefits in terms of risk mitigation that the remainder of the programme will deliver;
- consider the most up-to-date cost estimates of the programme; and
- assess whether any other approaches to gas mains safety would result in the same or increased risk mitigation while providing better value for money.

12. To help with this review, we have commissioned a piece of analysis evaluating the costs and benefits of the current gas mains replacement programme. We will be keen to share the results of this study at the relevant Ofgem working group at the earliest opportunity.

Financial issues

13. There are a wide range of financial issues that will need to be addressed in GDPCR2. In particular, GDPCR2 will be the first price control (in parallel with TPCR5) that will apply the concepts set out in the RIIO model. We understand that these issues will be addressed by a separate Ofgem workstream on financeability, covering both controls. We are very keen to participate in this work from as early a stage as possible.

14. The financial issues which we believe need to be addressed as a priority are:
    - treatment of repex;
    - application of RIIO recommendations; and
    - treatment of pension costs.

Financial treatment of repex

15. As set out above, estimates of the total cost of mains replacement programme are now in excess of £24bn. On the basis of current requirements for the programme be complete by 2032, we estimate that over £6.5bn will be required over GDPCR2 for repex alone. This will dominate the other capex programmes of the GDNs, and have a major impact on the bills of our customers. We estimate that, according to latest estimates of cost, the gas mains replacement programme will cost our customers around £165m in network charges per year alone (i.e. over £1.3billion in network charges over the eight years of GDPCR2). The comparatively large impact of repex on network charges is largely due to the decision at the last control to expense 50% of repex (effectively meaning current customers pay comparatively more than future customers for this spend).

16. Under the RIIO recommendations, Ofgem has set out that the key principles to be followed in determining the financing of networks will be[2]:
    - a longer-term view reinforced by regulatory commitment;
    - risks appropriately allocated between companies and consumers;
    - depreciation policy to reflect expected economic life of asset and potential uncertainty in future use; and
    - a financeability assessment informed by various sources including rating agencies' credit metrics (with an onus on companies to manage short term requirements).

[2] Ofgem, "City Briefing Introducing the RIIO model" July 2010

17. Taken as a whole, these principles would suggest that advancing revenues to networks is no longer appropriate. Instead, it would be up to the GDNs through their choice of level of financial gearing to manage financeability (including new equity as required). We would therefore strongly argue that none of repex should be expensed, and instead should receive the same financial treatment as capex.

18. A further principle set out in the RIIO model is the equitable treatment of current and future consumers. We believe that this principle also argues for repex to be financed in the same way as capex. Repex does not just improve safety levels for current consumers. The gas mains replacement programme improves safety levels for every period until the asset is replaced. This means that current consumers enjoy the same benefits of improved network safety as future consumers.

19. Further views on this issue are also set out in Annex A.

Wider application of RIIO recommendations

20. The RIIO model will have a major impact on the way in which financial issues will be addressed in GDPCR2. This new way of treating network financing has the potential to deliver significant benefits. However, consumers will only receive this benefit if the concepts are applied rigorously through Ofgem's working group in coming months.

21. One of the most significant changes for GDPCR2 (applied for the first time to good effect in the recent electricity distribution control), will be an increased emphasis on Return On Regulated Equity (RORE). We believe RORE provides a transparent high level sense check on the overall returns being made by networks on their regulated assets. The relatively simplicity of this measure, and accessibility to a wider range of stakeholders is also important, given that engagement will be at the heart of this control process. We are therefore very supportive of RORE's continued used in GDPCR2.

22. The other significant area to be addressed by the financing workstream will be the implementation of the RIIO model recommendations regarding cost of debt. The RIIO model recommendations propose an annual adjustment to the cost of debt, in response to changes in long-term trailing averages of forward interest rates. This approach will deliver greater certainty for networks. However, this will also deliver significant cost savings to customers, as it will allow the removal of a "headroom" risk premium in the cost of capital (previously included to cover uncertainty in the cost of debt).

23. The principle of setting the cost of debt on the basis of an indexed long-term trailing average of forward interest rates is relatively well understood. However, the exact mechanism by which this will be implemented is unclear. We set out a number of criteria that we believe should be applied when assessing alternative options for the mechanism and the cost of debt benchmark in Annex A.

24. We understand that some networks have suggested that the RIIO recommendations have caused uncertainty in the way networks are financed, therefore justifying an increase in the cost of equity. We do not believe this to be the case. This is because the process by which the RIIO model has been developed and communicated to the City has been very transparent and clear. As CEPA indicate in Annex A, any impact on cost of equity can be fully mitigated by Ofgem providing the capital markets with plenty of time to understand any changes to the regulatory framework. The City briefing conducted by Ofgem in July of this year is a good example of how this risk is being managed, and we look forward to this transparent approach continuing throughout GDPCR2.

Pension costs

25. The June 2010 document on treatment of pension costs sets out a number of important principles that will be followed in GDPCR2 (as well as in the transmission controls). Although we are disappointed that the principle of financial incentivisation was not applied to all categories of pension costs, we still believe that if applied robustly, these principles can deliver significant consumer benefit.
26. One of the most critical issues will be the way in which benchmarking will be used to set ex ante ongoing pension cost allowances. We strongly believe that non-network companies should be included in the benchmarking process. Benchmarking with companies in competitive markets will ensure that consumers pay no more than necessary in terms of allowed pension costs for network operators to attract and retain good quality staff.
27. We, for example, face similar challenges to those faced by the network companies in the management of our pension costs. This includes the need to balance the costs of the pensions we offer while still ensuring we offer our staff a competitive overall remuneration package. This is particularly relevant for the gas networks, where we started with the same pension scheme rules. As in DPCR5, we will be happy to provide information about our own pension costs for Ofgem's benchmarking exercise.
28. We understand that the Government Actuarial Department (GAD) will be undertaking an efficiency review of network pension costs in December, and that the preliminary results of this review will be included in the spring 2011 Strategy Decision documents (for both GDPCR2 and TPCR5). We fully support this review. However in order to maximise the benefit of this review, we would urge Ofgem to consult on the review's terms of reference before it is launched.
29. Given the stable and low risk nature of regulated networks, we are also strongly of the view that Ofgem should continue to allow longer deficit repair periods, and that there is no case to shorten these periods (given the detrimental impact this would have on current consumers).
30. Finally, it would be helpful if Ofgem clarified at an early stage in the controls how retained surpluses will be handled during GDPCR2. We believe it is an important principle that retained surpluses are returned to consumers on at least an equivalent basis to consumers who have effectively funded current and previous deficits. Ofgem's policy on this should therefore recognise that in recent price control periods, consumers have effectively been exposed to 100% of deficit repair costs. Consumers should therefore be returned most if not all of any surpluses generated in the near future.

Uncertainty and business planning

31. One of the most significant challenges facing the GDNs in GDPCR2 will be to develop well-justified business plans in the face of uncertainty over the level of gas demand over the eight years of the price control period. More broadly, the RIIO recommendations will require the development of new mechanisms to manage uncertainty. In particular, a mechanism will need to be specified that will allow network revenues to be indexed for changes in the cost of debt, whilst not introducing undue uncertainty into network charges.
32. Reductions in uncertainty for networks can in some instances deliver benefits for consumers as well (such as reducing the cost of financing through removal of "headroom" in cost of capital, as outlined above). However, it is also important to recognise that

consumers place a high value on the predictability of charges. It is because of this that we offer fixed-price contracts to our customers (both domestic and non-domestic).

33. The management of unpredictable network charges places significant risk on energy suppliers, given the size of charges to which we are exposed. The cost of managing this risk is ultimately borne by consumers. It is therefore important that the use of uncertainty mechanisms in GDPCR2 should be strictly limited to instances in which they can be clearly demonstrated to deliver value for money for consumers.

34. There are ways in which the impact of uncertainty mechanisms on network charge variability can be limited. DPCR5 and the RIIO recommendations both made significant advances in developing such mechanisms. "Logging up" is the most efficient way of balancing the need to provide revenue certainty for networks while also limiting impact on network charging uncertainty. Logging-up entails:

    - giving networks an assurance that their allowed revenues will be flexed in response to specific defined variables;
    - any such changes to allowances are "logged" as they occur;
    - the aggregate "logged up" revenue adjustments are then applied to network charges at the end of the control (or at a pre-defined point during the control), on a basis that will leave networks NPV-neutral.

35. The critical issues to be addressed in developing uncertainty mechanisms will be:

    - determining which risks are sufficiently material to require special treatment; and
    - whether it is necessary for "logged up" revenue adjustments to impact network charges within the control period (e.g. through a pre-defined reopener "window").

36. Given the extent of uncertainty surrounding gas demand, and the materiality of cost of debt it would seem sensible for both of these risks to be included in uncertainty mechanisms. We also believe it would be appropriate for costs relating to unpredictable issues such as the Traffic Management Act 2004 (TMA), which we understand may have a very material impact on GDN costs over GDPCR2.

37. As for the issue of setting a suitable reopener window, the mid-control review already provides a fixed window for review after four years. We would therefore suggest that changes to revenue allowances over the first four years of the control are "logged-up" and applied to charges at this point in the control. This would limit the volatility of network charges for consumers, yet also provide revenue certainty for the GDNs.

Environmental issues

38. GDPCR1 included incentives on the GDNs to reduce shrinkage and natural gas emissions, using a modelled approach. We understand that the leakage model has been modified during the course of the control to seek to more accurately reflect actual leakage volumes from the system. We also understand that Ofgem is now considering adopting alternative measures of leakage, given the difficulties of accurately recording actual shrinkage volumes.

39. DPCR4 (in which the electricity networks made significant windfall gains from the electricity losses incentive) demonstrated that unanticipated financial gains and losses can arise when incentives are poorly specified and tested. Clearly, the GDNs should only be incentivised to reduce elements of losses that they can control. Even where this link

between GDN actions and loss reduction can be clearly identified, accurate measurement of performance is essential to avoid blunting the incentive.

40. We would therefore encourage Ofgem to review the performance of the shrinkage incentive to date, and share findings with stakeholders as transparently as possible. The existing incentive can then be reassessed and the case for change made. This will include an assessment of whether alternative measures may be more proportionate and appropriate, and whether these should be input- or output-focused. Again, a key lesson from DPCR4 is that incentives will only be in the consumer interest if the measures on which they are based are controllable by the networks, and the targets set are sufficiently challenging.

Output-led regulation

41. One of the most significant changes introduced by the RIIO model will be a new focus on the specification of output measures, and the placing of these at the heart of the well-justified business plans developed by the GDNs. We support this as an approach, largely because outputs are a concept more readily understood by most stakeholders than detailed business plans. This should therefore lead to much richer engagement by networks with network users. Successfully gathering views on the outputs that customers expect networks to deliver through to 2021 will therefore be crucial for the RIIO model to succeed. We are very keen to be engaged in this process.

42. However, while engaging with stakeholders to gather views on desired levels of outputs will be valuable, it will also be very important that the cost of these desired outputs are well understood from an early stage. Some of the most valuable engagement with stakeholders will only come at the stage when the "price" (or range of prices) for a range of output scenarios is understood. It is therefore essential that output measure scenarios are translated into network charging implications at the earliest opportunity.

43. We support the concept of well-justified business plans being fast-tracked through the price control process. However, we believe it would be impossible for a business plan to be deemed "well-justified" unless the charging implications of output measure scenarios have also been tested with network users. At the very latest, we would therefore expect output scenarios to be translated into impact on network charges well ahead of the July 2011 submission of business plans to Ofgem by the GDNs.

Engagement process

44. Finally, we want to reiterate our support for Ofgem's decision to place stakeholder engagement at the heart of the GDPCR2 process. We hope that this engagement will mean that networks gather a clear understanding of the demands that users will place on networks over the eight years from April 2013, ahead of submitting their business plans to Ofgem for approval.

45. Energy suppliers that do not have network interests such as ourselves provide a unique perspective on price controls. We have already indicated our desire to participate broadly across the working groups, the stakeholder events and the Price Control Review Forum. We therefore look forward to working closely with Ofgem and the networks in coming months to help shape the thinking that will inform Ofgem's Initial Strategy consultation document at the end of this year.

46. We also recognise that this will be the first price control in which third parties will be able to ask Ofgem to refer a price control determination to the Competition Commission (in the event they believe final proposals are not in the interest of consumers). In our response to

the RIIO recommendations, we suggested that in certain circumstances it may be in the interest of consumers if third parties were able to refer specific issues to the Competition Commission ahead of final proposals. For example, if it was clear that networks and representatives of consumer interests had views that were diametrically opposed on issues such as cost of capital, then it may be more efficient for such policy issues to be adjudicated on earlier in the price control process. It would be helpful if Ofgem provided some clarity on whether this would be possible early in the control.

47. We hope these comments have been helpful. We would be very happy to discuss them in more detail if you would find this useful.

Yours sincerely,

Philip Davies
Director of Regulatory Affairs

Annex A: Financing and financeability

This Annex considers the key financeability issues that Ofgem will have to reach decisions on as part of the GDPCR2 review. It is presented in two sections:

- Section 1: considers the issues for financeability created by the HSE's replacement expenditure (repex) requirements; and
- Section 2: looks at the broader set of issues around financeability relating to the adoption of the principles of the new RIIO framework.

Financing the repex requirements

For GDPCR, Ofgem decided to finance replacement expenditure on the following basis:

- 50% of repex to be expensed and recovered in the year in which it is incurred; and
- 50% of repex to be added to the RAV and depreciated over a 45 year horizon.

The principle underlying the decision to partially expense repex was, according to Ofgem, that while repex is an enhancement to the long term asset base, the renewal programme is primarily concerned with present safety requirements rather than increasing the networks' capacity or significantly for the benefit of future customers. As such it was appropriate for present consumers to fund a proportion of the repex programme[3].

The analysis supporting the use of 50% as the proportion to expense is not made explicit although we understand that this was the level Ofgem believed gave sufficient cushion to the financeability measures for the GDNs.

This raises a number of key questions for the treatment of repex in GDPCR2:

- What implication does the likely significant increase in repex have?
- Is the expensing of repex to address financeability concerns consistent with the RIIO financeability framework?
- Why do today's users benefit more from a safer network than tomorrow's?

We discuss each of these below.

Impact of significantly greater level of repex

To meet the HSE's revised 2032 target, the level of repex will have to greatly increase for GDPCR2 which, under the current policy, will cause a steep increase in consumer prices.

For GDPCR1 Ofgem allowed average annual net repex of £705m in total (quoted in 2006/06 prices). This was based on a 2002 total repex programme of estimated to be around £12bn

[3] Ofgem, "GDPCR Updated Proposals", 2007 p85

and to be completed by 2032 under the 30/30 agreement (all iron pipes within 30 metres of households to be replaced within 30 years of the agreement – 2002). In the GDPCR2: Way Forward letter, Ofgem report that the estimate of the total cost of the repex programme will be in the order of £24bn. This leaves a further approx £19bn of repex expenditure to take place from the start of GDPCR2 through to 2032[4]. Clearly, a significant ramping-up of repex will be required if this target is to be achieved. Indeed, using these indicative numbers it seems likely that repex for GDPCR2 could be as much as 50% higher than for GDPCR1.

If the current 50% expensing policy were maintained this would, ceteris paribus, cause repex to increase from representing around 30% of total allowed revenues to around 40% and have a significant subsequent impact on the final prices faced by consumers. This would appear to be incompatible with the goal of stable final prices.

Consistency with RIIO and RPI-X@20 financeability guidelines

As part of the RIIO approach to regulation, Ofgem has highlighted (amongst others) the following principles to be followed in addressing financeability[5]:

- Longer-term view reinforced by regulatory commitment;
- Risks appropriately allocated between companies and consumers;
- Depreciation policy to reflect expected economic life of asset and potential uncertainty in future use; and
- Financeability assessment informed by various sources including rating agencies' credit metrics. Onus on companies to manage short term requirements.

These principles, together with the results of the RPI-X@20 review, point to a new approach for addressing financing issues. The advancement of revenues is no longer a viable option and it is up to companies through their choice of level of financial gearing to manage financeability. This is to include, if required, the addition of new equity to provide support for balance sheets and cushion cashflow ratios.

GDPCR2, in tandem with TPCR5, will be the first price control reviews conducted under the overarching framework RIIO. We would expect the mechanisms employed in GDPCR2 to address any financeability concerns that may arise to be consistent with the RIIO principles.

Intergenerational equity

Underlying the decision to expense 50% of the repex was effectively an intergenerational equity issue linked to who benefited from the safety enhancement caused through the replacement programme. Clearly existing customers have benefited from the replacement and consequently ought to pay for that benefit. But the 50% decision appears arbitrary and primarily aimed at financeability rather than reflecting an underlying principle.

[4] This assumes £1.5bn was spent from 2002-2007 and £3.5bn during GDPCR1.

[5] Ofgem, "City Briefing Introducing the RIIO model" July 2010

What would appear more appropriate would be to establish rules such that:

- Future customers are not disadvantaged through the early replacement of the existing operational assets; and
- Current customers are not subsidised by future customers (the corollary of the first point).

Consequently, a basis for charging ought to build on rules like:

- Existing iron mains assets are depreciated over their remaining life, so imposing costs on those customers that would have benefited from the operation of those assets; and
- The new assets are treated as normal assets and depreciated over their economic lives.

A rule like this would ensure that:

- The company is no worse off since all assets are fully depreciated over their lives;
- Future customers pay for the service that they will receive; and
- Existing customers pay for their safety benefit by paying twice for the service they receive, since they are paying for both the old iron and new replacement pipes.

Clearly a financeability problem could arise, but this should be assessed separately and dealt with separately rather than adjusting the rules for expensing repex.

Conclusion

Based on the above, we believe it is inappropriate to continue with the current policy of expensing 50% of repex. In our view, there is no strong case for repex to be treated differently from other types of capex and it should be added to the RAV with cost of the expenditure recovered over 45 years. This is the approach that best satisfies the RIIO principles and intergenerational equity.

What does RIIO mean for financing the asset base?

This section looks at the implication of RIIO approach to financing and financeability and, in particular, considers the impact on the WACC and its components:

- Cost of debt: how will this be rolled forward?
- Cost of equity: what impact will RIIO have on the cost of equity?

Cost of debt

The RIIO framework proposes annually adjusting the cost of debt which is to be based on long-term trailing averages of forward interest rates. It is proposed that new debt efficiently financed will be funded. Whilst the details still need to be worked through, in our view, an

automatic adjustment is appropriate and is the optimum approach to remove headroom and to deliver better value for money for customers.

It is too early to know what an automatic adjustment mechanism might look like, so we take this opportunity to set out what we believe the criteria for assessing options should include:

Table A1: Criteria for assessing CoD adjustment options

Criteria	Relevant factors
Incentives on companies	• What is the impact on incentives for efficient financing of the business?
Deadweight gains/losses	• What effect does indexation have on existing debt raised to fund the 'sunk' RAV?
Market response and impact on equity investors	• Does indexation change market expectations about returns on equity/equity risks? • Does it change the perception of regulatory risks/regulatory consistency?
Risk sharing/Impact on customers and government budget	• What is the magnitude of any immediate price reduction? • What increase in risk is borne by customers / users? • What is the impact on predictability of government transfers?
Regulatory burden	• Is there an increase in regulatory burden for companies? • For regulators? • Is it feasible to design mechanics 'fit for purpose' in accordance with sound principles?

Ofgem have indicated that the cost of debt will be based on long-term trailing averages of forward interest rates. Will these then form the benchmark that trigger annual adjustments? And what, precisely, will that benchmark be? Again it is early in this process so for the moment we set out below the principle we believe should be taken into account when selecting and developing the benchmark.

- *Non-controllability:* the benchmark clearly must not be subject to the influence or control of the regulated companies or their funders.
- *Transparency:* the basis of the benchmark must be transparent and information to determine its value over time provided by an authoritative source e.g. the Bank of England.
- *Correlation:* the benchmark should be constituted so as to offer close correlation in changes in its value with changes in the cost of debt likely to be incurred by an efficiently financed regulated business.

- *Diversification*: the components of the benchmark should be well diversified to avoid a situation where event risk affecting a single component of the benchmark could result in inappropriate change in the benchmark value.

Cost of equity

The RIIO framework does not, in our view, contain any elements that increase the cost of equity for GDNs. Gas distribution continues to be a low risk industry and an appropriate CAPM derived cost of equity represents a reasonable return for equity investors.

Whilst RIIO builds on the previous RPI-X approach it does also represent a marked change in approach for financing. Longer duration, indexation of the cost of debt, potentially company specific costs of debt and greater reliance on equity holders to manage short term financeability issues are all features of the new framework that were not present in the previous control, or which had not been applied universally across all sectors/determinations. Capital markets typically treat change with some suspicion as, until it is well understood and bedded in, it is unknown as to whether or not it has increased risk.

For example, the longer duration has the potential to be viewed as increasing the riskiness of cashflows and so impact upon a GDN's beta. This can, of course, be offset by the introduction of well designed and appropriate intra period adjustment mechanisms but these will need to be clearly explained and provide an appropriate balance of risks so as not to be overly generous and impact overly favourably on the RORE.

To prevent any of the RIIO proposals increasing the perceived riskiness of investing in the GDNs and so adding to the cost of equity and WACC, it will be vital that Ofgem gives the capital markets plenty of time to digest any changes as well as making these as transparent as possible with very clear ex ante rules. To this end we welcome the city briefing conducting in July of this year and look forward to seeing Ofgem continuing to communicate clearly its proposals to the City.

Stakeholder engagement

Given the impact on consumers of the implementation of the RIIO principles in relation to financing of the asset base, it is critical that Ofgem leads an open and participatory workstream on these issues.