Electricity North West
304 Bridgewater Place, Birchwood Park,
Warrington, Cheshire WA3 6XG
Telephone: +44 (0) 1925 846999
Fax: +44 (0) 1925 846991
Email: enquiries@enwl.co.uk
Web: www.enwl.co.uk

Rachel Fletcher
Partner, Local Grids
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Direct line 01925 846863
Paul.Bircham@enwl.co.uk

4 November 2010

Dear Rachel

Please find attached our response to the reasonable profits test for the independent gas transporters review.

Ofgem's traditional approach for calculating the reasonable rate of return is to look at the most recent price control settlement to provide an indication of a starting point. There are merits in this approach as the current reasonable profits determination was conducted over five years ago under considerably different circumstances than the current market conditions. At the same time, the most recent determination in the energy sector (DPCR5) was widely criticised by companies as being overly aggressive. We acknowledged in our response to the price control that the only reason why we accepted the cost of capital was due to the level of uncertainty of a CC referral. The recent Bristol Water CC determination illustrated the inadequacy of the allowed cost of capital (CC for Bristol Water 5.0% compared with Ofgem's 4.7%). We suggest that the most appropriate starting point would be the recently announced RIIO financeability principles.

Risks to be allocated appropriately

The risk profiles of the IGTs are very different to both the risk profile of companies subject to the most recent price controls and those priced into the February 2002 determination. The degree of uncertainty around the current state of economic recovery and its' impact on new development opportunities, upon which the IGTs rely upon for growth, will impact on the risk profile of the companies. At the same time, the IGT are network companies with relatively stable revenue streams. It is important that the balance of risks should be appropriately compensated through a robust cost of equity evaluation. Ofgem should also explicitly recognise the risk impact of deferred revenue in the cost of capital.

Principles-based approach to the calculation of notional gearing

The February 2002 determination suggested that the appropriate gearing ratio should be set at 37.5%. Ofgem should review the current gearing levels of the businesses to determine an appropriate gearing level. In line with the Bristol Water determination, it may be more appropriate to allow a lower gearing level as a protection mechanism rather than a relatively costly premium on WACC. The 62.5% gearing ratio used at DPCR5 would be inappropriate for the IGTs.

Cost of debt based on a long-term trailing average

Ofgem and CEPA both argued that future piece controls should include an indexed cost of debt. Whilst no final decision has been made on the actual target index, the principle was included within the final conclusions. We continue to challenge Ofgem on the suitability of a trailing average cost of debt which may result in Ofgem failing to discharge its financeability duties under specific circumstances. Ofgem must also recognise the impact of transaction costs above the trailing average or it will also fail its financing duties. In DPCR5 we estimated that this was approximately 40 bps.

Financeability assessment

When assessing the financeability of any price control package, it is important to use appropriate debt and equity metrics to assess the impact of the proposals. The final RIIO price control principles recognise the value of both sets of ratios but does not specify which equity metrics would be used. Ofgem should work with companies to understand potential constraints over the price control and to identify the most appropriate indicators

We have already noted the importance of calculating notional gearing for the IGTs. It is important that the companies' relative size and risk profile is recognised in setting an appropriate gearing ratio.

WACC assessment

We suggest that several of the components of recent controls may be applicable in the reasonable profits test. Whilst the cost of debt could be linked to an agreed index (with an uplift to recognise transaction costs), the cost of equity assessment via CAPM requires an assessment of the risk free rate. Numerous academics have noted the current issues with the calculation of the RFR using index linked gilts whilst Ofgem, Ofwat and the CC have adopted a new regulatory "norm" for the RFR of 2%. It is important to ensure that the cost of equity reflects the returns required for companies to continue to retain investor confidence and to provide finance for future investments.

If you have any questions regarding our response pleased do not hesitate to contact me or a member of my team.

Yours sincerely

Digitally signed by Paul Bircham
Reason: I am approving this document
Location: Electricity North West Limited
Date: 2010.11.05 14:08:01 Z

Paul Bircham
Customer and Regulation Director