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Gareth Walsh,
Senior Manager Transmission Policy
Ofgem

By e-mail to:

TPCR4.Rollover@ofgem.gov.uk

13th May 2011

Dear Gareth,

Consultation: Transmission Price Control Review (TPCR4) roll-over policy update and initial analysis of business plans

1. Thank you for the opportunity to comment on the above consultation. This non confidential response is on behalf of the Centrica group of companies excluding Centrica Storage Ltd. As a large integrated energy company in Great Britain that does not own any network interests, Centrica is in a key position to provide an unconflicted perspective on the issues raised in your consultation. While Centrica has not supported the application of a rollover for the period 2012-2013, we agree that as a decision has been made to apply a one year control, it is reasonable to take a proportionate approach. As we have highlighted previously, it will be important to ensure that in applying the proportionate approach, suitable incentives are maintained and that customers do not suffer unnecessary costs.
2. We welcome Ofgem's commitment to take policy decisions for the rollover that represent best value for money for consumers. We also agree that provided the interests of consumers are protected, the TPCR4 rollover should be proportionate to a one-year control and where possible keep regulatory change and burden to a minimum. We are therefore very supportive of Ofgem's proposals to maintain existing incentives on transmission operators and to leave other aspects of price control policy unaltered. Strategic longer term issues affecting the sector should be addressed and consulted on as part of the RIIO-T1 process.
3. Within this context, we have focused our response on the issues most material for consumers. As set out in the annex to this letter, we believe there is evidence to support a reduction in the cost of capital for regulated transmission businesses since TPCR4. On balance, given the one year rollover period and the basis on which the TPCR4 allowance was set, we suggest leaving the cost of equity assumption unchanged but updating the cost of debt for the rollover. This will allow the benefits of an observed fall in the cost of debt for energy network businesses to be shared with consumers. Keeping the allowed cost of equity unchanged would be consistent with the

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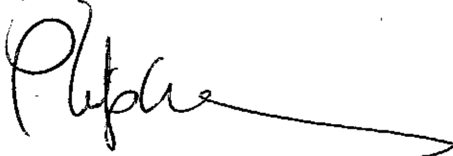
original TPCR4 decision and the principle to leave price control incentives and policy (and therefore business risk) unaltered.We would caution Ofgem against changing other aspects of financial policy ahead of consultation and agreement on longer term business plans for the sector and stakeholder consultation on these issues. Cost of capital, gearing and financeability issues will be a key part of the forthcoming RIIO-T1 and RIIO-GD1 review. In relation to the gearing assumption for SHETL, we do not see how changes in gearing (linked to future capex programmes) cannot but set a precedent. It will be more appropriate to consider the wider financial issues affecting the sector as part of the RIIO consultations. We therefore expect Ofgem to require SHETL to make a strong case for any change of financial policy for this short one-year price control, and that further consultation will be required on this issue if Ofgem wishes to consider it further in the rollover. We trust these comments have been helpful. If you have any questions or comments relating to this response, please contact me on 07789 576685 or at Philip.davies@centrica.com

Yours sincerely,



Philip Davies
Director, Regulatory Affairs
Centrica Energy

CEPA

TPCR4 Rollover financial issues: a preliminary note prepared by CEPA LLP

Notional gearing

- Ofgem has asked for views on whether it should review SHETL's notional gearing for the rollover year. We expect Ofgem to require SHETL to make a strong case for any change in notional gearing. Firstly, although the approach adopted for the rollover reflects the determination for TPCR4, rather than the approach adopted for RIIO price controls, we still expect such a decision would set a precedent for the forthcoming RIIO determinations. Second, any reduction in notional gearing would need to be supported by evidence of changes in depreciation policy and SHETL's expected capex programme (relative to RAV) are indeed expected to change for the rollover year. Finally, there is the relationship between cost of capital, notional gearing and underlying risk to consider.

- In view of the scale of capex required, financing issues will be a key determinant of the overall cost to consumers of the outputs delivered under RIIO-T1. We would caution Ofgem against setting precedence on financial issues that may arise in the future ahead of transmission operators' longer term business plans and stakeholder consultation on these issues. Ofgem notes that TPCR4 and the TPCR4 rollover year rely on a different approach to setting the allowed return than that under the RIIO model. But we cannot see how changes in notional gearing linked to a view of size of future transmission capex programmes (relative to RAV) can be separated from the longer term financial and planning issues affecting the sector.

- A reduction in notional gearing would also need to be supported by evidence of changes in depreciation policy and SHETL's expected capex programme (relative to RAV) are expected to change for the rollover year. While changes in asset lives and depreciation policy are being considered for RIIO-T1, we note no change has been proposed for the TPCR4 rollover year. Also while transmission operators may be forecasting significant increases in costs compared with their existing allowances, the actual (outturn) 'ramp-up' in capex (incurred within the rollover year) would need to be certain to justify such a change / review of the underlying financial settlement of the price control.

- We note the important congruence between the cost of equity, notional gearing and risk. Under a classical interpretation of CAPM, changes in notional gearing should have a relatively limited impact on the overall vanilla WACC that is judged appropriate. This is because a decrease in the notional gearing (as is discussed for SHETL) increases the weighting of the cost of equity in the vanilla WACC formula, but also leads to a corresponding decrease in the cost of equity. Plausible changes in SHETL's notional gearing are likely to have only a modest impact on WACC assuming no change in asset beta – which measures underlying business risk – which is in line with the classical interpretation of CAPM.

- As the asset beta for SHETL is not impacted by larger capex programmes (and the rollover is not proposing major changes to incentives and risk allocation which could impact on asset beta) we would expect the underlying assumption of SHETL's business risk to remain unchanged for the TPCR4 rollover year. Therefore, the WACC methodology should ensure the impact on WACC of any reduction of SHETL notional gearing would be marginal. The table below illustrates the impact of changing gearing on equity beta, and thus on allowed WACC (note the analysis ignores the impact on tax of changes in gearing). We see no good reason to think that the asset beta for the TPCR4 rollover year will change, and therefore any decision to decrease SHETL gearing would also need to be considered in the context of a reduction in the company's equity beta.

Table 1: Illustration of changing gearing on the cost of equity

WACC element	Notional gearing at 60%	Notional gearing at 55%
Asset beta	0.4	0.4
Notional gearing	60%	55%
Equity beta	1.0	0.9
Risk free rate	2.5%	2.5%
Debt premium	1.25%	1.25%
Risk premium	4.5%	4.5%
Cost of equity	7.00%	6.50%
Cost of debt	3.75%	3.75%
Vanilla WACC	5.05%	4.99%

Note: Analysis does not show impact on tax from changes in notional gearing

Cost of debt

- We agree that market evidence presented by Ofgem's consultants, and recent regulatory determinations on the risk-free rate, suggests a case for setting a lower risk-free rate for the TPCR4 rollover year and maintaining a range of 1.0 - 1.5 % for the debt premium adopted during TPCR4. But we note Ofgem's consultation makes little reference to analysis of actual embedded debt incurred at a different cost to current / future debt rates observed in the market. Nor is there a link made to the envisaged capex programmes of the transmission operators over the rollover year.

- We believe it is worth Ofgem analysing the embedded cost of debt of the transmission operators, how this relates to the cost of debt for TPCR4 and the envisaged new debt to be raised (at current / future rates) over the roll over period to finance capex programmes. An alternative approach, as adopted in GDPCR and DPCR5, is to assess the fall in the risk-free rate and the overall allowance for cost of debt in the context of longer term trailing averages.

Within this framework, we believe there is evidence to support a reduction in the overall allowance for cost of debt in the rollover year in order to share the benefits of the observed fall in rates with consumers.

Cost of equity

- The proposal to leave the cost of equity assumption for the rollover year unchanged would be consistent with the original TPCR4 decision (subject to our comments on notional gearing provided above) which gave greater weight to long term aggregate market returns on equity. In contrast, we note an updated analysis of individual CAPM parameters would suggest a fall in cost of equity. There is a strong case for setting a lower risk-free rate for the TPCR4 rollover year given evidence suggests the risk-free rate has declined over TPCR4. For the ERP, we suggest Ofgem take a long term view of market data and a range of 4-5% as representative of the medium and long term. A point estimate even towards the top end of this range (say 4.75%) would imply a fall in the overall cost of equity allowance. On balance, given a one year rollover period and the basis on which the TPCR4 allowance was set, we suggest leaving the cost of equity assumption unchanged.

Summary

- In summary, we believe there is evidence to support updating the cost of debt for the TPCR4 rollover year. Our indicative calculation shows that a 50bps reduction in the cost of debt would be worth £40 million per annum for users. Such a reduction might be conservative, and each 10bps is worth approx £8m. However, the precise impact on the overall cost of debt allowance should be considered in the context of companies existing (embedded) debt and the envisaged capex programmes for the one-year period.
- Any change in the estimate should also be verified for consistency with underlying assumptions made by Ofgem in other aspects of the financial calculations (the equity calculation in particular).
- We expect Ofgem to require SHETL to make a strong case for any change in notional gearing and note strong arguments in favour of not reviewing gearing at this determination, particularly given the precedent that might be set for RIIO and impacts on cost of equity under CAPM.
- On the cost of equity, the proposal to leave the assumption for the rollover year unchanged from TPCR4 would be consistent with the original decision which placed weight on long term aggregate market returns on equity. However, an updated analysis of individual CAPM parameters would suggest a fall in cost of equity. As context, Table 3 (overleaf) summarises recent cost of capital decisions and proposals made by Ofgem, its consultants and the CC. On balance, given the one year rollover period and the basis on which the TPCR4 allowance was set, we suggest leaving the cost of equity assumption unchanged.

- Table 2 below, summarises our comments and proposed changes for the TPCR rollover year cost of capital.

Table 2: Summary of comments

WACC element	Key comments	Proposed change
Gearing	Strong argument in favour of not reviewing SHETL gearing. Precedent might be set for RIIO and also CoE impacts to consider.	No change
Cost of debt	Support reduction in CoD but impact must be considered in context of embedded debt and envisaged capex programme.[1]	↓
Cost of equity	On balance, given the one year rollover period and basis of TPCR4 allowance, we suggest leaving CoE assumption unchanged.	No change
Vanilla WACC	Overall reduction for update to the CoD assumption in the TPCR4 rollover year.	↓

[1] An alternative approach, as adopted in GDPCR and DPCR5, is to assess the fall in the risk-free rate and the overall allowance for cost of debt in the context of longer term trailing averages.

Table 3: Regulatory determinations

Component of WACC	TPCR4 (2006)	DPCR5 (2009)	GDPCR (2007)	RIIO**	EE (TPCR4 Rollover)	CC Bristol Water
Risk free rate	2.5%	2.0%	2.5%	1.7 – 2.0%	1.5%	1.0% - 2.0%
Debt premium	125bps	N/A	N/A	Move to cost of debt indexation	125bps	N/A
Cost of debt	3.75%	3.6%	3.55		2.75%	3.9%
Equity risk premium	Not explicit (chosen figure of cost of equity compatible with 4.5%)	5.25%	4.5%	4.75% - 5.5%	Not explicit but compatible with 5%	4.0% - 5.0%
Equity beta	Not explicit (chosen figure of cost of equity compatible with 1%)	0.9	1	0.9 – 0.95	No change	0.64 – 0.92
Cost of Equity	7%	6.73%	7.25%	6.0% - 7.2%	6.5%	3.6% - 6.6%
Gearing	60%	65%	62.5%	No decision	60%	60%
Vanilla WACC	5.05%	4.7%	4.94%	No decision	4.25%	3.8% – 5.0%

Sources: Ofgem (2007). Gas distribution price control review final proposals. Ofgem (2009). Electricity Distribution Price Control Review Final Proposals – Allowed Revenue and Financial Issues. Ofgem (2011). Decision on strategy for the next transmission and gas distribution price controls- RIIO – T1 and GD1 Financial issues. Europe Economics (2011). Updating the Cost of Capital for the Transmission Price control rollover.

** *RIIO numbers present the initial views indicated in: Ofgem (2011). Decision on strategy for the next transmission and gas distribution price controls- RIIO – T1 and GD1 Financial issues.*