

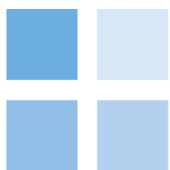
RIIO-GD1: ASSESSMENT OF FINANCEABILITY AND TRANSITION ARRANGEMENTS

A REPORT FOR CENTRICA

21 September 2012

Submitted by:

CEPA LLP



CEPA

CONTENTS

- 1. Introduction 1
- 2. Approach to financeability..... 1
- 3. Background and context..... 3
- 4. Modelling and sensitivity analysis..... 4
- 5. Analyst commentary 8
- 6. Conclusions..... 10
- Annex: Further results of financeability analysis 11

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1. INTRODUCTION

This brief paper sets out our specific comments on financeability and the transition arrangements proposed by Ofgem in its Initial Proposals (IPs).¹ It has been commissioned by Centrica but provides CEPA's independent view. In this paper we:

- summarise the approach taken to assessing financeability of regulated networks;
- present an overview of the relevant measures proposed by Ofgem, including a summary of the analysis underpinning these decisions;
- present our own analysis of financeability for notional efficiently financed gas distribution networks, drawing on our own financial modelling and commentary from equity analysts; and
- highlight our main conclusions.

The objective of this analysis is to provide our own views on both Ofgem's notional gearing assumption and whether the transition measures proposed by Ofgem are either warranted or indeed sufficient. We have commented on the allowed cost of capital in a separate note.²

2. APPROACH TO FINANCEABILITY

Ofgem has stated that RIIO is intended to encourage companies to help deliver a sustainable energy sector that delivers value for money for consumers. Ofgem's statutory duties also require it to have regard to "the need to secure that licence holders are able to finance the activities which are the subject of obligations on them"³.

In practice this is interpreted by Ofgem (and other sector regulators) as meaning that an efficiently financed notional entity should be capable of maintaining an investment grade credit rating. Assessing financeability therefore entails an analysis of how the notional entity would be treated by credit rating agencies. Such agencies will take into consideration a mixture of qualitative and quantitative factors.

Under Moody's methodology ('Moody's Global Infrastructure Finance – Regulated Electric and Gas Networks – Rating Methodology') qualitative factors are weighted more heavily than the quantitative credit metrics: these factors account for 60% of the overall credit rating. These factors include:

- regulatory environment and asset ownership model;

¹ Ofgem (2012): 'Initial Proposals – Overview', 27 July 2012.

² CEPA (2012): 'RIIO-GD1: Cost of capital – An update note for Centrica', 21 September 2012. This is an update of the CEPA note from 19 June 2012, available at: <http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/CEPA%20response%202nd%20business%20plans%20consultation%207112.pdf>

³ See: <http://www.ofgem.gov.uk/About%20us/Authority/Pages/TheAuthority.aspx>

- efficiency and execution risk; and
- stability of business model and financial structure.

UK regulated networks generally score well on these factors, which means that it is not necessary for a company to meet target ranges for all metrics at all times. Rather, a holistic view is required, taking into consideration the overall environment and any trends over time.

The remaining 40% of the overall rating is accounted for by credit metrics. In this paper we consider the six metrics referred to by rating agencies in general (the Moody's methodology referred to above includes only the first five):

- FFO⁴ interest coverage;
- adjusted interest coverage or PMICR⁵;
- the ratio of FFO to debt;
- the ratio of net debt to RAV, i.e. gearing;
- the ratio of RCF⁶ to capex; and
- the ratio of RCF to debt.

We support this interpretation of financeability. In this paper we focus on the quantitative credit metrics; our assumption is that the notional entity would score very highly on qualitative factors.

The primary lever used by Ofgem to influence financeability is its gearing assumption. This has two effects on the notional entity.⁷ First, it influences the allowed revenue; this aspect is particular to regulated entities. Lower levels of gearing reduce the weight attached to the (relatively cheap) cost of debt in the Weighted Average Cost of Capital (WACC), increasing allowed returns and required revenue. Second, it influences (cash) interest costs. Lower levels of gearing will reduce these fixed obligations, thus limiting the risk of financial distress. The gearing assumption determines the initial financial structure – and hence interest costs – of the notional entity at the beginning of the price control period. For subsequent years, the level of debt (and gearing) will develop based on cash flow after accounting for operating and financing costs.

Actual Gas Distribution Networks (GDNs) will of course only directly experience the first effect. Ofgem's approach is to ensure that the notional entity is financeable, with companies left responsible for their own financing decisions. The experience of individual companies will, therefore, differ from Ofgem's modelling.

⁴ Funds from operations, defined as allowed revenue less 'opex-like' expenditures, interest payments (in line with rating agencies we exclude the inflation component of index-linked debt) and tax payments.

⁵ Post-maintenance interest cover ratio, which is defined based on FFO less capital maintenance charges.

⁶ Retained cashflow, defined as FFO less dividend payments.

⁷ In theory, adjusting the gearing assumption also has a third effect, on the cost of equity. Since the degree of risk reflected in the cost of equity is a function of underlying business risk and financing risk, a reduction in the level of gearing will reduce the cost of equity. Within a narrow range of gearing, however, this is likely to fall within the margin of error of the cost of equity allowance.

For GD1, Ofgem also proposes to use the repex capitalisation rate as a financeability lever. It has decided to move to 100% capitalisation of repex, rather than the current 50%. Since this implies an increase in the proportion of ‘slow’ money, it may place pressure on some credit metrics. If necessary, Ofgem has stated it will consider a gradual transition to 100% repex capitalisation over the course of the GD1 price control in order to mitigate any financeability concerns. Its IPs include a transition over the full price control period, from 50% (i.e. no change) in 2013/14 to 100% in 2020/21

Finally, Ofgem has also proposed to release ‘catch-up’ depreciation over the course of GD1. This relates to the difference between straight line and sum of digits depreciation for 2002-13 assets. The profile of this additional income can be used to address financeability concerns in specific years.

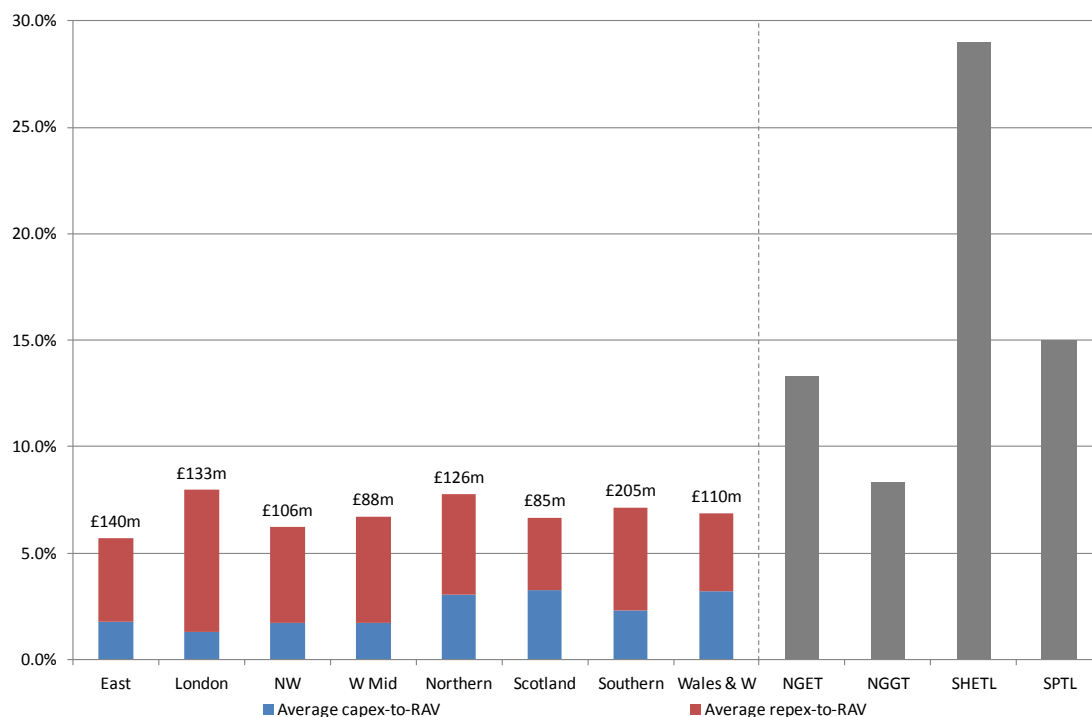
3. BACKGROUND AND CONTEXT

An assessment of movements in allowed revenue between GDPCR1 and GD1 gives an indication of the overall level of balance of Ofgem’s approach, noting that companies do not appear to have had financeability issues in GDPCR1. The changes to depreciation and repex capitalisation (relative to GDPCR1, including repex transition over eight years) appear to increase allowed revenue. Our interpretation of this is that the relatively high notional gearing assumption (65%) is essential to ensuring balance in this area, such that current consumers are not paying more than required.

The relative scale of the investment programme for each network is an additional source of useful background information (see Figure 1 below). There is significant variation between networks, with East of England at the low end and London and Northern at the high end. London, in particular, has an extensive repex programme compared with other networks. Despite this variation, none of the networks can be considered to have a significant capex programme in the context of GB energy networks more generally. The two Scottish transmission networks – which Ofgem considers and has treated as ‘high’ capex networks – have annual average capex:RAV⁸ ratios of 29% (SHE1L) and 15% (SPTL) in the upcoming price control.

⁸ Regulatory Asset Value

Figure 1: Average annual capex and repex as a proportion of RAV



Source: RIIO GD1 Financial Model, T1 Initial Proposals for NGET & NGGT, T1 Final Proposals for SHETL & SPTL. Note: Figures denote Ofgem’s ‘best case’ view based on average capex and repex, and opening RAV in real terms.

This variation by network suggests a diverse package of allowances may be required. The move to repex capitalisation might be expected to have particular implications for London, given the scale of its repex programme. Ultimately, however, the financeability will draw on an assessment of notional company-specific credit metrics rather than the scale of the capex and repex programmes alone.

The GDNs had previously argued for financeability concessions, including reduced notional gearing and repex transition. The capital programme best case estimates presented in Figure 1, however, represent a significant decrease from those assumed by the GDNs as part of their business plan submissions. We would expect financeability decisions to be based on revised analysis using the allowances in IPs⁹; this analysis is the subject of the following section.

4. MODELLING AND SENSITIVITY ANALYSIS

Our approach begins by assessing financeability over the price control period under a base case, which we take to be Ofgem’s package of IPs based on its best view of cost allowances. We compare this with our own alternative scenarios (also based on best view cost allowances). To develop these scenarios, we first assume no transition measures (i.e. moving immediately to 100% capitalisation) and a level of gearing (70%) that represents the highest figure that on its own would be consistent

⁹ Ofgem (2012): ‘Initial Proposals – Finance paper’, 27 July 2012

with an investment grade credit rating.¹⁰ We then adjust the level of gearing and transition measures until, in our judgement, the notional entity achieves an appropriate level on credit metrics. In the figures that follow, the shaded areas represent the approximate target ranges for a company with an investment grade credit rating (based on Moody's rating methodology).

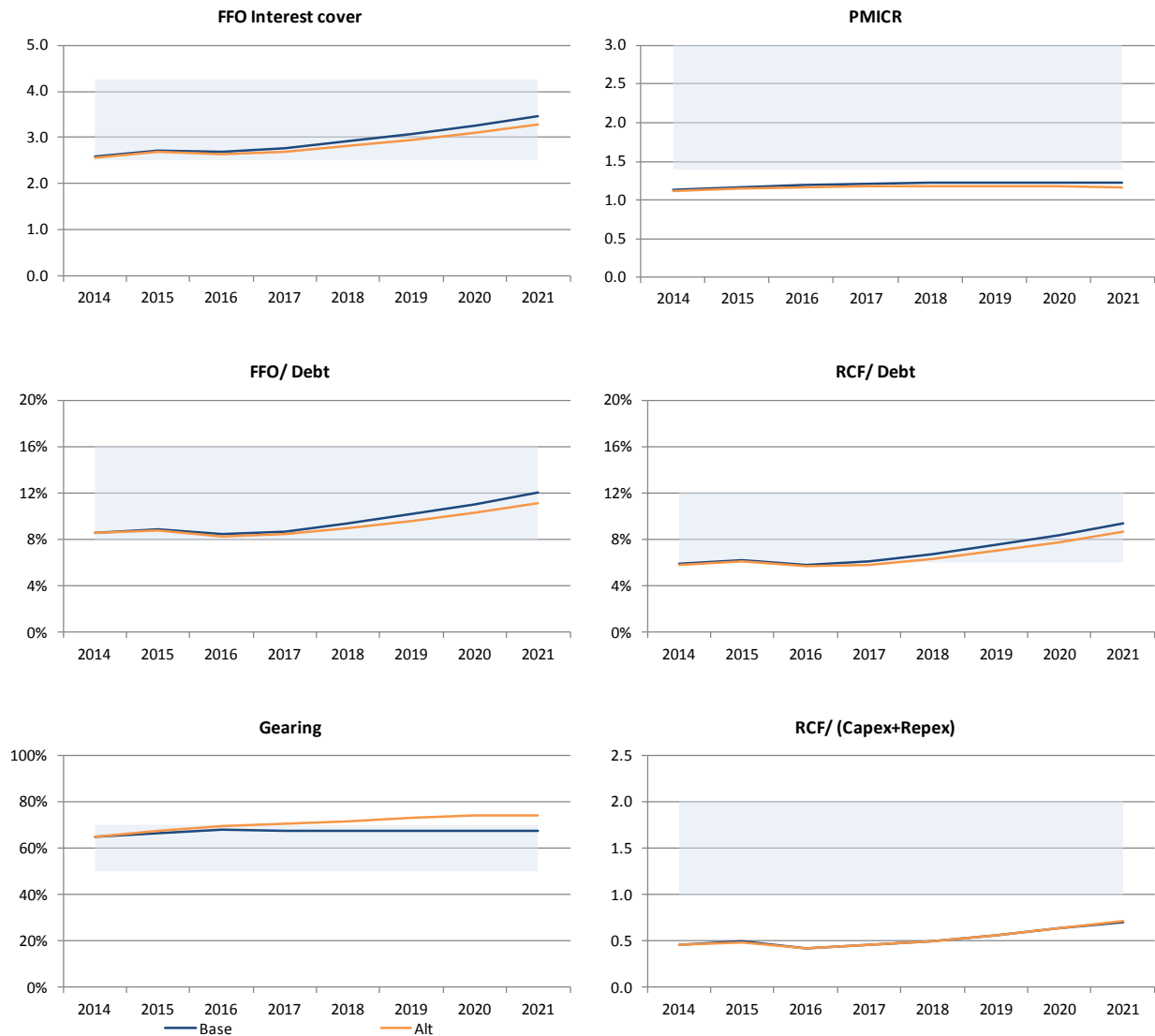
In our analysis, we display trends in the PMICR and RCF/(capex + repex) ratios. However, these may be considered less relevant as presented than other ratios. The PMICR is somewhat affected by depreciation policy – in particular the release of catch-up depreciation and the introduction of accelerated sum of digits depreciation. A relatively high proportion of allowed revenue is in the form of a depreciation allowance, and, under Moody's approach, does not contribute to PMICR. Moody's approach is intended to exclude “the portion of revenues (and thus FFO) that is not available to cover interest because it needs to be allocated to replenishing the asset base/maintaining the economic value of the assets”. It is not necessarily clear that catch-up depreciation (or indeed accelerated depreciation) is unavailable in this sense. In practice, therefore, a period of below-target PMICR may be manageable, particularly if combined with other metrics within target ranges. The RCF/(capex + repex) ratio is less relevant in the case of a regulated entity for which capex is not discretionary and is rewarded through the RAV.

As is clear from Figure 1, the scale of the investment programme and the relative importance of repex differs by network. In particular, the London network may have different financeability characteristics from the others. Figure 2 below summarises the credit metrics for London under two scenarios. The 'base' case represents Ofgem's IPs and its best view of cost allowances. The 'alternative' case combines Ofgem's gearing assumption of 65% with a faster transition to 100% repex capitalisation, beginning in 2013/14 and reaching 100% in 2017/18 (Ofgem's transition begins in 2014/15 and reaches 100% only in 2020/21).

The interest and debt cover ratios appear relatively little affected by the transition relief. They therefore appear manageable in the alternative scenario with reduced transition relief. Under both scenarios, gearing rises at the beginning of the price control. Based on Ofgem's IPs it stabilises at around 67%, while with reduced transition relief it continues to rise, and reaches 74% by the end of the price control. This raises the prospect that a (modest) equity injection may be needed in order to keep gearing within the target range.

¹⁰ Gearing is one measure the rating agencies refer to. Based on our assessment of their approach, gearing above 70% would, on its own, likely be viewed as a risk factor from a financeability perspective.

Figure 2: London network credit metrics



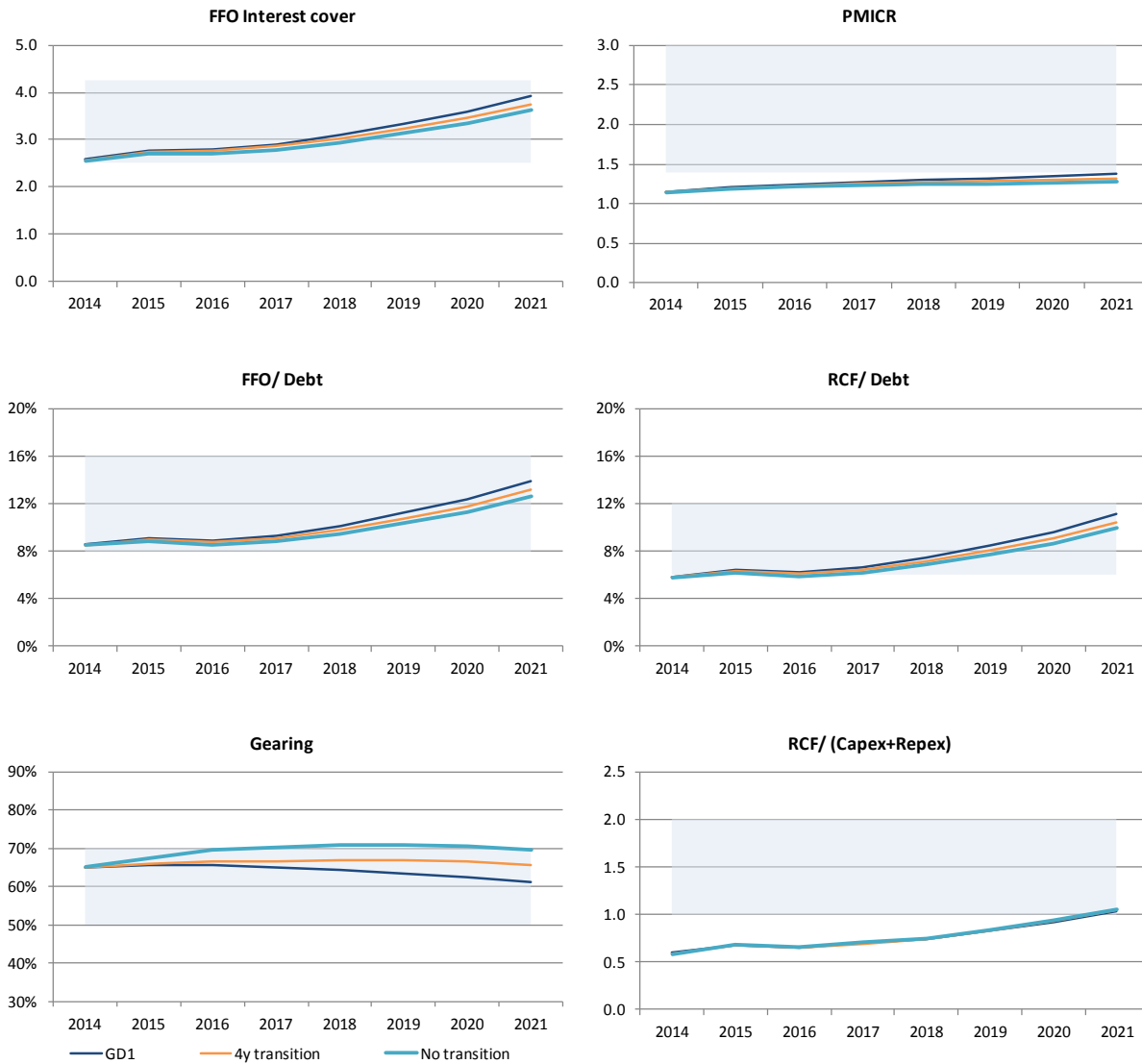
Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem’s Initial Proposals. ‘Alt’ case is 65% gearing combined with a 4-year repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

In the case of a network requiring the completion of a significant repex programme, we consider some degree of flexibility on the part of equity investors to be a reasonable requirement. This is particularly true where other credit metrics are consistently improving over the course of the price control. Short term pressure should not be a cause for concern, and according to our analysis would be manageable by the networks. We therefore conclude that a repex transition period of eight years may not be necessary.

We next present analysis for the East of England network, which is broadly representative of the remaining networks with lower investment requirements (as a proportion of RAV). Here, we reach a stronger conclusion since financeability under Ofgem’s IPs appears more robust (see Figure 3 below). All credit metrics improve consistently over the price control period, with FFO interest

cover, FFO/debt and RCF/debt reaching the upper region of the target ranges. Gearing falls below the notional level, to around 60% by the end of the price control. In our view, this suggests that it may well be possible to provide a financeable package with fewer concessions to company cash flow.

Figure 3: East of England network credit metrics



Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

Two alternative cases are presented in Figure 3. The 'No transition' case represents a move to 100% repex capitalisation in 2013/14 with the gearing assumption remaining at 65%. The '4y transition' case mirrors the 'alternative' case from Figure 2, i.e. a gearing assumption of 65% with a faster transition to 100% repex capitalisation, beginning in 2013/14 and reaching 100% in 2017/18.

In each of these scenarios, interest and debt cover ratios remain largely within target ranges and on an improving trend. In the case of no repex transition measures, gearing increases to slightly above the target range, though it does not create problems in any of the other credit metrics. In the four-year transition scenario, gearing remains closer to the 65% assumption and does not, in our opinion, pose any financeability concerns. We have examined the implications of this alternative case for other networks, and though there is some variation by network our conclusion is the same.

We have also examined the sensitivity of our analysis to alternative assumptions regarding inflation and the cost of debt. We used the following sensitivities:

- scenarios of 1.5% and 4.5% for RPI inflation (compared to the base case assumption of c. 2.7%); and
- scenarios of 2.0% and 4.5% for the cost of debt index (compared to the base case assumption of 3.03%, Ofgem’s most recent published view for the index)¹¹.

Each sensitivity primarily affects the FFO interest cover ratio, and affects each network to a similar degree. Under the scenarios described above, interest cover largely remains within target ranges. In our view, this range of scenarios is sufficiently wide to represent a reasonable test of financeability. We also note that while either index could in theory move up or down, in practice movements in both the RPI and the cost of debt index are likely to support financeability in the upcoming price control. This is especially the case for the cost of debt index where figures above the ten-year rolling average are falling out of the calculations and are being replaced by current rates significantly below the rolling average figure. Interest cover ratios include interest costs in both the numerator and the denominator. As a result, other things being equal if the cost of debt index falls interest cover ratios will rise. This may suggest our financeability analysis is relatively conservative.

5. ANALYST COMMENTARY

Ofgem’s package of IPs has received significant attention from equity analysts to examine the financeability implications. Naturally, these focus on actual business and group entities rather than the notional licenced entity, and typically do not distinguish between different sectors. (For instance, the financeability implications for National Grid (NG) Transmission and Distribution are often assessed jointly.) Hence any commentary needs to be interpreted carefully.

Our overall interpretation is that analysts have limited concerns over financeability:

“...we believe that the proposals leave the financeability of the overall NG group in a healthy situation based on an analysis of all relevant credit and leverage metrics.” – Morgan Stanley, 17 July 2012.

“The lower revenues under the Initial Proposals are offset by a £4bn reduction in capex in real terms during the period and accelerated financability cash in the early years. Our forecasts suggest that there is no serious deterioration in the [National Grid] Group’s ability to fund itself - in fact, even our new conservative base case scenario shows that the most fragile credit metric (RCF/Net Debt) only gets close to the threshold in

¹¹ These are stylised assumptions, since in practice the index would move gradually. They are intended to be illustrative.

2019. If Grid did not manage to achieve any outperformance at all, the credit metrics would be breached in 2015/6 on our numbers. Achieving the full upside by the end of the regulatory period would result in RCF/net debt remaining above 9.3% throughout. Other metrics such as interest cover and FFO/Net debt are less problematic under most scenarios.” – Bank of America Merrill Lynch, 2 August 2012.

Many analysts note that compared with the networks’ business plans, Ofgem’s IPs include lower capex requirements. This confirms that the degree of financeability support requested through those plans is no longer relevant.

Some analysts suggest that Ofgem’s financeability concessions may be too generous:

“...measures [proposed by Ofgem] to improve cash flow in Gas Distribution were better than we expected ... [National Grid] will go to 100% Repex capitalisation and 45 year asset lives for new assets gradually over 8 years. The point on Repex is a positive surprise, as it improves the credit metrics versus our assumptions.” – Credit Suisse, 17 July 2012.

Our analysis suggests there may be some short term pressure on credit metrics in the early years of the price control. As a result, it is important to consider the likely reaction should the notional entity be required to manage such a financeability challenge:

“Although we think that Grid will have to address its capital structure and dividend issues over time, it does have plenty of options (notably divestment of underperforming assets) and we believe some time (we don’t see credit ratios becoming a constraint until the latter half of the decade).” – JP Morgan Cazenove, 3 August 2012.

“...raising the dividend at the same time as committing to double-digit RAV growth will be challenging. We thus believe that a 15% dividend rebase in 2014 will improve National Grid’s debt metrics and dividend cover ratio, while bringing Grid’s dividend yields into line with those of the UK water companies.” – Berenberg, 15 May 2012.

The discussion from equity analysts focuses on the range of options available to National Grid at the group level; it is not critical of the price control allowance. From this, we infer that Ofgem’s IPs should not, in general, prevent the networks from financing their activities, although clearly the specific circumstances of each notional licensed entity will differ.

6. CONCLUSIONS

Drawing conclusions on financeability is difficult, and inevitably requires the application of judgement. Our overall perspective is that the financeability issues for most GDNs may not be as significant as implied by Ofgem's IPs. Companies are likely to continue to benefit from strong credit ratings resulting from the 60% (based on Moody's methodology) of the total rating not affected by financial ratios. We have taken this into consideration in assessing notional entity performance against credit metric target ranges.

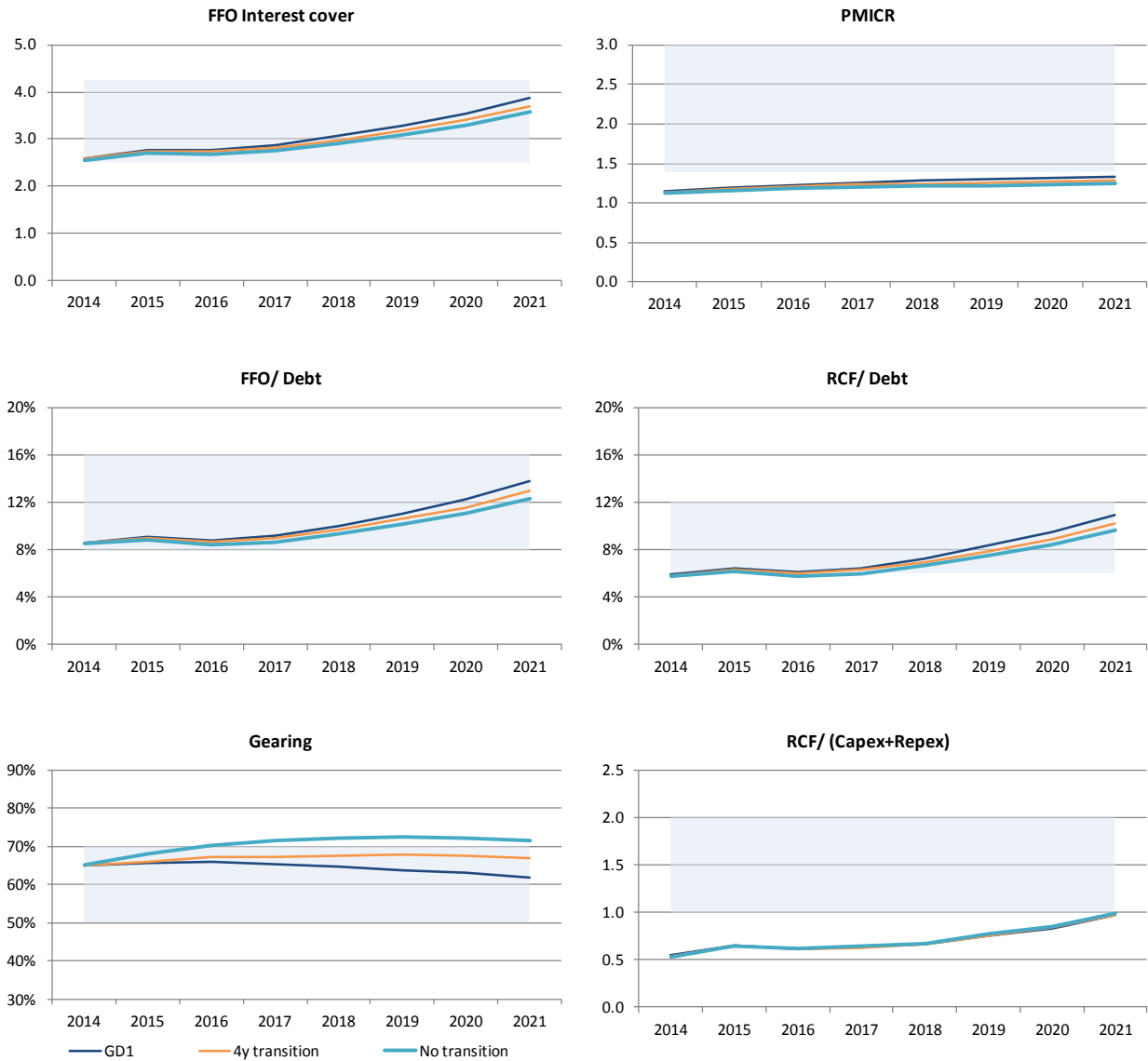
For the majority of the networks, our analysis suggests that a transition to 100% repex capitalisation over the full duration of the price control is an unnecessary concession. A four year transition period (with repex capitalisation beginning at 60% in 2013/14 and reaching 100% at the midpoint of the price control) would be consistent with key metrics largely remaining within target ranges. Arguably, Ofgem should consider a scenario with no transition period. Although this would likely result in some metrics breaching target ranges, given the overall security of the UK regulatory regime this would carry a relatively limited risk of credit rating downgrade and to networks' ability to access capital markets. Our overall view is that a four year transition period would represent a balanced approach for most networks.

The exception to this is the London GDN, which has a significantly higher proportion of repex than other networks. Our analysis indicates that the case for repex transition is stronger than for other networks. Although there is some evidence to suggest that financeability would be possible based on a four year transition, in our view a longer transition period is warranted in this case to ensure that there is no undue financeability burden.

Wider evidence, including our own scenario analysis and the views of analysts, largely supports this conclusion. Our conclusions are robust to a range of scenarios for the cost of debt index and RPI inflation. Indeed, we note that our modelling has used a relatively conservative assumption that the cost of debt index will remain at present levels. In addition, we note that some analysts consider Ofgem's proposed transition approach to have been more generous than expected. Based on our interpretation of analyst commentary, a faster transition could be achieved without damaging market sentiment in relation to financeability.

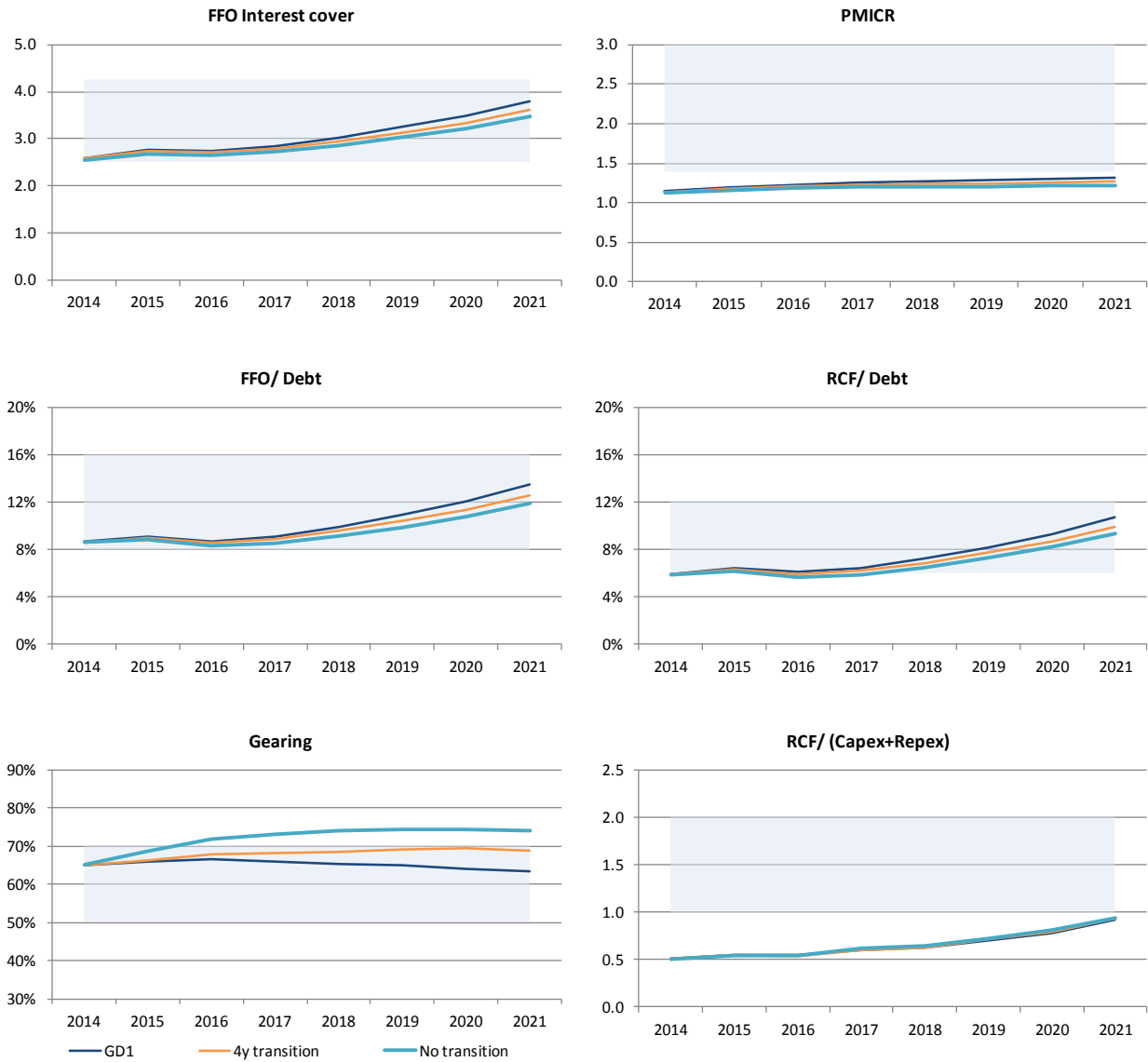
ANNEX: FURTHER RESULTS OF FINANCEABILITY ANALYSIS

Figure A1: North-West network credit metrics



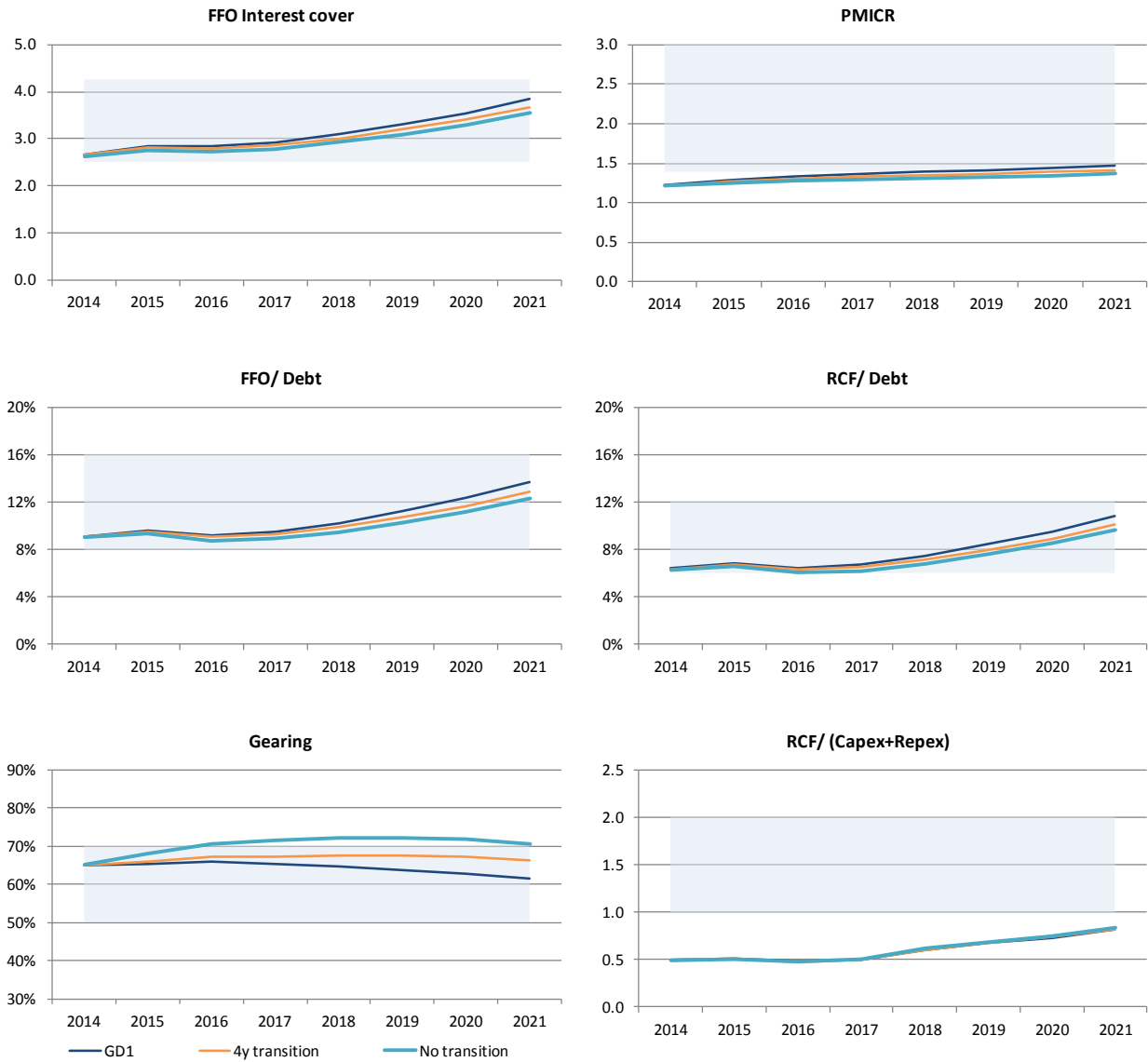
Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

Figure A2: West Midlands network credit metrics



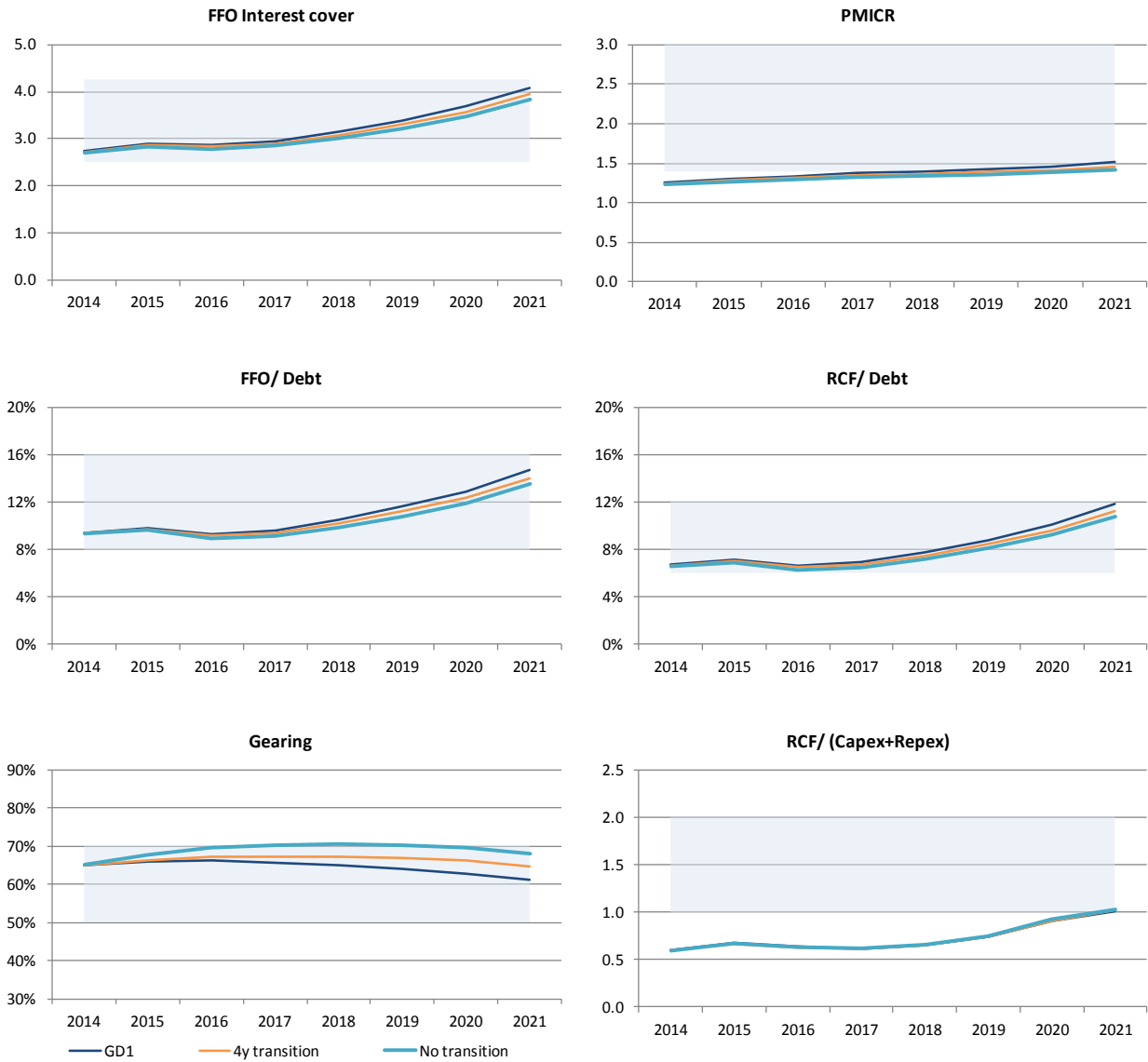
Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

Figure A3: Northern network credit metrics



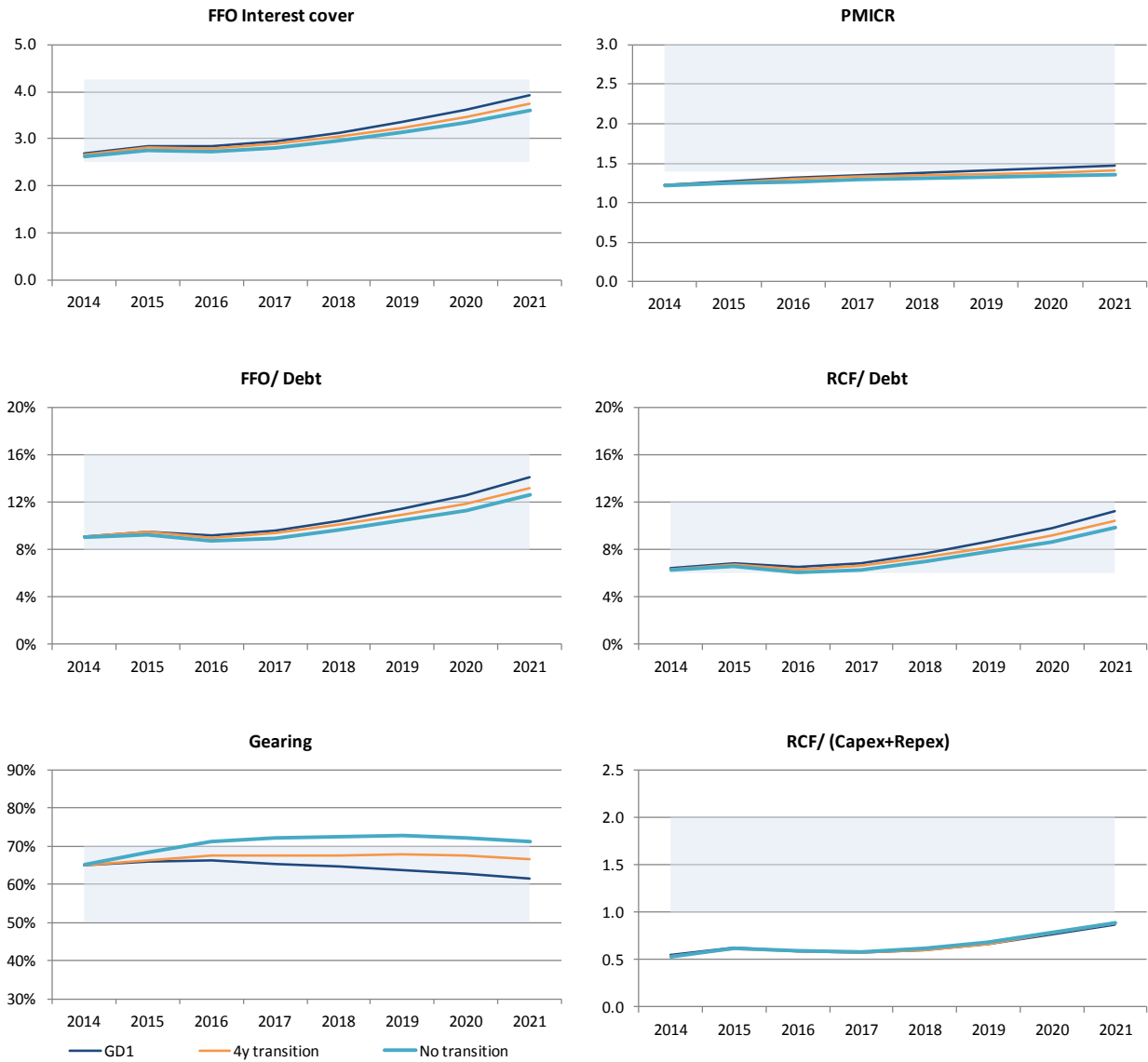
Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

Figure A4: Scotland network credit metrics



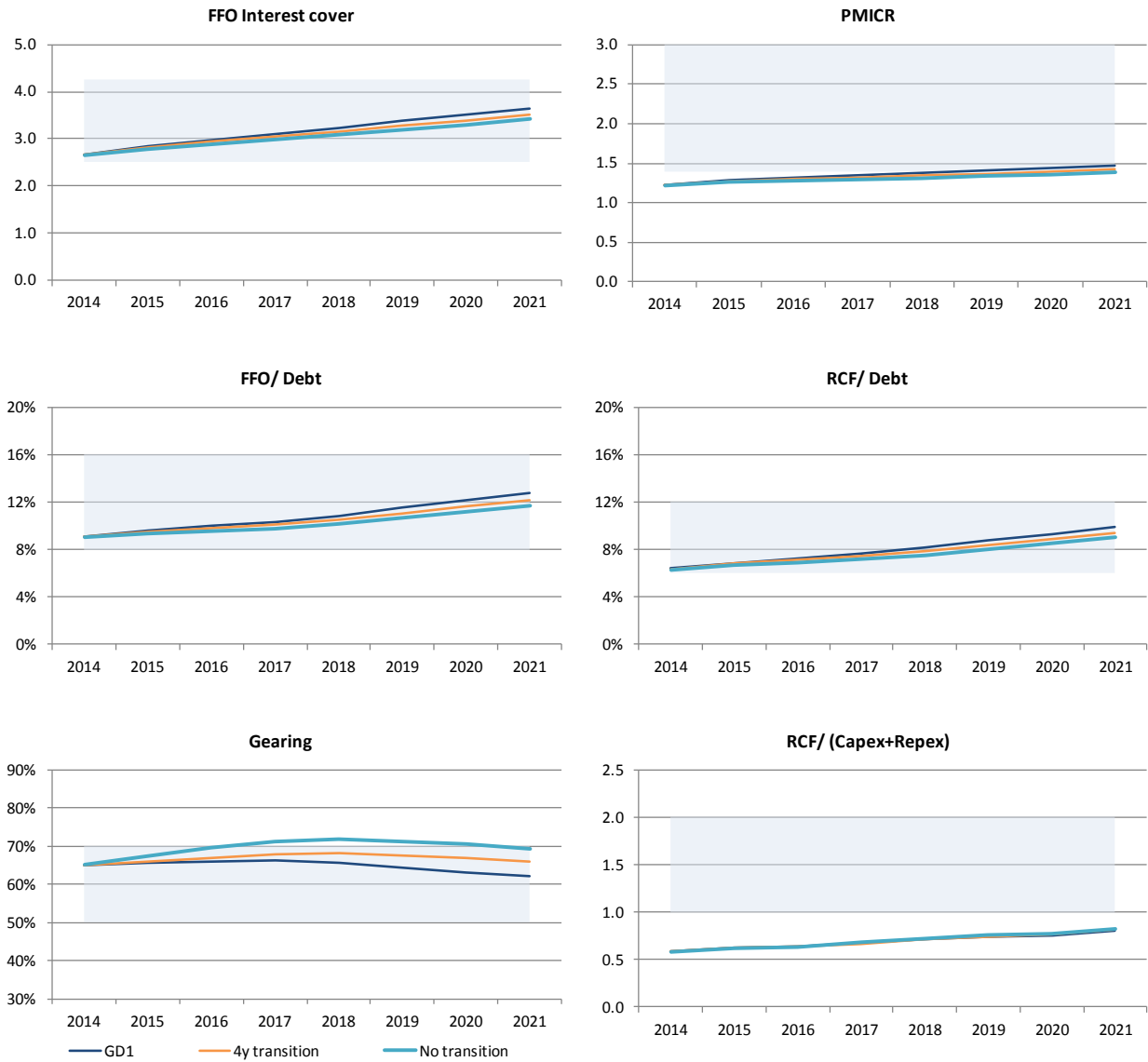
Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

Figure A5: Southern network credit metrics



Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.

Figure A6: Wales & West network credit metrics



Note: Base case is 65% notional gearing and 8-year repex transition as in Ofgem's Initial Proposals. '4y transition' case is 65% notional gearing and repex transition starting in 2013/14 and reaching 100% after four years. 'No transition' case is 65% notional gearing and no repex transition. Shaded areas indicate approximate target ranges for investment grade rating.