Paper 1: Benchmark vs Actual Cost of Debt in 2011

Prepared by First Economics for the Electricity DNOs

FIRST ECONOMICS

www.first-economics.com

8 June 2012

1. Introduction

During the last two years, the ENA and individual regulated network businesses have repeatedly criticised Ofgem for failing to include allowances for fees, new issue premia and the inflation-risk premium in its cost of debt index.

Ofgem has responded to these criticisms by arguing that its new formula contains sufficient headroom to pay for these things.

In the analysis that follows we show that this headroom was not apparent to the electricity DNOs that issued new bonds during 2011.

2. Data

Tables 1 and 2 contain a summary of the new debt that was issued by the DNOs last year. The second last and last columns of the tables identify the yields payable by the companies and the value of Ofgem's index on the date at which these yields were fixed.

Table 1: Conventional issuance

Date	Issuer	Amount	Maturity	Spread (approx)	Yield		Ofgem's benchmark
17/05/11	WPD East Midlands	£600m	2023	G + 168 bps	5.25%		5.38%
17/05/11	WPD West Midlands	£800m	2032	G + 163 bps	5.77%		5.38%
10/06/11	UKPN SPN	£200m	2030	G + 160 bps	5.74%		5.43%
10/06/11	UKPN LPN	£250m	2023	G + 168 bps	5.21%		5.43%
08/07/11	SP Distribution	£350m	2026	G + 200 bps	5.96%		5.51%
27/09/11	UKPN EPN	£250m	2021	G +225 bps	4.85%		5.31%

Table 2: Index-linked issuance

Date	Issuer	Amount	Maturity	Spread (approx)	Yield		Ofgem's benchmark
01/06/11	WPD East Midlands	£100m	2043	G + 195 bps	2.67%		2.09%

3. Analysis

The tables show that four of the seven issues last year were more expensive than Ofgem's benchmark index. Three issues were less expensive, mainly due to the comparatively short tenor of the bonds. (This is a reflection of the upward sloping shape of the yield curve – something that means that companies typically have to pay more than Ofgem's benchmark if they try to lock in for the long term to historically low interest rates.)

On average, the DNOs paid 13 basis points more than Ofgem's implicit cost of debt allowance.

4. Implications

This experience calls into question the extent to which ‘headroom’ will exist in future to pay for items that are missing from Ofgem’s cost of debt formula.

In our view, as outsiders, it is preferable that Ofgem should design an index that is robust in both theoretical and practical terms rather than rely on the assumption that asymmetric noise/error in the match between the chosen iBoxx indices and the DNOs’ actual cost of debt will compensate companies for efficiently incurred costs.