Ofgem Strategy Consultation for the RIIO-ED1 Electricity Distribution Price Control
Issued 28th September 2012 (Ref 122/12)
SP Energy Networks Response to Annex – Financial Issues

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OVERVIEW

We welcome Ofgem's commitment to ensuring that DNOs are able to finance themselves. It is essential that DNOs are able to attract and retain funding from investors in a global capital market. DNOs are predominantly financed by international companies, global infrastructure funds and sovereign wealth funds. All of these allocate capital across countries and sectors on the basis of relative returns.

There are unprecedented demands for the funding of infrastructure investment. The OECD report on Infrastructure to 2030, published in 2006/07, estimated global infrastructure requirements to 2030 to be in the order of US$50 tn. The International Energy Agency also estimated that adapting to and mitigating the effects of climate change over the next 40 years to 2050 will require around US$45 tn or around US$1 tn a year.

In the UK, DECC has acknowledged the need for £200 bn of investment in our energy infrastructure by 2020. npower has published the Future Report that projects that up to £330 bn of investment will be needed by 2030.

Analysts and rating agencies have already warned that too low a return would fail to attract sufficient funding, given the increased risks and the unprecedented increase in investment requirements.

Furthermore, new regulation recently approved and to be implemented in the coming years will affect sources of finance (debt and equity) for infrastructure, potentially limiting their availability. Proposed EU legislation, following the review of the Directive on Institutions for Occupational Retirement Provision (IORP Directive), could apply the Solvency II approach to occupational pension schemes, which would have an impact also on infrastructure investment. Basel III will affect in particular long term bank lending. In addition, the Volker Rule and the EU Directive on Alternative Investment Fund Managers (AIFM) will have consequences on infrastructure funds and fundraising in the future.

We are concerned that, for the electricity DNOs, indexation of the allowed cost of debt is expected to increase the risk of error in estimating the cost of debt. This is because of the relatively infrequent need for DNOs to issue debt results in a profile vastly different from that implicit in the construction of the index as the average of daily yields.

We propose that Ofgem use a longer weighted average of yields, starting from January 1998 (from when the iBoxx yields become available), which continues to expand in length, until it becomes a 20 year trailing average. This would smooth out movements in interest rates and more closely match the maturity of DNO debt.

Nevertheless, it is essential that residual risk arising from debt indexation is fully reflected in the cost of equity, as shareholders bear the residual risk. Moreover, RoRE analysis should include the risk of a mismatch between the actual and the allowed cost of debt.

Furthermore, initial analysis suggests that electricity DNOs are relatively more risky than GDNs, with:

- Higher capex/RAV
- Higher opex/RAV; and
- Higher totex/RAV ratios

The "cash flow risk", as measured by totex/RAV is expected to be similar to RIIO-T1 and substantially higher than RIIO-GD1.

While the theoretical debates about the impact of the longer duration of cash flows in RIIO may continue, we are clear that a longer price control period and the increase in the assumed lives of new assets will increase the risk compared to DPCR5. Simply, risk will be higher as respectively more unanticipated developments will occur over a longer time period than a shorter one and the period

capital will be invested has increased substantially. NERA have estimated that the increase in asset lives will increase the risk premium by 50bps.

Similarly, Oxera have estimated the term premium component to be 70bps.

Furthermore, the longer price control period means that the allowed return is locked in for more years, increasing the required return. In US regulation, an allowance is made for this through an additional "stay-out" premium.

In addition, considering the entire strategy consultation, the RoRE analysis will also need to reflect additional risk from the Investment Quality Incentive (IQI) from the higher range for the totex efficiency incentive rate. Also, as proposed in the strategy document, the incentive will now include 'incremental' (post-31 March 2010) ongoing pension contributions and the 'incremental' pension deficit funding. Considering these issues investors will be seeking a higher Cost of Equity for electricity DNOs than that proposed for GDNs and that allowed for DPCR5 and at the upper end of Ofgem's proposed range.

Ofgem will need to take cognisance that international demand for infrastructure investment will drive competition for equity infrastructure investors. ED-1 relative returns will need to be internationally competitive to support UK DNO's ability to finance their investment programmes.

We require a package of financial measures that maintains our investment grade credit rating with sufficient certainty, in the face of the risk of contagion from the continuing sovereign debt crisis or adverse changes in the RPI. We do not consider that a package with potential requirements for dividend cuts would be consistent with utility investors' requirements for income.

We consider a BBB investment grade credit rating to be suboptimal and will increase the overall WACC. Furthermore, low investment grade rated companies face the risk that financial markets will become effectively closed to them in periods of capital market disruption. This risk should be mitigated by the initial credit metrics and gearing assumption, which should be consistent with an A rating. To ensure an adequate credit rating, we shall be proposing a lower level of gearing than that assumed for DPCR5.

QUESTIONS RESPONSE

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1. CHAPTER ONE – INTRODUCTION

No questions posed.

2. CHAPTER TWO – ALLOWED RETURN

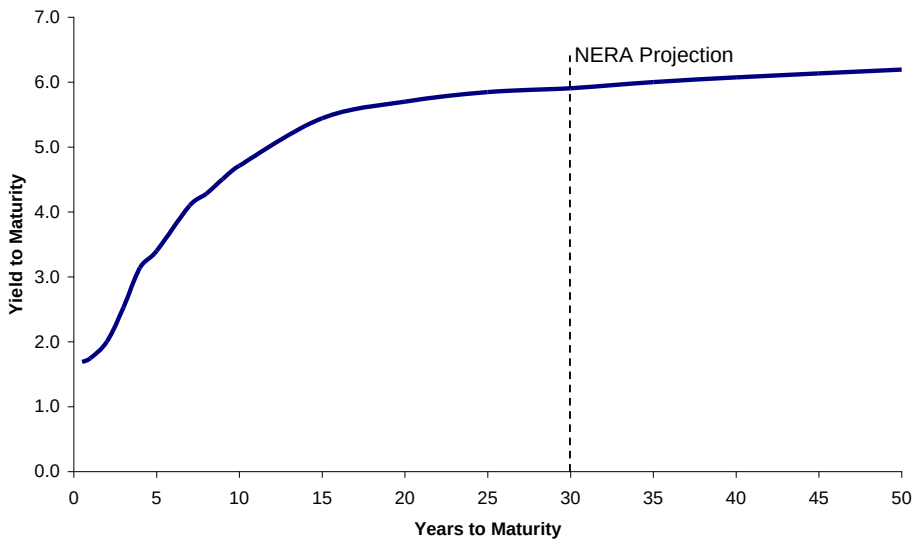
2.1 Question 1: *Is our approach for setting the allowed return appropriate, particularly in the context of an eight-year price control?*

The proposals for RIIO-ED1 will significantly increase the duration of cash flows by extending depreciation lives for electricity distribution assets and lengthening the period of the price control to eight years.

Although Ofgem's advisers have disputed the evidence from equity markets, there is clear evidence from corporate debt markets that investors require a premium to compensate for duration risk. Based on the yield curve for US corporate debt, rated BBB, NERA have estimated that the increase in asset lives will increase the risk premium by 50bps.

Similarly, Oxera have estimated the term premium component to be 70bps, for a company with an asset beta of 0.4.

Figure 1: Debt yield curve: increase in yield with length of term



Source: Bloomberg and NERA calculation

Furthermore, the longer price control period means that the allowed return is locked in for more years, increasing the required return. In US regulation, an allowance is made for this through an additional "stay-out" premium.

The Capital Asset Pricing Model (CAPM) is a single period model and cannot be used to assess the impact of duration of cash flows on the expected return. Comparing the cost of capital for different profiles of cash flows over time is fundamentally a multi-period problem. There is a substantial

literature on multi-period asset pricing models, which have become a well established part of finance theory.

Ofgem do not appear to have cross-checked their range for the cost of equity against alternative approaches including:

- The Dividend Discount Model;
- The conditional CAPM, which allows variation in risk and expected returns;
- The zero beta CAPM, which does not rely on a risk free asset;
- Higher moment models, which allow for skewness in returns; and
- The Inter-temporal CAPM, which is a multi-period model.

As it is especially challenging to estimate the parameters of the CAPM in current market conditions, it is essential that such cross-checks are undertaken. These show that shareholders require a higher return.

Since the onset of Credit Crisis, investors have become much more concerned about tail risks, which are not adequately modelled by the CAPM.

The problem of "time inconsistency" has been exacerbated, as DNOs have to rely on the consistency of regulatory decisions over a longer period of time. Reviews of the principles of economic regulation and sectoral regulatory authorities, the cull of non-departmental public bodies, following the last election, and the views on energy regulation expressed by the Shadow Energy Secretary at the Labour Party Conference demonstrate that investors cannot rely on consistency over time.

A recent report[1] by Credit Suisse highlighted how risk is increasing in the UK water sector, which was previously perceived as a low risk sector. Some factors, including potential changes to the construction of the RPI, also apply to the energy sector.

*2.2 **Question 2:** What considerations do we need to take into account when setting the notional gearing level?*

We expect the principles-based approach to notional gearing for SPD and SPM, based on the contents of the strategy consultation, will present a lower gearing than that assumed for DPCR5. Our initial RoRE modelling based on the strategy consultation and considering the capex to RAV, proposed incentive rates and uncertainty mechanisms, indicates a lower gearing than the previous review will be essential to setting an appropriate WACC.

Gearing should be lower than the DPCR5 level and be consistent with an A credit rating, which would allow finance to be continued to be raised during periods of financial distress. A BBB rating would be sub-optimal and increase the overall WACC, as well as limit access to external finance during periods of capital market disruption. We observe that the average Common Equity Ratio for a (utility commission's) staff proxy group of US energy companies is 45%.

[1] Credit Suisse (2012), "UK Water – Murky outlook: we turn negative", 26 July

Figure 2: Common equity ratios for US energy companies

Staff Proxy Group Characteristics

Company	Parent Company Rating S&P[1]	Parent Company Rating Moody's[2]	S&P Business Profile[1]	Score	S&P Financial Profile[1]	Score	Regulated Revenue (%)[3]	FY 2010 Common Equity Ratio[4]	QTR Ending 9-30-11 Common Equity Ratio[4]
1. ALLETE	BBB+	Baa1	Strong	2	Significant	4	92.1%	55.11%	54.93%
2. Alliant Energy Corp.	BBB+	Baa1	Excellent	1	Significant	4	92.4%	49.06%	50.57%
3. Ameren Corp.	BBB-	Baa3	Satisfactory	3	Significant	4	80.9%	49.48%	52.06%
4. American Electric Power	BBB	Baa2	Excellent	1	Aggressive	5	94.9%	42.15%	45.12%
5. Avista Corp.	BBB	Baa2	Excellent	1	Aggressive	5	91.0%	45.13%	46.35%
6. Black Hills Corp	BBB-	Baa3	Strong	2	Aggressive	5	85.7%	42.05%	38.12%
7. CenterPoint Energy	BBB	Baa3	Excellent	1	Aggressive	5	75.3%	25.22%	31.70%
8. CH Energy Group[5]	A	A3	Excellent	1	Significant	4	74.0%	50.59%	47.74%
9. Cleco Corp.	BBB	Baa3	Excellent	1	Aggressive	5	94.6%	45.71%	49.87%
10. Consolidated Edison	A-	Baa1	Excellent	1	Significant	4	86.2%	50.35%	51.24%
11. DTE Energy Co.	BBB+	Baa2	Strong	2	Significant	4	77.6%	45.02%	46.38%
12. Edison International	BBB-	Baa2	Strong	2	Aggressive	5	80.4%	43.63%	42.92%
13. Empire District Electric	BBB-	Baa2	Excellent	1	Aggressive	5	99.0%	47.67%	49.40%
14. Entergy Corp.	BBB	Baa3	Strong	2	Significant	4	77.8%	41.20%	41.26%
15. FirstEnergy Corp.	BBB-	Baa3	Strong	2	Aggressive	5	73.6%	36.71%	42.53%
16. Great Plains Energy Corp.	BBB	Baa3	Excellent	1	Aggressive	5	100.0%	42.75%	43.49%
17. Hawaiian Electric Industries, Inc.	BBB-	Baa2	Strong	2	Aggressive	5	89.4%	47.13%	48.04%
18. IDACORP, Inc.	BBB	Baa2	Excellent	1	Aggressive	5	91.6%	47.67%	51.74%
19. MGE Energy Inc.[6]	AA-	A1	Excellent	1	Intermediate	3	98.9%	59.43%	60.18%
20. Pepco Holdings, Inc.	BBB+	Baa3	Excellent	1	Significant	4	72.7%	47.45%	47.26%
21. PG&E Corp.	BBB+	A3	Strong	2	Significant	4	100.0%	44.75%	47.00%
22. Pinnacle West Capital	BBB	Baa3	Excellent	1	Aggressive	5	97.5%	49.31%	49.13%
23. Portland General Electric	BBB	Baa2	Excellent	1	Aggressive	5	93.3%	46.47%	47.86%
24. SCANA Corp.	BBB+	Baa3	Excellent	1	Aggressive	5	72.9%	42.46%	41.49%
25. Sempra Energy	BBB+	Baa1	Strong	2	Intermediate	3	75.7%	47.91%	46.13%
26. Southern Co.	A	Baa1	Excellent	1	Intermediate	3	88.1%	42.60%	43.73%
27. TECO Energy, Inc.	BBB+	Baa3	Excellent	1	Significant	4	77.2%	40.11%	42.37%
28. UIL Holdings Corp.	BBB	Baa3	Excellent	1	Aggressive	5	99.1%	39.13%	39.09%
29. Vectren Corp.[7]	A-	A3	Excellent	1	Significant	4	73.4%	43.96%	42.87%
30. Westar Energy	BBB	Baa3	Excellent	1	Aggressive	5	74.8%	43.70%	44.78%
31. Wisconsin Energy	A-	A3	Excellent	1	Significant	4	99.1%	42.74%	43.22%
32. Xcel Energy, Inc.	A-	Baa1	Excellent	1	Significant	4	99.3%	44.97%	45.47%
Staff Proxy Group Average:				1.3		4.4	86.8%	45.1%	46.1%

We are concerned that should there be another period of stress within the capital markets, for example, as a result of contagion from the sovereign debt crisis, refinancing will be available only to companies with higher investment grade credit ratings. This risk should be mitigated by the initial credit metrics and gearing assumption which should be consistent with an A rating.

In addition, in view of recent criticisms of the rating agencies, their rating methodologies and criteria may be become more demanding in future, which is of particular concern in view of the long term nature of electricity distribution.

2.3 Question 3: Is our proposed mechanism for annually updating the cost of debt assumption based on an index appropriate?

Although we understand Ofgem's policy and reasons for introducing a variable cost of debt, nevertheless, we have significant reservations in relation to the approach proposed. We include a recommendation of an alternative approach that would mitigate some of our concerns.

It is essential that residual risk arising from debt indexation is fully reflected in the cost of equity, as shareholders bear the residual risk. Ofgem's RoRE analysis should include the risk of a mismatch between the actual and the allowed cost of debt.

Alternative approach - We propose that Ofgem use a longer weighted average of yields, starting from January 1998 (from when the iBoxx yields become available), which continues to expand in length, until it becomes a 20 year trailing average. This would smooth out movements in interest rates and more closely match the maturity of DNO debt. Although we would be prepared to consider other options, such as a cap and floor or company specific weighting, provided that they clearly reduced the risk of shortfalls from the actual cost of debt, our initial view is that they would add considerably to the complexity of the calculation of the cost of debt. Nevertheless, such mechanisms may contribute to reducing the volatility of charges and therefore further consideration of them may be justified.

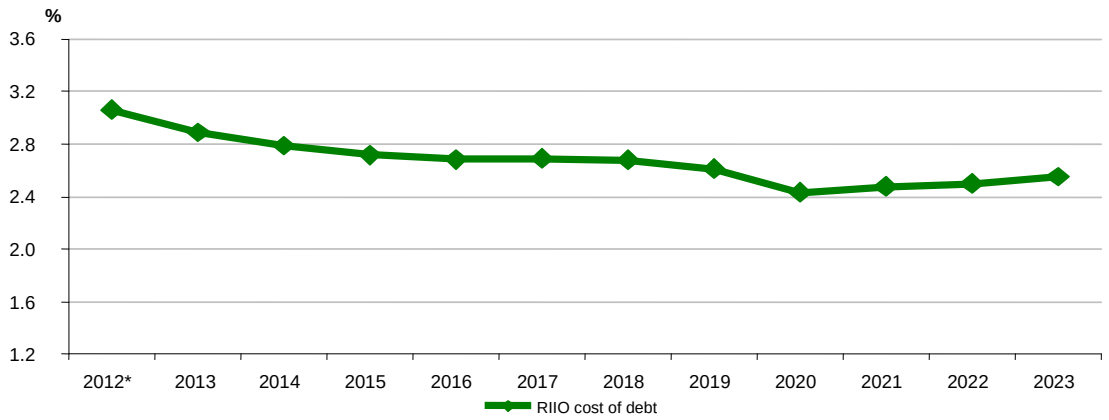
It should be remembered that cost of debt indexation exposes customers to the risk of increases in interest rates and contributes significantly to the volatility of charges, which Ofgem are seeking to mitigate.

Our significant reservations on the proposed approach are:

Embedded debt costs - The proposed ten year trailing average fails to take into account the cost of embedded debt, particularly that raised prior to the beginning of the ten year window. Historically, nominal coupons were higher and DNOs are obliged to continue paying the same coupon until maturity.

The forward implied RIIO real cost of debt index is projected to decline until 2020 and remain below the current level of the index until the end of RIIO-ED1. This will exacerbate the shortfall against the cost of embedded DNO debt.

Figure 3: Forward implied RIIO real cost of debt index



Source: Lloyds

Issuance costs - In addition, an explicit allowance is required for the issuance costs of debt. Ofgem have over-estimated the apparent headroom in the iBoxx index as:

- Historically, it includes the benefits of index-linked debt, which is no longer readily available
- Inadequate account is taken of the inflation risk premium
- The maturity of bonds are not matched with the benchmark, so the term premium is inappropriately treated as apparent headroom
- The margin has declined in recent months and the average difference since the start of 2010 is 12bps

- The share of utilities' bonds in the iBoxx indices has increased, which makes outperformance more difficult.

Risk that actual cost of debt varies from that allowed - For the electricity DNOs, indexation of the allowed cost of debt is expected to increase the risk of error in estimating the cost of debt. This is because of the relatively infrequent need for DNOs to issue debt results in a profile vastly different from that implicit in the construction of the index as the average of daily yields.

DNOs are exposed to the risk that their issuance yields are different from the average of daily yields. As a result of the intra-year volatility in yields DNOs will continue to be exposed to the risk that their actual cost of debt varies from that allowed.

As debt indexation does not eliminate risk for an average DNO, it is not appropriate to remove completely the implicit margin in the cost of debt allowance.

Inflation risk premium - The inflation risk premium increases with the horizon. A variance decomposition shows that a substantial proportion of the variation in longer term break-even inflation rates reflects changes in the inflation risk premia.

Furthermore, the liquidity premium appears to be time-varying (for example, peaking at the height of the Credit Crisis) and liquidity appears uncorrelated with the real interest rate and inflation risk premia.

Moreover, prior to the CPI inflation target of 2.0%, the RPIX target was set at 2.5%, and the arithmetic difference between the CPI and the RPI measures of inflation has changed over time.

We therefore do not accept the assertion that the inflation risk premium is simply offset by a liquidity premium. Indeed, Ofgem's own consultants, FTI Consulting conclude[2]:

"it seems likely that the inflation risk premium is larger than the liquidity premium"

Companies remain exposed to the significant risk that, at the time of issue, the inflation risk premium exceeds the liquidity premium.

Solvency II and Basel III - We remain concerned that Solvency II and Basel III will increase the cost of debt for network companies. As Freshfields Bruckhaus Deringer caution in their Outlook for Infrastructure 2012:

"The capital and balance sheet requirements for banks under Basel III and insurers under Solvency II mentioned earlier could prove a major barrier to attracting investors because of the level of capital required to be held against long-tenor debt instruments such as infrastructure debt."

Similarly, the OECD has warned[3]:

"the overall regulatory setting has often been providing unfavourable incentives to such long-term investment (LTI) and to long-term oriented investors. The Basel rules and capital requirements have promoted short-termism and discouraged long-term banking and financial initiatives. Accounting rules conceived for investment banks and trading activities and appropriate for their business model have often penalised LTI and proved to be inappropriate for long-term investors (such as pension funds, insurance companies, SWFs, and development public banks) and for their unique business models. The IASB mark-to-market philosophy may be particularly damaging for long-term investors, attributing

[2] FTI Consulting (2012), "Cost of capital study for the RIIO-T1 and GD1 price controls", 24 July, paragraph 11.23
[3] OECD (2011), "Financial Stability, Fiscal Consolidation, and Long-Term Investment after the Crisis", Financial Market Trends, No. 100, Volume 2011, Issue 1

instant market values to assets whose valuations may take years to accurately assess; and the Solvency II Directive in Europe, as we will discuss later, discourages insurance companies and pension funds from holding infrastructural assets, not allowing for a proper matching of long-term liabilities with long-term assets on their balance sheets."

and

"the negative impact of Solvency II on Institutional Investors' capital requirements can foster a reduced appetite for buying/investing in long-term financial instruments, thus reducing the potential market scope. "

Given the construction of the iBoxx benchmark indices, which are used to calculate the allowed cost of debt, this additional cost will not be fully taken into account, as there are substantial proportions of shorter maturity bonds within the indices. This mis-match in maturities of DNO bonds with those within the index increases the residual risk inherent in indexation.

*2.4 **Question 4:** Does our range for the cost of equity capture the DNOs' probable cost of equity in RIIO-ED1?*

We believe the February policy decision document needs to include more detailed evidence on the rationale for Ofgem's range. In particular consideration of forward-looking estimates of the equity risk premium which are well above 5.5%. The Bank of England's estimate of the premium required by investors to hold UK equities is above 7%. Similarly, Goldman Sachs has estimated that the UK risk premium is 7% and Deutsche Bank as above 8%. These would indicate that, on a forward looking basis, the top end of Ofgem's range is too low.

In addition we detail below other important considerations in relation to the cost of equity:

Equity beta - There is widely recognised empirical support for movement of estimated beta towards unity over time. Clearly, with an eight year price control a raw beta estimate from a short period of data is inadequate and should be adjusted towards unity, using:

- The Blume[4] adjustment (as used by a number of beta measurement services);
- Bayesian adjustment (as used by the LBS Risk Management Service);
- Upper confidence limit of beta estimate; or
- Zero-beta CAPM

We estimate the asset beta for a comparable network company to be within the range of 0.39 to 0.42.

[4] Blume, M. (1971) "On the assessment of risk", Journal of Finance, 26, pp 1-10

Figure 4: Comparable network companies range

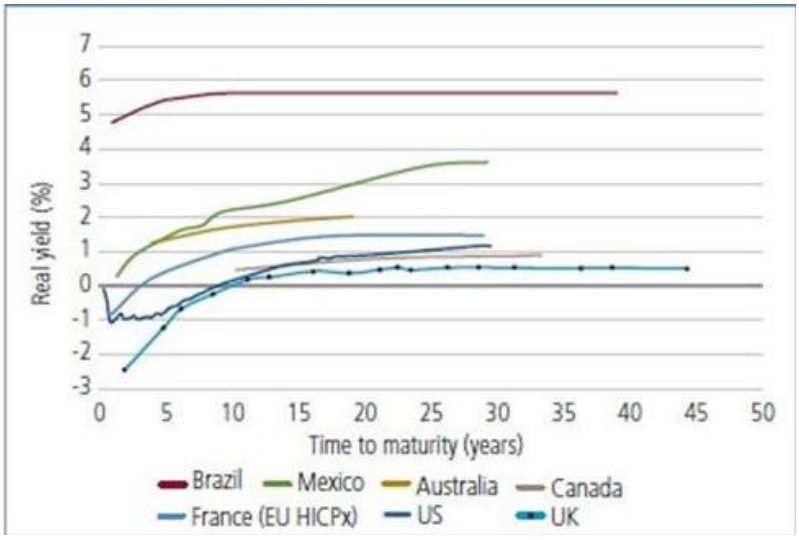
Company	Market Cap	D/(D+E)		5 YEARS MONTHLY MXWO		3 YEARS WEEKLY MXWO	
		5 years	Last	BRI	R2	BRI	R2
Networks							
REE	4.882	45%	55%	0,49	35%	0,51	39%
Enagas	3.428	49%	59%	0,48	31%	0,48	35%
Snam Rete Gas	13.228	47%	51%	0,32	12%	0,33	12%
Terna S.p.a.	6.114	38%	5%	0,38	13%	0,43	20%
Redes Energeticas Nacionais	1.208	60%	68%	0,22	4%	0,27	14%
National Grid	27.102	56%	52%	0,28	9%	0,23	5%
United Utilities	4.862	55%	57%	0,27	11%	0,30	17%
Severn Trent	4.413	57%	56%	0,23	5%	0,27	13%
Pennon Group	3.087	54%	53%	0,32	21%	0,33	22%
Southern Company	28.995	38%	35%	0,36	12%	0,40	19%
PG&E	13.238	44%	45%	0,35	13%	0,38	17%
ConEdison	12.583	43%	37%	0,31	6%	0,41	33%
Northeast Utilities	8.454	51%	46%	0,38	28%	0,43	40%
UIL Holdings	1.310	48%	50%	0,43	23%	0,54	39%
Mean		**49%**	**48%**				
Weighted average by R2				**0,39**	**16%**	**0,42**	**23%**

Therefore, we believe it is inappropriate to rule out an equity beta of at least unity, as, for example, would result from, say, an asset beta of 0.4 with assumed gearing of 60%.

Risk free rate - We agree that the Bank of England's policy of quantitative easing (QE) has lowered gilt yields. However, the 100bps estimate of this reduction relates only to the first stage of this programme. Between March and November 2009, the Monetary Policy Committee (MPC) authorised the purchase of £200bn (billion) worth of assets, mostly UK gilts. The MPC voted to begin further purchases of £75bn in October 2011 and, subsequently at its meeting in February 2012 the MPC decided to buy an additional £50bn. In July, the MPC announced the purchase of a further £50bn to bring total assets purchases to £375 bn. Assuming a proportionate impact (as the Bank of England did for its July 2012 assessment of the distributional effects of asset purchases), the overall impact of QE will therefore have been to reduce gilt yields by 187.5bps.

UK pension liabilities are about four times as large as outstanding UK inflation-linked bond issuance, and this supply-demand imbalance has driven real yields on index-linked gilts to record lows. The Figure below shows that UK real yields across the curve are the lowest of all global inflation-linked bond markets.

Figure 5: Real yield curves

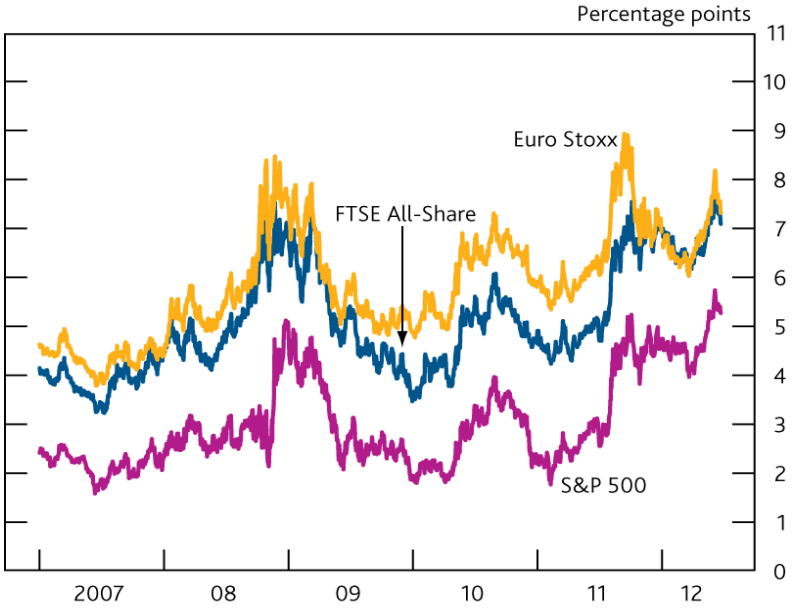


Source: Barclays Capital, as of 31 August 2011.

The UK government currently benefits as a relative "safe-haven", especially within Europe, and yields on UK government securities have been depressed by a "flight to safety". Therefore, they do not provide a reliable guide to the underlying risk free rate.

The vast majority of recent regulatory decisions have determined the real risk free rate to be at least 2.0%.

Figure 6: Bank of England estimates of the premia required by investors to hold equities[5]



Sources: Bloomberg, Thomson Reuters Datastream and Bank of England calculations.

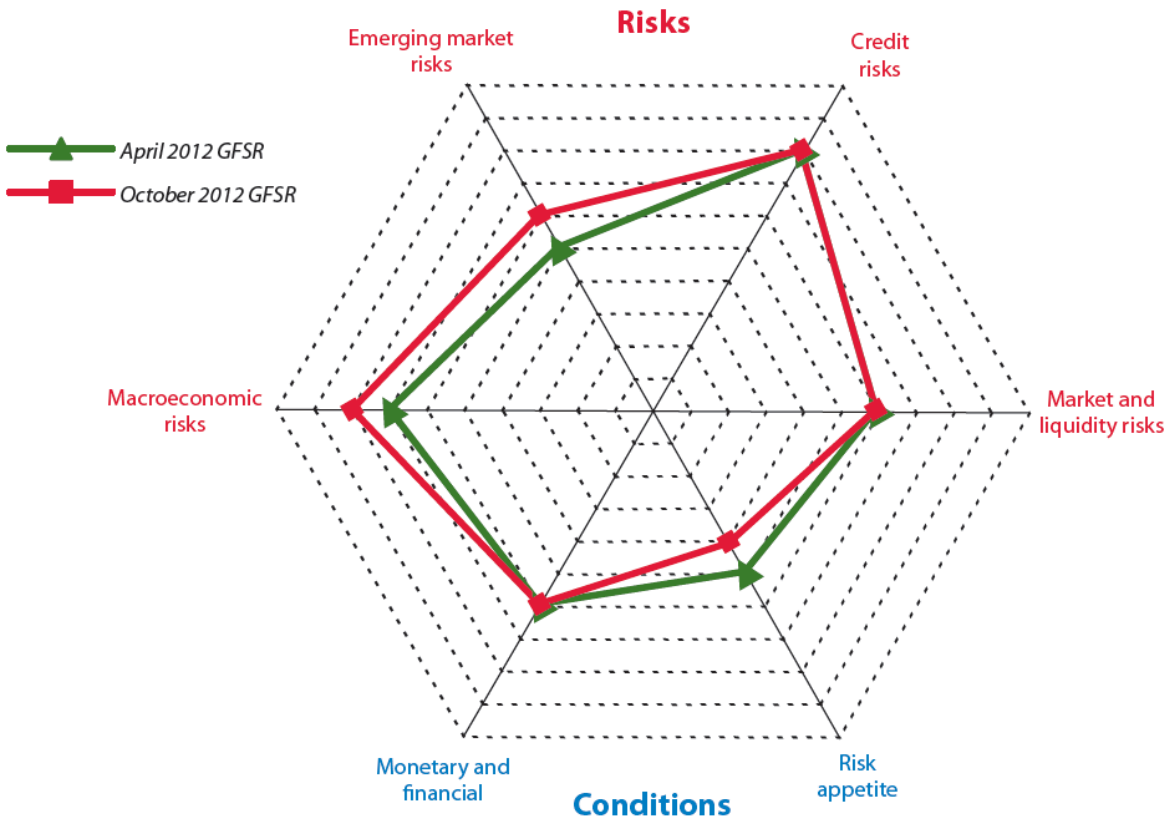
Risk appetite - Risk appetite can be viewed as the inverse of the price of risk. So when investors' risk appetite falls, they require larger expected excess returns to hold risky assets. Analysis by the IMF shows that in recent months that investors' risk appetite has decreased at the same time as risks have increased.

In its October 2012 Global Financial Stability Report the IMF warns:

"Risks to financial stability have increased since the April 2012 Global Financial Stability Report (GFSR), as confidence in the global financial system has become very fragile (Figures 1.1 and 1.2). Despite significant and continuing efforts by European policymakers, which have been essential in addressing investors' biggest fears, the principal risk remains the euro area crisis."

[5] As implied by a multi-stage dividend discount model

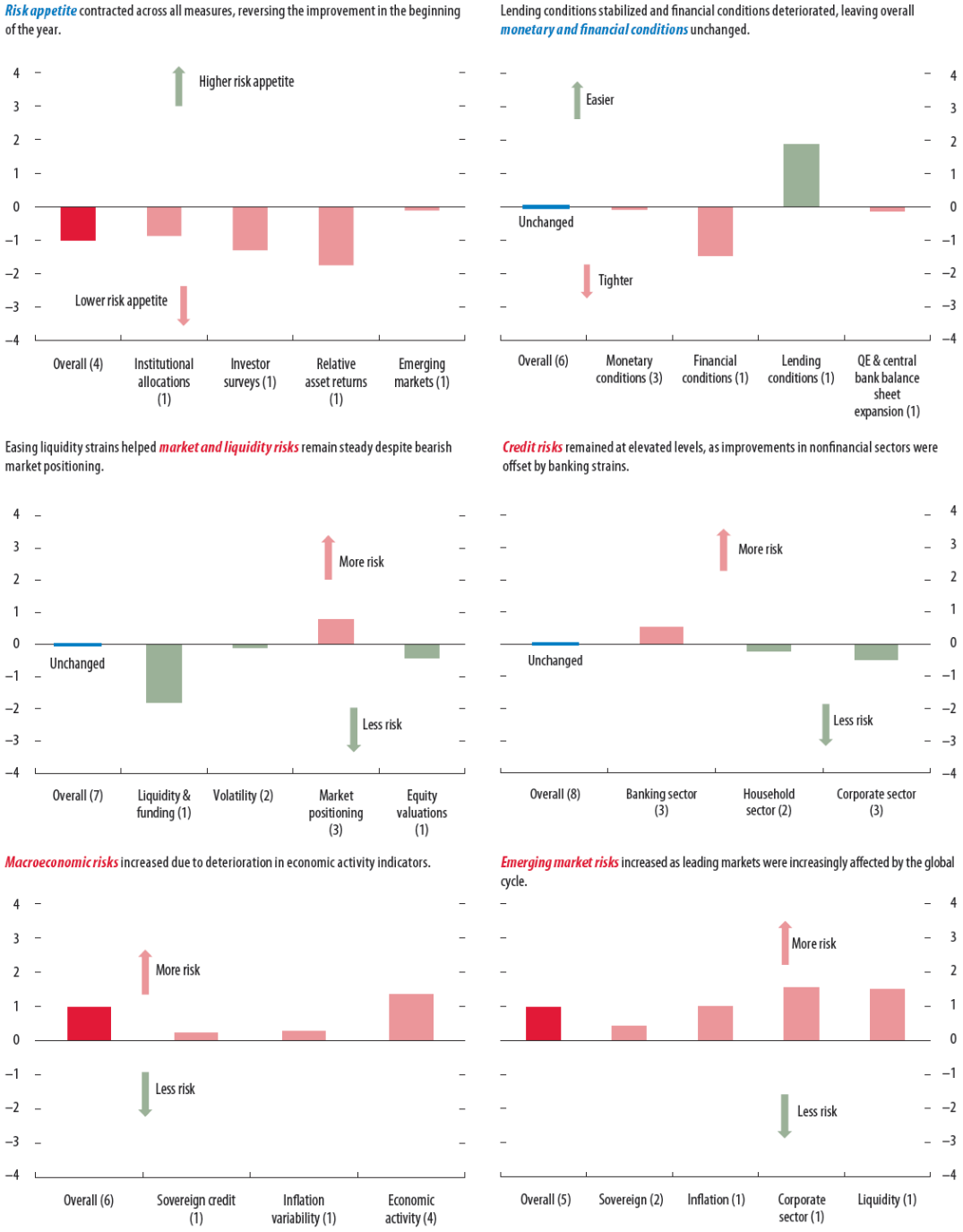
Figure 7: Global Financial Stability Map



Source: IMF staff estimates.
Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Source: IMF staff estimates.

Figure 8: Global Financial Stability Map: Assessment of Risks and Conditions (in notch changes since the April 2012 GFSR)



Source: IMF staff estimates.
Note: Changes in risk and conditions are based on a range of indicators, complemented with IMF staff judgment; see Annex 1.1. in the April 2010 GFSR and Dattels and others (2010) for a description of the methodology underlying the Global Financial Stability Map. Numbers in parentheses denote the number of individual indicators within each subcategory of risks and conditions. The "overall" notch change in each panel is the simple average of notch changes in individual indicators in that panel. In the panel on monetary and financial conditions, a positive value for lending conditions represents slower pace of tightening or faster easing, and QE = quantitative easing.

Source: IMF staff estimates.

2.5 ***Question 5:*** *Is the ex ante approach to the cost of raising notional equity appropriate for RIIO-ED1?*

In principle, we agree that the cost of raising equity can be set as an allowance in the financial model. We estimate the cost of raising equity to be at least 5%, although it would be higher for smaller amounts.

The true-up should take into account equity raised elsewhere in the Group, provided that it is for the benefit of SPD & SPM. For example, it is likely to be more cost effective to raise new equity for more than one network licensee in a group, at the same time.

The true-up should take place at the beginning of the next price control period, which allows the precise timing of an equity issuance to remain flexible. Clearly, the timing of any equity issuance would be dependent on market conditions, which can change rapidly.

3. CHAPTER THREE – ASSESSING FINANCEABILITY

3.1 ***Question 1:*** *Have we identified the correct equity and credit metrics?*

The credit metrics identified are in line with those used by the Credit Rating Agencies. We note however that Fitch also use "FFO lease adjusted leverage" which is similar in many respects to an inverted FFO/net debt calculation. Furthermore, if a rating agency gives more or less weight to a specific credit ratio then its relative importance should be reflected when assessing financeability

In respect of the calculation of these credit metrics we believe they should be calculated on a basis that is consistent with the methodologies employed by the rating agencies.

3.2 ***Question 2:*** *Do the rating agency credit metric levels quoted provide the most appropriate levels?*

The credit metric levels required for a single A or BBB will be dependent on the overall regulatory framework. For example, if the price control results in less certainty and visibility over cashflows then it is likely that the necessary ratios for a particular rating would change to reflect the additional uncertainty.

In addition, in view of recent criticisms of the rating agencies, their rating methodologies and criteria may be more demanding in future, which is of particular concern in view of the long term nature of electricity distribution.

When targeting a credit rating, ratios should be set to achieve mid-cycle ratios – ratios at a level that are comfortably above the minimum prescribed ratios for a particular rating. Negative rating pressure and downgrades develop when a company is routinely close to the bottom of the range of acceptable credit ratios for their current rating.

Due to volatility of capital markets and their changing nature as a result of the financial crisis, single A rating metric levels should be targeted in order to maintain investor confidence in the sector and minimise the risk of DNOs not having access to the capital markets.

4. CHAPTER FOUR – REGULATORY ASSET VALUE (RAV), ASSET LIVES AND DEPRECIATION

4.1 ***Question 1:*** *Do you agree with our approach for the calculation of the percentage of totex allowed into RAV?*

We are of the view that a link between RAV and fixed asset additions per statutory accounting rules would be a constructive approach when setting the totex capitalisation percentage.

As you state in paragraph 4.6, it is critical we test the totex capitalisation percentage against your assessment of the overall financeability of DNOs.

From our own analysis, we would expect the 'RAV additions percentage' to be set close to that which applied for DPCR5, subject to financeability.

4.2 ***Question 2:*** *Do you agree with our revised approach to Totex and with the costs that are included and excluded?*

We agree with the revised approach. The proposed approach should reduce the potential distortions that may arise from boundary issues.

In relation to pension scheme administration costs and pension protection fund levies, our preference is to retain the current DPCR5 method. That is, any variations to allowances are dealt with as part of the totex incentive mechanism.

4.3 ***Question 3:*** *We invite views on whether the definition of related parties should exclude captive insurance companies and whether our proposed approach is proportionate.*

We agree with the proposal to exclude captive insurance companies from the related parties definition.

The captive charges its premiums based on its long-run average cost of claims, which will typically be longer than a price control period. The results of a captive are inherently unstable and this is mitigated by basing premiums on long-term average claims values. The rationale is to prevent the large annual variations in premium that can arise due to the cyclical nature of insurance. Inclusion of the captive insurers related party margin would also distort DNO reporting depending on the timing of insurable events.

5. CHAPTER FIVE – TAXATION

5.1 ***Question 1:*** *Do you agree with modelling tax under the ASB proposed accounting frameworks for financial reporting in the UK with any changes to be subject to the tax trigger?*

Yes - we have adopted EU-IFRS in our statutory accounts. In respect of capital contributions received from customers the treatment under EU-IFRS is open to interpretation. Our treatment of taking capital contributions to deferred income in the Balance Sheet (as opposed to Turnover in the P&L) is consistent with the treatment applied by many other network companies and we would expect our tax allowances to be modelled on this basis. If the accounting treatment were to change, we would not expect the tax treatment to change as there is specific legislation that requires capital contributions to be set off against expenditure qualifying for capital allowances. However, if the tax treatment was to change, then the tax trigger would apply.

5.2 ***Question 2:*** *We invite views on the calibration of the dead-band.*

We agree the materiality of the proposed dead band calibration level is at an appropriate values to adjust for changes to taxation. However, once the dead band threshold is breached we believe that the whole of the tax trigger effect should be adjusted, not just the amount in excess of the dead band limit.

5.3 ***Question 3:*** *Do you agree that clawback of the tax benefit of excess gearing in DPCR5 should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?*

Yes, we agree that the clawback should be spread over eight years.

5.4 ***Question 4:*** *Do you agree that the revenue adjustment for tax clawback should be applied annually as part of the annual iteration process?*

Yes, we agree with this proposal.

5.5 ***Question 5:*** *Do you agree with our treatment of expenditure for tax modelling including the cash flows of corporation tax payments?*

Although the approach is not consistent with the statutory approach of spreading CT payments over two years, we accept that the tax impact on the interest charge variance arising from the proposed treatment is likely to be immaterial; and as a result, the impact on base revenue calculations will also be immaterial. Therefore on practical grounds we agree with the proposed treatment.

5.6 ***Question 6:*** *Do you agree with modelling of expenditure subject to capital allowance and capital allowance pool balances?*

Yes, we agree with this proposal.

5.7 ***Question 7:*** *Do you agree with our proposal for funding business rates*

Yes, although we note that this places more risk on the DNO business.

6. CHAPTER SIX – PENSIONS

6.1 ***Question 1:*** *Do you agree that the fast money true-up adjustments for DPCR5 should be spread over the eight years of the RIIO-ED1 price control if they exceed £1m per DNO? If not, which alternative option do you prefer?*

Our preference would be for the true-up of fast money for DPCR5 to be applied in year one of RIIO-ED1 as this is money that has been over/under funded during DPCR5 and should be corrected as soon as possible. Our understanding is that this was the approach used for true-up of pension costs in DPCR4 (difference in opex was funded in year one of DPCR5). However, we recognise the concerns over volatility of charges for customers but believe a threshold of £1m (around 0.3% of average DNO revenues in real terms) is too low. We suggest a threshold of 1% of year 1 base revenues would be more appropriate and would not be a significant factor in charges compared with the last year of DPCR5 – the other elements of base revenue will have a much more significant impact. So our suggested approach is “if the true-up exceeds 1% of base revenues in year one of

RIIO-ED1 then the true up could be spread over the 8 year period of the price control. Otherwise, the true-up should be paid in year one.

6.2 ***Question 2:*** *Do you agree with our proposals for the basis for the first and subsequent reset adjustments?*

Yes, we agree with these proposals.

6.3 ***Question 3:*** *We invite views from interested parties on how we conducted the latest pension reasonableness review, with a view to understanding what elements of the review were conducted well, what could be improved and what should be done differently in future reviews.*

To the extent that most of the information used by GAD for their review will have come from the standard annual reporting packs, this appears to have worked reasonably well as the number of additional queries was not significant. Ofgem should note that where a roll-forward valuation has been provided, additional calculations may be required where the numbers are not calculated as a matter of course (providing information in these scenarios can take longer). Further queries following the publication of the GAD report should only be necessary to the extent that the scheme has been identified as an outlier and this should be communicated prior to any possible adjustments to allowances.

6.4 ***Question 4:*** *We invite views on which of the options for pension scheme administration costs and Pension Protection Fund levies we should adopt; and, if our preferred approach were adopted, the methodology itself, and the level of the de minimis thresholds.*

Our preference is to retain the current DPCR5 method. That is, any variations to allowances are dealt with as part of the totex incentive mechanism.

6.5 ***Question 5:*** *Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?*

It should be noted that for closed schemes, it is expected that as the scheme matures further that the investment strategy will change to reflect the change in nature of the liabilities and cashflow requirements. We would therefore not expect to justify a de-risking strategy which made gradual changes to the investment allocation to reflect changes in scheme maturity. However, to the extent that a GAD review highlights an unusually aggressive de-risking strategy compared to our peers, then we would agree to the provision of further information.

6.6 ***Question 6:*** *Do you agree that the costs of contingent assets be funded if clearly demonstrated to be in consumers' interests?*

Our view is that the use of a contingent asset may be a suitable way to mitigate increasing costs in certain situations. Provision of the contingent asset would provide additional security to members at the expense of the parent group/shareholders. We would therefore agree that costs of contingent assets be funded if the benefits to consumers can be demonstrated.

6.7 ***Question 7:*** *We invite views on whether the revised guidance to our pension principles and the methodology is comprehensive and adequate for DNOs and stakeholders to understand how the principles will be applied in RIIO controls and for network companies to prepare their business plan.*

We note in 6.13 that you propose that a roll-forward valuation at 31 December 2012 (i.e. a roll forward to 31st December 2012 of the valuations at 31st March 2009 or 2010) be used for the purposes of our business plans. DNOs are required to provide up to date actuarial calculations (including the most recent formal actuarial valuation of the relevant schemes) to support their business plan estimates. We appreciate that use of the rolled forward 2009 valuation has been suggested because these valuations have been subjected to a reasonableness review – we hope you would gain comfort from the fact that the two SP schemes were not outliers in either of the two reasonableness reviews carried out so far. By the time we submit our business plan in July 2013, the 2009 valuations will have been superseded by the 31st March 2012 formal actuarial valuations; and importantly, the 2012 valuation will reflect an updated view of underlying variable assumptions e.g longevity.

Equally importantly, we acknowledge that ongoing and incremental deficit pension costs will be funded as part of totex from RIIO-ED1 and will be subject to adjustment via the totex incentive mechanism as part of the annual iteration process. Therefore, to ensure that customers are not over/undercharged, it is important that the pension cost element of totex reflects the most up to date actuarial view, not an outdated 2009 roll-forward. Therefore, our view is that our business plan should reflect the most up to date position i.e. the results of the 31st March 2012 valuation rolled forward to 31st December 2012.

With regard to 6.14 we note that we are required to provide a forecast of the incremental deficit. As noted in 6.15, the pension deficit methodology document (PDAM) must be used to allocate deficit payments to incremental service. Based on the current PDAM, the first asset-liability reconciliation will be due in 2014. Given that the PDAM has still to be finalised, we would not expect to be able to implement and use PDAM in full before the business plan is submitted in July next year. Therefore, if a forecast of incremental deficits is required for the business plan submission then we would not expect to provide the full reconciliations etc. that may be required by the final PDAM. These will be provided in 2014 when the first full submission is due. We would appreciate further guidance and clarification on how we are to calculate eight year forecasts of the incremental deficit bearing in mind that this will change during the eight years as a result of the triennial resets; and that these costs are subject to the totex incentive mechanism and therefore DNOs could be significantly over/under funded.

Given that the PDAM has yet to be finalised, the principles (e.g. number 2) should be reviewed once the PDAM is finalised so that guidance and terms are consistent.

We recognise the aim to fund ongoing and incremental deficit pension costs via totex (and the totex incentive mechanism) but changes due to unexpected movements in market conditions could lead to relatively large differences compared to initial forecasts and so customers could easily be significantly over/under charged over the course of RIIO-ED1 and beyond. Therefore, we propose it would be more appropriate to fund these costs via a specific ex ante allowance (i.e. not part of totex) with full true up as part of the three yearly reset process.

7. CHAPTER SEVEN – ANNUAL ITERATION PROCESS FOR BASE REVENUE

7.1 ***Question 1:*** *We invite views from interested parties on the proposed annual iteration process.*

In principle, the annual iteration process appears to be logical, although we would like to see a live example.

We have several specific comments:

- In paragraph 7.15 the last bullet point – we believe this should also include updates to opening tax pools as envisaged in paragraph 5.14 of the taxation section.
- In addition, in paragraph 7.14 we suggest that another adjustment should be an annual update to actual and forecast RPIs for regulatory years to ensure that the nominal tax calculations are correct and are consistent with the statutory tax calculations which the tax modelling aims to repeat
- In paragraph 7.17 we are unclear under “Revenue allowance amounts” why the tax cost allowances are off-line – we thought the model would calculate this.